

Stock Yards Bancorp, Inc.
Form 10-Q
November 05, 2014
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended September 30, 2014

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____.

Commission file number 1-13661

STOCK YARDS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Kentucky
(State or other jurisdiction of

61-1137529
(I.R.S. Employer

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incorporation or organization)

Identification No.)

1040 East Main Street, Louisville, Kentucky 40206

(Address of principal executive offices including zip code)

(502) 582-2571

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a 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

The number of shares of the registrant's Common Stock, no par value, outstanding as of October 23, 2014, was 14,710,796.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Consolidated Balance Sheets

September 30, 2014 and December 31, 2013

(In thousands, except share data)

| | September 30, 2014 (Unaudited) | December 31, 2013 |
|---|--------------------------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 38,302 | \$ 34,519 |
| Federal funds sold | 31,265 | 36,251 |
| Cash and cash equivalents | 69,567 | 70,770 |
| Mortgage loans held for sale | 4,069 | 1,757 |
| Securities available-for-sale (amortized cost of \$448,254 in 2014 and \$493,066 in 2013) | 449,572 | 490,031 |
| Federal Home Loan Bank stock and other securities | 6,347 | 7,347 |
| Loans | 1,785,320 | 1,721,350 |
| Less allowance for loan losses | 27,124 | 28,522 |
| Net loans | 1,758,196 | 1,692,828 |
| Premises and equipment, net | 38,821 | 39,813 |
| Bank owned life insurance | 29,879 | 29,180 |
| Accrued interest receivable | 5,629 | 5,712 |
| Other assets | 45,791 | 51,824 |
| Total assets | \$ 2,407,871 | \$ 2,389,262 |
| Liabilities and Stockholders Equity | | |
| Deposits: | | |
| Non-interest bearing | \$ 491,677 | \$ 423,350 |
| Interest bearing | 1,516,144 | 1,557,587 |
| Total deposits | 2,007,821 | 1,980,937 |
| Securities sold under agreements to repurchase | 66,955 | 62,615 |
| Federal funds purchased | 16,296 | 55,295 |
| Accrued interest payable | 128 | 128 |
| Other liabilities | 28,306 | 26,514 |
| Federal Home Loan Bank advances | 36,919 | 34,329 |
| Total liabilities | 2,156,425 | 2,159,818 |
| Stockholders equity: | | |
| Preferred stock, no par value. Authorized 1,000,000 shares; no shares issued or outstanding | | |
| Common stock, no par value. Authorized 20,000,000 shares; issued and outstanding 14,703,802 and 14,608,556 shares in 2014 and 2013, respectively | 9,898 | 9,581 |
| Additional paid-in capital | 36,711 | 33,255 |
| Retained earnings | 204,215 | 188,825 |
| Accumulated other comprehensive income (loss) | 622 | (2,217) |
| Total stockholders equity | 251,446 | 229,444 |
| Total liabilities and stockholders equity | \$ 2,407,871 | \$ 2,389,262 |

See accompanying notes to unaudited consolidated financial statements.

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Consolidated Statements of Income (Unaudited)

For the three and nine months ended September 30, 2014 and 2013

(In thousands, except per share data)

| | For three months ended September 30, | | For nine months ended September 30, | |
|---|---|-----------|--|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income: | | | | |
| Loans | \$ 20,429 | \$ 20,233 | \$ 59,575 | \$ 58,762 |
| Federal funds sold | 73 | 63 | 215 | 215 |
| Mortgage loans held for sale | 54 | 57 | 128 | 177 |
| Securities taxable | 1,845 | 1,626 | 5,506 | 4,388 |
| Securities tax-exempt | 291 | 288 | 885 | 853 |
| Total interest income | 22,692 | 22,267 | 66,309 | 64,395 |
| Interest expense: | | | | |
| Deposits | 1,065 | 1,209 | 3,319 | 3,833 |
| Fed funds purchased | 8 | 9 | 23 | 26 |
| Securities sold under agreements to repurchase | 37 | 38 | 100 | 106 |
| Federal Home Loan Bank advances | 219 | 221 | 621 | 657 |
| Subordinated debentures | | 773 | | 2,318 |
| Total interest expense | 1,329 | 2,250 | 4,063 | 6,940 |
| Net interest income | 21,363 | 20,017 | 62,246 | 57,455 |
| (Credit) provision for loan losses | (2,100) | 1,325 | (400) | 4,975 |
| Net interest income after provision for loan losses | 23,463 | 18,692 | 62,646 | 52,480 |
| Non-interest income: | | | | |
| Investment management and trust services | 4,502 | 4,017 | 13,825 | 12,032 |
| Service charges on deposit accounts | 2,294 | 2,348 | 6,620 | 6,592 |
| Bankcard transaction revenue | 1,182 | 1,087 | 3,466 | 3,068 |
| Mortgage banking revenue | 641 | 995 | 1,951 | 3,370 |
| Loss on sales of securities available for sale | | | (9) | (5) |
| Brokerage commissions and fees | 539 | 456 | 1,506 | 1,693 |
| Bank owned life insurance income | 229 | 260 | 699 | 771 |
| Gain on acquisition | | | | 449 |
| Other | 463 | 489 | 1,324 | 1,221 |
| Total non-interest income | 9,850 | 9,652 | 29,382 | 29,191 |
| Non-interest expenses: | | | | |
| Salaries and employee benefits | 11,855 | 10,508 | 33,697 | 30,186 |
| Net occupancy expense | 1,422 | 1,522 | 4,431 | 4,188 |
| Data processing expense | 1,591 | 1,520 | 4,869 | 4,695 |
| Furniture and equipment expense | 269 | 269 | 796 | 846 |
| FDIC insurance expense | 340 | 348 | 1,032 | 1,055 |
| Loss (gain) on other real estate owned | 7 | 475 | (342) | 366 |
| Acquisition costs | | | | 1,548 |
| Other | 3,225 | 2,929 | 9,471 | 9,088 |
| Total non-interest expenses | 18,709 | 17,571 | 53,954 | 51,972 |
| Income before income taxes | 14,604 | 10,773 | 38,074 | 29,699 |
| Income tax expense | 4,715 | 3,091 | 11,974 | 8,842 |
| Net income | \$ 9,889 | \$ 7,682 | \$ 26,100 | \$ 20,857 |

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Net income per share:

| | | | | | | | | |
|------------------------|----|--------|----|--------|----|--------|----|--------|
| Basic | \$ | 0.68 | \$ | 0.53 | \$ | 1.79 | \$ | 1.47 |
| Diluted | \$ | 0.67 | \$ | 0.53 | \$ | 1.77 | \$ | 1.47 |
| Average common shares: | | | | | | | | |
| Basic | | 14,574 | | 14,408 | | 14,542 | | 14,144 |
| Diluted | | 14,748 | | 14,556 | | 14,732 | | 14,228 |

See accompanying notes to unaudited consolidated financial statements.

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Consolidated Statements of Comprehensive Income (Unaudited)

For the three and nine months ended September 30, 2014 and 2013

(In thousands)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 9,889 | \$ 7,682 | \$ 26,100 | \$ 20,857 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized (losses) gains on securities available-for-sale: | | | | |
| Unrealized (losses) gains arising during the period (net of tax of (\$234), \$45, \$1,521 and (\$2,974), respectively) | (435) | 83 | 2,823 | (5,523) |
| Reclassification adjustment for securities losses realized in income (net of tax of \$0, \$0, \$3, and \$2, respectively) | | | 6 | 3 |
| Unrealized gains on hedging instruments: | | | | |
| Unrealized gains arising during the period (net of tax of \$12, \$0, \$6 and \$0, respectively) | 23 | | 10 | |
| Other comprehensive (loss) income | (412) | 83 | 2,839 | (5,520) |
| Comprehensive income | \$ 9,477 | \$ 7,765 | \$ 28,939 | \$ 15,337 |

See accompanying notes to unaudited consolidated financial statements.

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Consolidated Statement of Changes in Stockholders' Equity (Unaudited)

For the nine months ended September 30, 2014 and 2013

(In thousands, except per share data)

| | Common stock | | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income (loss) | Total |
|---|---------------------|----------|-------------------------------|----------------------|--|------------|
| | Number of shares | Amount | | | | |
| Balance December 31, 2012 | 13,915 | \$ 7,273 | \$ 17,731 | \$ 174,650 | \$ 5,421 | \$ 205,075 |
| Net income | | | | 20,857 | | 20,857 |
| Other comprehensive income, net of tax | | | | | (5,520) | (5,520) |
| Stock compensation expense | | | 1,473 | | | 1,473 |
| Stock issued for exercise of stock options and dividend reinvestment plan | 93 | 309 | 1,784 | (124) | | 1,969 |
| Stock issued for non- vested restricted stock | 55 | 184 | 1,083 | (1,267) | | |
| Stock issued for acquisition | 531 | 1,769 | 10,429 | | | 12,198 |
| Cash dividends, \$0.60 per share | | | | (8,602) | | (8,602) |
| Shares repurchased or cancelled | (40) | (137) | (882) | 104 | | (915) |
| Balance September 30, 2013 | 14,554 | \$ 9,398 | \$ 31,618 | \$ 185,618 | \$ (99) | \$ 226,535 |
| Balance December 31, 2013 | 14,609 | \$ 9,581 | \$ 33,255 | \$ 188,825 | \$ (2,217) | \$ 229,444 |
| Net income | | | | 26,100 | | 26,100 |
| Other comprehensive loss, net of tax | | | | | 2,839 | 2,839 |
| Stock compensation expense | | | 1,459 | | | 1,459 |
| Stock issued for exercise of stock options and dividend reinvestment plan | 81 | 269 | 1,870 | (95) | | 2,044 |
| Stock issued for non- vested restricted stock | 48 | 160 | 994 | (1,154) | | |

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| | | | | | | | | | |
|----------------------------------|--------|----|-------|----|---------|----|---------|----|----------------|
| Cash dividends, \$0.65 per share | | | | | (9,534) | | | | (9,534) |
| Shares repurchased or cancelled | (34) | | (112) | | (867) | | 73 | | (906) |
| Balance September 30, 2014 | 14,704 | \$ | 9,898 | \$ | 36,711 | \$ | 204,215 | \$ | 622 \$ 251,446 |

See accompanying notes to unaudited consolidated financial statements.

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Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended September 30, 2014 and 2013

(In thousands)

| | 2014 | 2013 |
|---|-----------|-----------|
| Operating activities: | | |
| Net income | \$ 26,100 | \$ 20,857 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| (Credit) provision for loan losses | (400) | 4,975 |
| Depreciation, amortization and accretion, net | 4,769 | 4,940 |
| Deferred income tax benefit | (306) | (1,229) |
| Loss on sale of securities available-for-sale | 9 | 5 |
| Gain on sales of mortgage loans held for sale | (1,139) | (2,333) |
| Origination of mortgage loans held for sale | (64,332) | (129,742) |
| Proceeds from sale of mortgage loans held for sale | 63,159 | 142,293 |
| Bank owned life insurance income | (699) | (771) |
| (Gain) loss on the disposal of premises and equipment | (30) | 22 |
| (Gain) loss on the sale of other real estate | (342) | 366 |
| Gain on acquisition | | (449) |
| Stock compensation expense | 1,459 | 1,473 |
| Excess tax benefits from share-based compensation arrangements | (257) | (109) |
| Decrease in accrued interest receivable and other assets | 1,107 | 3,677 |
| Increase in accrued interest payable and other liabilities | 2,049 | 4,498 |
| Net cash provided by operating activities | 31,147 | 48,473 |
| Investing activities: | | |
| Purchases of securities available-for-sale | (220,296) | (282,262) |
| Proceeds from sale of securities available-for-sale | 7,732 | 701 |
| Proceeds from maturities of securities available-for-sale | 256,948 | 337,762 |
| Net increase in loans | (66,748) | (95,157) |
| Purchases of premises and equipment | (1,517) | (1,807) |
| Proceeds from disposal of premises and equipment | 344 | |
| Acquisition, net of cash acquired | | 8,963 |
| Proceeds from sale of foreclosed assets | 4,768 | 3,102 |
| Net cash used in investing activities | (18,769) | (28,698) |
| Financing activities: | | |
| Net increase (decrease) in deposits | 26,884 | (19,677) |
| Net (decrease) increase in securities sold under agreements to repurchase and federal funds purchased | (34,659) | 9,727 |
| Proceeds from Federal Home Loan Bank advances | 32,740 | 575 |
| Repayments of Federal Home Loan Bank advances | (30,150) | (35) |
| Issuance of common stock for options and dividend reinvestment plan | 1,445 | 1,260 |
| Excess tax benefits from share-based compensation arrangements | 257 | 109 |
| Common stock repurchases | (564) | (315) |
| Cash dividends paid | (9,534) | (8,602) |
| Net cash used in financing activities | (13,581) | (16,958) |
| Net (decrease) increase in cash and cash equivalents | (1,203) | 2,817 |
| Cash and cash equivalents at beginning of period | 70,770 | 67,703 |
| Cash and cash equivalents at end of period | \$ 69,567 | \$ 70,520 |
| Supplemental cash flow information: | | |

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| | | | | |
|---|----|-------|----|-------|
| Income tax payments | \$ | 8,764 | \$ | 6,230 |
| Cash paid for interest | | 4,063 | | 6,984 |
| Supplemental non-cash activity: | | | | |
| Transfers from loans to other real estate owned | \$ | 1,780 | \$ | 2,382 |

See accompanying notes to unaudited consolidated financial statements.

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STOCK YARDS BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all information and footnotes required by U.S. generally accepted accounting principles (US GAAP) for complete financial statements. The consolidated unaudited financial statements of Stock Yards Bancorp, Inc. (Bancorp) and its subsidiary reflect all adjustments (consisting only of adjustments of a normal recurring nature) which are, in the opinion of management, necessary for a fair presentation of financial condition and results of operations for the interim periods.

The unaudited consolidated financial statements include the accounts of Stock Yards Bancorp, Inc. and its wholly-owned subsidiary, Stock Yards Bank & Trust Company (Bank). Significant intercompany transactions and accounts have been eliminated in consolidation. In preparing the unaudited consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of related revenues and expenses during the reporting period. Actual results could differ from the aforementioned estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, valuation of other real estate owned, valuation of securities, income tax assets, and estimated liabilities and expense.

A description of other significant accounting policies is presented in the notes to the Consolidated Financial Statements for the year ended December 31, 2013 included in Stock Yards Bancorp, Inc.'s Annual Report on Form 10-K. Certain reclassifications have been made in the prior year financial statements to conform to current year classifications. These reclassifications had no effect on Bancorp's total assets, liabilities, equity or net income.

Interim results for the three and nine month periods ended September 30, 2014 are not necessarily indicative of the results for the entire year.

Critical Accounting Policies

Management has identified the accounting policy related to the allowance and provision for loan losses as critical to the understanding of Bancorp's results of operations and discussed this conclusion with Bancorp's Audit Committee. Since the application of this policy requires significant management assumptions and estimates, it could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Assumptions include many factors such as changes in borrowers' financial condition which can change quickly or historical loss ratios related to certain loan portfolios which may or may not be indicative of future losses. To the extent that management's assumptions prove incorrect, the results from operations could be materially affected by a higher or lower provision for loan losses. The accounting policy related to the allowance for loan losses is applicable to the commercial banking segment of Bancorp.

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The allowance for loan losses is management's estimate of probable losses in the loan portfolio. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Prior to the third quarter of 2013, management measured the appropriateness of the allowance for loan losses in its entirety using (a) quantitative (historical loss rates) and qualitative factors (management adjustment factors); (b) specific allocations on impaired loans, and (c) an unallocated amount. The unallocated amount was evaluated on the loan portfolio in its entirety and was based on additional factors,

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such as national and local economic trends and conditions, changes in volume and severity of past due loans, volume of non-accrual loans, volume and severity of adversely classified or graded loans and other factors and trends that affect specific loans and categories of loans, such as a heightened risk in the commercial and industrial loan portfolios. Bancorp considered the sum of all allowance amounts derived as described above, including a reasonable unallocated allowance, as an indicator of the appropriate level of allowance for loan losses.

During the third quarter of 2013, Bancorp refined its allowance calculation to allocate the portion of allowance that was previously deemed to be unallocated based on management's determination of appropriate qualitative adjustments. This calculation includes specific allowance allocations for qualitative factors including, among other factors, (i) national and local economic conditions, (ii) the quality and experience of lending staff and management, (iii) changes in lending policies and procedures, (iv) changes in volume and severity of past due loans, classified loans and non-performing loans, (v) potential impact of any concentrations of credit, (vi) changes in the nature and terms of loans such as growth rates and utilization rates, (vii) changes in the value of underlying collateral for collateral-dependent loans, considering Bancorp's disposition bias, and (viii) the effect of other external factors such as the legal and regulatory environment. Bancorp may also consider other qualitative factors for additional allowance allocations, including changes in Bancorp's loan review process. Changes in the criteria used in this evaluation or the availability of new information could cause the allowance to be increased or decreased in future periods. In addition, bank regulatory agencies, as part of their examination process, may require adjustments to the allowance for loan losses based on their judgments and estimates.

Management has also identified the accounting policy related to accounting for income taxes as critical to the understanding of Bancorp's results of operations and discussed this conclusion with the Audit Committee of the Board of Directors. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in Bancorp's financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences, including the effects of periodic IRS and state agency examinations, could materially impact Bancorp's financial position and its results from operations.

(2) Acquisition

On April 30, 2013, Bancorp completed the acquisition of 100% of the outstanding shares of THE BANCorp, Inc. (Oldham), parent company of THE BANK Oldham County, Inc. As a result of the transaction, THE BANK Oldham County merged into Stock Yards Bank & Trust Company. Since the acquisition date, results of operations acquired in the Oldham transaction have been included in Bancorp's financial results.

The Oldham transaction has been accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration transferred were recorded at estimated fair value on the acquisition date. Assets acquired totaled approximately \$146.0 million, including \$39.8 million of loans. Liabilities assumed totaled \$125.1 million, including \$120.4 million of deposits. Fair value adjustments resulted in net assets acquired in excess of the consideration paid. Accordingly, a non-taxable gain of \$449 thousand was recognized.

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The following table summarizes the consideration paid and the amounts of assets acquired and liabilities assumed, adjusted for fair value at the acquisition date.

| | | |
|--|-----------|---------------|
| Purchase price: | | |
| Cash | \$ | 8,297 |
| Total purchase price | | 20,495 |
| Identifiable assets: | | |
| Investment securities | | 81,827 |
| Premises and equipment | | 4,008 |
| Other assets | | 605 |
| Deposits | | 120,435 |
| Other liabilities | | 1,857 |
| Net gain resulting from acquisition | \$ | 449 |
| Acquisition costs (included in other non-interest expenses in Bancorp's income statement for the nine months ended September 30, 2013) | \$ | 1,548 |

Fair value of the common shares issued as part of the consideration paid was determined based on the closing market price of Bancorp's common shares on the acquisition date.

Bancorp recorded a core deposit intangible of \$2.5 million which is being amortized using methods that anticipate the life of the underlying deposits to which the intangible is attributable. At September 30, 2014, the unamortized core deposit intangible was \$1.9 million. See Note 7 for details on the core deposit intangible.

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In many cases, determining the fair value of acquired assets and assumed liabilities required Bancorp to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of these determinations related to the valuation of acquired loans. Below is an analysis of the fair value of acquired loans as of September 30, 2014.

| (in thousands) | | Acquired impaired loans | | Acquired non- impaired loans | | Total acquired loans |
|---|----|-------------------------------|----|------------------------------------|----|----------------------------|
| Contractually required principal and interest at acquisition | \$ | 3,285 | \$ | 37,763 | \$ | 41,048 |
| Contractual cash flows not expected to be collected | | (372) | | (723) | | (1,095) |
| Expected cash flows at acquisition | | 2,913 | | 37,040 | | 39,953 |
| Interest component of expected cash flows | | (174) | | (24) | | (198) |
| Basis in acquired loans at acquisition - estimated fair value | \$ | 2,739 | \$ | 37,016 | \$ | 39,755 |

Fair values of checking, savings and money market deposit accounts acquired from Oldham were assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued at the present value of the certificates expected contractual payments discounted at market rates as of the acquisition date for similar certificates.

In connection with the Oldham acquisition, Bancorp incurred expenses related to executing the transaction and integrating and conforming acquired operations with and into Bancorp. Those expenses consisted largely of conversion of systems and/or integration of operations.

(3) Securities

The amortized cost, unrealized gains and losses, and fair value of securities available-for-sale follow:

| (in thousands) September 30, 2014 | | Amortized cost | | Unrealized Gains | | Unrealized Losses | | Fair value |
|--|----|-------------------|----|---------------------|----|----------------------|----|------------|
| Government sponsored enterprise obligations | \$ | 204,992 | \$ | 1,535 | \$ | 1,122 | \$ | 205,405 |
| Mortgage-backed securities - government agencies | | 180,890 | | 1,379 | | 2,419 | | 179,850 |
| Obligations of states and political subdivisions | | 61,616 | | 1,808 | | 65 | | 63,359 |
| Corporate equity securities | | 756 | | 202 | | | | 958 |
| Total securities available-for-sale | \$ | 448,254 | \$ | 4,924 | \$ | 3,606 | \$ | 449,572 |

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| (in thousands) December 31, 2013 | Amortized cost | Gains | Unrealized Losses | Fair value |
|---|-------------------|----------|----------------------|------------|
| U.S. Treasury and other U.S. government obligations | \$ 110,000 | \$ | \$ | \$ 110,000 |
| Government sponsored enterprise obligations | 138,094 | 1,623 | 1,872 | 137,845 |
| Mortgage-backed securities - government agencies | 176,524 | 1,391 | 5,222 | 172,693 |
| Obligations of states and political subdivisions | 68,448 | 1,473 | 428 | 69,493 |
| Total securities available-for-sale | \$ 493,066 | \$ 4,487 | \$ 7,522 | \$ 490,031 |

There were no securities held-to-maturity as of September 30, 2014 or December 31, 2013.

Corporate equity securities, included in the available-for-sale portfolio at September 30, 2014, consist of common stock in a public-traded small business investment company.

In the second quarter of 2014, Bancorp sold securities with total fair market value of \$7.7 million, generating a net loss of \$9 thousand. These securities consisted of mortgage-backed securities with small remaining balances, obligations of state and political subdivisions, and agency securities. In the second quarter of 2013, Bancorp sold obligations of state and political subdivisions with total fair market value of \$696 thousand, generating a loss of \$5 thousand. These sales were made in the ordinary course of portfolio management. Management has the intent and ability to hold all remaining investment securities available-for-sale for the foreseeable future.

A summary of the available-for-sale investment securities by maturity groupings as of September 30, 2014 is shown below.

| (in thousands) Securities available-for-sale | Amortized cost | Fair value |
|---|----------------|------------|
| Due within 1 year | \$ 52,895 | \$ 53,174 |
| Due after 1 but within 5 years | 131,963 | 133,441 |
| Due after 5 but within 10 years | 23,117 | 23,695 |
| Due after 10 years | 58,633 | 58,454 |
| Mortgage-backed securities | 180,890 | 179,850 |
| Corporate equity securities | 756 | 958 |
| Total securities available-for-sale | \$ 448,254 | \$ 449,572 |

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Actual maturities may differ from contractual maturities because some issuers have the right to call or prepay obligations. In addition to equity securities, the investment portfolio includes agency mortgage-backed securities, which are guaranteed by agencies such as the FHLMC, FNMA, and GNMA. These securities differ from traditional debt securities primarily in that they may have uncertain principal payment dates and are priced based on estimated prepayment rates on the underlying collateral.

Securities with a carrying value of approximately \$209.2 million at September 30, 2014 and \$243.5 million at December 31, 2013 were pledged to secure accounts of commercial depositors in cash management accounts, public deposits, and cash balances for certain investment management and trust accounts.

Securities with unrealized losses at September 30, 2014 and December 31, 2013, not recognized in the statements of income are as follows:

| (in thousands) | Less than 12 months | | 12 months or more | | Total | |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
| September 30, 2014 | | | | | | |
| Government sponsored enterprise obligations | \$ 45,050 | \$ 163 | \$ 33,565 | \$ 959 | \$ 78,615 | \$ 1,122 |
| Mortgage-backed securities - government agencies | 45,123 | 445 | 45,133 | 1,974 | 90,256 | 2,419 |
| Obligations of states and political subdivisions | 1,924 | 12 | 6,341 | 53 | 8,265 | 65 |
| Total temporarily impaired securities | \$ 92,097 | \$ 620 | \$ 85,039 | \$ 2,986 | \$ 177,136 | \$ 3,606 |
| December 31, 2013 | | | | | | |
| Government sponsored enterprise obligations | \$ 76,755 | \$ 1,429 | \$ 4,353 | \$ 443 | \$ 81,108 | \$ 1,872 |
| Mortgage-backed securities - government agencies | 112,652 | 4,400 | 8,752 | 822 | 121,404 | 5,222 |
| Obligations of states and political subdivisions | 22,092 | 405 | 1,211 | 23 | 23,303 | 428 |
| Total temporarily impaired securities | \$ 211,499 | \$ 6,234 | \$ 14,316 | \$ 1,288 | \$ 225,815 | \$ 7,522 |

The applicable dates for determining when securities are in an unrealized loss position are September 30, 2014 and December 31, 2013. As such, it is possible that a security had a market value less than its amortized cost on other days during the past twelve months, but is not in the Investments with an unrealized loss of less than 12 months category above.

Unrealized losses on Bancorp's investment securities portfolio have not been recognized as expense because the securities are of high credit quality, and the decline in fair values is largely due to changes in the prevailing interest rate environment since the purchase date. Fair value is expected to recover as securities reach their maturity date and/or the interest rate environment returns to conditions similar to when these securities were purchased. These investments consist of 73 and 155 separate investment positions as of September 30, 2014 and December 31, 2013, respectively. Because management does not intend to sell the investments, and it is not likely that Bancorp will be required to sell the

investments

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before recovery of their amortized cost bases, which may be maturity, Bancorp does not consider these securities to be other-than-temporarily impaired at September 30, 2014.

FHLB stock and other securities are investments held by Bancorp which are not readily marketable and are carried at cost. This category includes holdings of Federal Home Loan Bank of Cincinnati (FHLB) stock which are required for access to FHLB borrowing, and are classified as restricted securities. As of December 31, 2013, FHLB Stock and other securities included a \$1 million Community Reinvestment Act (CRA) investment which matured in the second quarter of 2014.

(4) Loans

The composition of loans by primary loan portfolio segment follows:

| (in thousands) | September 30, 2014 | | December 31, 2013 | |
|--|--------------------|------------------|-------------------|------------------|
| Commercial and industrial | \$ | 550,487 | \$ | 510,739 |
| Construction and development, excluding undeveloped land | | 93,964 | | 99,719 |
| Undeveloped land | | 27,177 | | 29,871 |
| Real estate mortgage | | 1,085,537 | | 1,046,823 |
| Consumer | | 28,155 | | 34,198 |
| Total loans | \$ | 1,785,320 | \$ | 1,721,350 |

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The following table presents the balance in the recorded investment in loans and roll-forward of allowance for loan losses by portfolio segment and based on impairment evaluation method as of September 30, 2014 and December 31, 2013.

| (in thousands) September 30, 2014 | Type of loan | | | | | | Total |
|---|---------------------------|---|------------------|----------------------|-----------|--|--------------|
| | Commercial and industrial | Construction and development excluding undeveloped land | Undeveloped land | Real estate mortgage | Consumer | | |
| Loans | \$ 550,487 | \$ 93,964 | \$ 27,177 | \$ 1,085,537 | \$ 28,155 | | \$ 1,785,320 |
| Loans individually evaluated for impairment | \$ 8,778 | \$ 516 | \$ 6,722 | \$ 4,207 | \$ 78 | | \$ 20,301 |
| Loans collectively evaluated for impairment | \$ 541,626 | \$ 92,835 | \$ 20,455 | \$ 1,080,853 | \$ 28,065 | | \$ 1,763,834 |
| Loans acquired with deteriorated credit quality | \$ 83 | \$ 613 | \$ | \$ 477 | \$ 12 | | \$ 1,185 |

| | Commercial and industrial | Construction and development excluding undeveloped land | Undeveloped land | Real estate mortgage | Consumer | Unallocated | Total |
|---|---------------------------|---|------------------|----------------------|----------|-------------|-----------|
| Allowance for loan losses | | | | | | | |
| At December 31, 2013 | \$ 7,644 | \$ 2,555 | \$ 5,376 | \$ 12,604 | \$ 343 | \$ | \$ 28,522 |
| Provision (credit) | 1,897 | (1,011) | (4,294) | 2,963 | 45 | | (400) |
| Charge-offs | (582) | | (30) | (810) | (400) | | (1,822) |
| Recoveries | 211 | | 166 | 98 | 349 | | 824 |
| At September 30, 2014 | \$ 9,170 | \$ 1,544 | \$ 1,218 | \$ 14,855 | \$ 337 | \$ | \$ 27,124 |
| Allowance for loans individually evaluated for impairment | \$ 1,559 | \$ 90 | \$ | \$ 432 | \$ 78 | \$ | \$ 2,159 |
| Allowance for loans collectively evaluated for impairment | \$ 7,611 | \$ 1,454 | \$ 1,218 | \$ 14,423 | \$ 259 | \$ | \$ 24,965 |
| Balance: loans acquired with deteriorated credit quality | \$ | \$ | \$ | \$ | \$ | \$ | \$ |

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| (in thousands) December 31, 2013 | Type of loan | | | | | | Total |
|---|---------------------------|---|------------------|----------------------|-----------|--|--------------|
| | Commercial and industrial | Construction and development excluding undeveloped land | Undeveloped land | Real estate mortgage | Consumer | | |
| Loans | \$ 510,739 | \$ 99,719 | \$ 29,871 | \$ 1,046,823 | \$ 34,198 | | \$ 1,721,350 |
| Loans individually evaluated for impairment | \$ 7,579 | \$ 26 | \$ 7,340 | \$ 7,478 | \$ 84 | | \$ 22,507 |
| Loans collectively evaluated for impairment | \$ 502,535 | \$ 98,428 | \$ 22,531 | \$ 1,038,824 | \$ 34,095 | | \$ 1,696,413 |
| Loans acquired with deteriorated credit quality | \$ 625 | \$ 1,265 | \$ | \$ 521 | \$ 19 | | \$ 2,430 |

| | Commercial and industrial | Construction and development excluding undeveloped land | Undeveloped land | Real estate mortgage | Consumer | Unallocated | Total |
|---|---------------------------|---|------------------|----------------------|----------|-------------|-----------|
| Allowance for loan losses | | | | | | | |
| At December 31, 2012 | \$ 5,949 | \$ 1,638 | \$ 2,898 | \$ 14,288 | \$ 362 | \$ 6,746 | \$ 31,881 |
| Provision | 1,583 | 779 | 10,358 | 490 | 86 | (6,746) | 6,550 |
| Charge-offs | (457) | (25) | (7,961) | (2,758) | (763) | | (11,964) |
| Recoveries | 569 | 163 | 81 | 584 | 658 | | 2,055 |
| At December 31, 2013 | \$ 7,644 | \$ 2,555 | \$ 5,376 | \$ 12,604 | \$ 343 | \$ | \$ 28,522 |
| Allowance for loans individually evaluated for impairment | \$ 762 | \$ | \$ | \$ 606 | \$ 84 | \$ | \$ 1,452 |
| Allowance for loans collectively evaluated for impairment | \$ 6,882 | \$ 2,555 | \$ 5,376 | \$ 11,998 | \$ 259 | \$ | \$ 27,070 |
| Balance: loans acquired with deteriorated credit quality | \$ | \$ | \$ | \$ | \$ | \$ | \$ |

Management uses the following portfolio segments of loans when assessing and monitoring the risk and performance of the loan portfolio:

- Commercial and industrial

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- Construction and development, excluding undeveloped land
- Undeveloped land
- Real estate mortgage
- Consumer

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Bancorp has loans that were acquired in the Oldham acquisition, for which there was, at acquisition, evidence of deterioration of credit quality since origination and for which it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans is included in the balance sheet amounts of loans at September 30, 2014 and December 31, 2013. Changes in the interest component of the fair value adjustment for acquired impaired loans for the year ended December 31, 2013 and the nine months ended September 30, 2014 are shown in the following table:

| (in thousands) | | |
|---|----|------|
| Balance at December 31, 2012 | \$ | |
| Additions due to Oldham acquisition | | 174 |
| Accretion | | (37) |
| Reclassifications from (to) non-accretable difference | | |
| Disposals | | |
| Balance at December 31, 2013 | | 137 |
| Accretion | | (61) |
| Reclassifications from (to) non-accretable difference | | |
| Disposals | | |
| Balance at September 30, 2014 | \$ | 76 |

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The following table presents loans individually evaluated for impairment as of September 30, 2014 and December 31, 2013.

| (in thousands) September 30, 2014 | Recorded investment | Unpaid principal balance | Related allowance | Average recorded investment |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|
| Loans with no related allowance recorded | | | | |
| Commercial and industrial | \$ 617 | \$ 761 | \$ | \$ 1,021 |
| Construction and development, excluding undeveloped land | 26 | 151 | | 26 |
| Undeveloped land | 6,722 | 8,785 | | 7,010 |
| Real estate mortgage | 2,308 | 2,773 | | 3,048 |
| Consumer | | | | |
| Subtotal | 9,673 | 12,470 | | 11,105 |
| Loans with an allowance recorded | | | | |
| Commercial and industrial | \$ 8,161 | \$ 8,636 | \$ 1,559 | \$ 6,911 |
| Construction and development, excluding undeveloped land | 490 | 490 | 90 | 123 |
| Undeveloped land | | | | |
| Real estate mortgage | 1,899 | 1,899 | 432 | 2,264 |
| Consumer | 78 | 78 | 78 | 81 |
| Subtotal | 10,628 | 11,103 | 2,159 | 9,379 |
| Total | | | | |
| Commercial and industrial | \$ 8,778 | \$ 9,397 | \$ 1,559 | \$ 7,932 |
| Construction and development, excluding undeveloped land | 516 | 641 | 90 | 149 |
| Undeveloped land | 6,722 | 8,785 | | 7,010 |
| Real estate mortgage | 4,207 | 4,672 | 432 | 5,312 |
| Consumer | 78 | 78 | 78 | 81 |
| Total | \$ 20,301 | \$ 23,573 | \$ 2,159 | \$ 20,484 |

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| (in thousands) December 31, 2013 | Recorded investment | Unpaid principal balance | Related allowance | Average recorded investment |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|
| Loans with no related allowance recorded | | | | |
| Commercial and industrial | \$ 830 | \$ 974 | \$ | \$ 4,499 |
| Construction and development, excluding undeveloped land | 26 | 151 | | 54 |
| Undeveloped land | 7,340 | 9,932 | | 3,272 |
| Real estate mortgage | 3,731 | 5,069 | | 5,559 |
| Consumer | | | | 3 |
| Subtotal | 11,927 | 16,126 | | 13,387 |
| Loans with an allowance recorded | | | | |
| Commercial and industrial | \$ 6,749 | \$ 6,749 | \$ 762 | \$ 3,806 |
| Construction and development, excluding undeveloped land | | | | 259 |
| Undeveloped land | | | | 7,152 |
| Real estate mortgage | 3,747 | 4,065 | 606 | 3,705 |
| Consumer | 84 | 84 | 84 | 34 |
| Subtotal | 10,580 | 10,898 | 1,452 | 14,956 |
| Total | | | | |
| Commercial and industrial | \$ 7,579 | \$ 7,723 | \$ 762 | \$ 8,305 |
| Construction and development, excluding undeveloped land | 26 | 151 | | 313 |
| Undeveloped land | 7,340 | 9,932 | | 10,424 |
| Real estate mortgage | 7,478 | 9,134 | 606 | 9,264 |
| Consumer | 84 | 84 | 84 | 37 |
| Total | \$ 22,507 | \$ 27,024 | \$ 1,452 | \$ 28,343 |

Differences between recorded investment amounts and unpaid principal balance amounts less related allowance are due to partial charge-offs which have occurred over the life of loans and fair value adjustments recorded for loans acquired.

Impaired loans include non-accrual loans and loans accounted for as troubled debt restructurings (TDR), which continue to accrue interest. Non-performing loans include the balance of impaired loans plus any loans over 90 days past due and still accruing interest. Loans past due more than 90 days or more and still accruing interest amounted to \$207 thousand at September 30, 2014 and \$437 thousand at December 31, 2013.

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The following table presents the recorded investment in non-accrual loans as of September 30, 2014 and December 31, 2013.

| (in thousands) | September 30, 2014 | December 31, 2013 |
|--|--------------------|-------------------|
| Commercial and industrial | \$ 2,825 | \$ 846 |
| Construction and development, excluding undeveloped land | 516 | 26 |
| Undeveloped land | 6,722 | 7,340 |
| Real estate mortgage | 3,782 | 7,046 |
| Consumer | | |
| Total | \$ 13,845 | \$ 15,258 |

At September 30, 2014 and December 31, 2013, Bancorp had accruing loans classified as TDR of \$6.5 million and \$7.2 million, respectively.

Bancorp did not modify and classify any loans as TDR during the nine months ended September 30, 2014. The following table presents the recorded investment in loans modified and classified as TDR during the nine months ended September 30, 2013.

| (dollars in thousands) September 30, 2013 | Number of contracts | Recorded investment |
|--|------------------------|------------------------|
| Commercial & industrial | 1 | \$ 796 |
| Consumer | 1 | 86 |
| Total | 2 | \$ 882 |

Bancorp did not have any loans accounted for as TDR that were restructured and experienced a payment default within the previous 12 months as of September 30, 2014. The following table presents the recorded investment in loans accounted for as TDR that were restructured and experienced a payment default within the previous 12 months as of September 30, 2013.

| (dollars in thousands) September 30, 2013 | Number of contracts | Recorded investment |
|--|------------------------|------------------------|
| Real estate mortgage | 2 | \$ 2,426 |
| Total | 2 | \$ 2,426 |

Loans accounted for as TDR include modifications from original terms such as those due to bankruptcy proceedings, modifications of amortization periods or temporary suspension of principal payments due to customer financial difficulties. Loans accounted for as TDR, which have not defaulted, are individually evaluated for impairment and, at September 30, 2014, had a total allowance allocation of \$706 thousand, compared to \$942 thousand at December 31, 2013.

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At September 30, 2014, Bancorp had no outstanding commitments to lend additional funds for loans classified as TDR. At December 31, 2013, Bancorp had outstanding commitments to lend additional funds totaling \$262 thousand for loans classified as TDR.

The following table presents the aging of loans as of September 30, 2014 and December 31, 2013.

| (in thousands) | 30-59 days past due | 60-89 days past due | Greater than 90 days past due (includes non-accrual) | Total past due | Current | Total loans | Recorded investment > 90 days and accruing |
|--|------------------------|------------------------|---|-------------------|---------------------|---------------------|--|
| September 30, 2014 | | | | | | | |
| Commercial and industrial | \$ 85 | \$ 276 | \$ 2,827 | \$ 3,188 | \$ 547,299 | \$ 550,487 | \$ 2 |
| Construction and development, excluding undeveloped land | | 242 | 516 | 758 | 93,206 | 93,964 | |
| Undeveloped land | 87 | | 6,722 | 6,809 | 20,368 | 27,177 | |
| Real estate mortgage | 3,514 | 730 | 3,986 | 8,230 | 1,077,307 | 1,085,537 | 205 |
| Consumer | 702 | 18 | | 720 | 27,435 | 28,155 | |
| Total | \$ 4,388 | \$ 1,266 | \$ 14,051 | \$ 19,705 | \$ 1,765,615 | \$ 1,785,320 | \$ 207 |
| December 31, 2013 | | | | | | | |
| Commercial and industrial | \$ 808 | \$ 201 | \$ 1,268 | \$ 2,277 | \$ 508,462 | \$ 510,739 | \$ 421 |
| Construction and development, excluding undeveloped land | | 429 | 26 | 455 | 99,264 | 99,719 | |
| Undeveloped land | | | 7,340 | 7,340 | 22,531 | 29,871 | |
| Real estate mortgage | 4,529 | 1,180 | 7,062 | 12,771 | 1,034,052 | 1,046,823 | 16 |
| Consumer | 110 | | | 110 | 34,088 | 34,198 | |
| Total | \$ 5,876 | \$ 1,381 | \$ 15,696 | \$ 22,953 | \$ 1,698,397 | \$ 1,721,350 | \$ 437 |

Consistent with regulatory guidance, Bancorp categorizes loans into credit risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends. Pass-rated loans included all risk-rated loans other than those classified as special mention, substandard, and doubtful, which are defined below:

- **Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. These potential weaknesses may result in deterioration of repayment prospects for the loan or of Bancorp's credit position at some future date.
- **Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize repayment of the debt. They are characterized by the distinct possibility that Bancorp will sustain some loss if the deficiencies are not corrected.

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- Substandard non-performing: Loans classified as substandard non-performing have all the characteristics of substandard loans and have been placed on non-accrual status or have been accounted for as troubled debt restructurings.
- Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

As of September 30, 2014 and December 31, 2013, the internally assigned risk grades of loans by category were as follows:

| (in thousands) | Commercial and industrial | Construction and development, excluding undeveloped land | Undeveloped land | Real estate mortgage | Consumer | Total |
|----------------------------|---------------------------|--|------------------|----------------------|-----------|--------------|
| September 30, 2014 | | | | | | |
| Grade | | | | | | |
| Pass | \$ 525,362 | \$ 82,319 | \$ 19,761 | \$ 1,065,631 | \$ 27,999 | \$ 1,721,072 |
| Special mention | 6,039 | 5,137 | 533 | 12,679 | 78 | 24,466 |
| Substandard | 10,306 | 5,992 | 161 | 2,816 | | 19,275 |
| Substandard non-performing | 8,780 | 516 | 6,722 | 4,411 | 78 | 20,507 |
| Doubtful | | | | | | |
| Total | \$ 550,487 | \$ 93,964 | \$ 27,177 | \$ 1,085,537 | \$ 28,155 | \$ 1,785,320 |
| December 31, 2013 | | | | | | |
| Grade | | | | | | |
| Pass | \$ 486,140 | \$ 87,896 | \$ 22,366 | \$ 1,014,216 | \$ 34,028 | \$ 1,644,646 |
| Special mention | 12,983 | 7,091 | | 17,916 | 86 | 38,076 |
| Substandard | 3,616 | 4,706 | 165 | 7,197 | | 15,684 |
| Substandard non-performing | 8,000 | 26 | 7,340 | 7,494 | 84 | 22,944 |
| Doubtful | | | | | | |
| Total | \$ 510,739 | \$ 99,719 | \$ 29,871 | \$ 1,046,823 | \$ 34,198 | \$ 1,721,350 |

(5) Federal Home Loan Bank Advances

Bancorp had outstanding borrowings of \$36.9 million at September 30, 2014, via seven separate fixed-rate advances. For two advances totaling \$30 million, both of which are non-callable, interest payments are due monthly, with principal due at maturity. For the remaining advances totaling \$6.9 million, principal and interest payments are due monthly based on an amortization schedule.

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The following is a summary of the contractual maturities and average effective rates of outstanding advances:

| (In thousands) | September 30, 2014 | | December 31, 2013 | |
|----------------|--------------------|------------|-------------------|------------|
| | Advance | Fixed rate | Advance | Fixed rate |
| 2014 | \$ 10,000 | 0.21% | \$ 10,000 | 0.21% |
| 2015 | 20,000 | 3.34% | 20,000 | 3.34% |
| 2020 | 1,896 | 2.23% | 1,931 | 2.23% |
| 2021 | 514 | 2.12% | 564 | 2.12% |
| 2024 | 3,113 | 2.36% | 408 | 2.40% |
| 2028 | 1,396 | 1.47% | 1,426 | 1.46% |
| | \$ 36,919 | 2.26% | \$ 34,329 | 2.26% |

Advances from the FHLB are collateralized by certain commercial and residential real estate mortgage loans under a blanket mortgage collateral agreement and FHLB stock. Bancorp views the borrowings as an effective alternative to higher cost time deposits to fund loan growth. At September 30 2014, the amount of available credit from the FHLB totaled \$422.9 million.

(6) Derivative Financial Instruments

Occasionally, Bancorp enters into free-standing interest rate swaps for the benefits of its commercial customers who desire to hedge their exposure to changing interest rates. Bancorp offsets its interest rate exposure on commercial customer transactions by entering into swap agreements with approved reputable independent counterparties with substantially matching terms. These undesignated derivative instruments are recognized on the consolidated balance sheet at fair value. Because of matching terms of offsetting contracts and the collateral provisions mitigating any non-performance risk, changes in fair value subsequent to initial recognition are expected to have an insignificant effect on earnings. Exchanges of cash flows related to the undesignated interest rate swap agreements for the first nine months of 2014 were offsetting and therefore had no net effect on Bancorp's earnings or cash flows.

Interest rate swap agreements derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Bancorp is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. Bancorp mitigates the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations.

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At September 30, 2014 and December 31, 2013, Bancorp had outstanding undesignated interest rate swap contracts as follows:

| (dollar amounts in thousands) | Receiving | | Paying | |
|-----------------------------------|-----------------------|----------------------|-----------------------|----------------------|
| | September 30, 2014 | December 31, 2013 | September 30, 2014 | December 31, 2013 |
| Notional amount | \$ 7,381 | \$ 5,159 | \$ 7,381 | \$ 5,159 |
| Weighted average maturity (years) | 7.0 | 6.4 | 7.0 | 6.4 |
| Fair value | \$ (337) | \$ (275) | \$ 337 | \$ 275 |

In December 2013, Bancorp entered into an interest rate swap to hedge cash flows of a \$10 million floating-rate FHLB borrowing. The interest rate swap involves exchange of Bancorp's floating rate interest payments for fixed rate swap payments on the underlying principal amount. This swap was designated, and qualified, for cash-flow hedge accounting. The term of the swap began December 6, 2013 and ends December 6, 2016. For derivative instruments that are designated and qualify as hedging instruments, the effective portion of gains or losses is reported as a component of other comprehensive income, and is subsequently reclassified into earnings as an adjustment to interest expense in periods in which the hedged forecasted transaction affects earnings. The following table details Bancorp's derivative position designated as a cash flow hedge, and the fair values as of September 30, 2014 and December 31, 2013:

(dollars in thousands)

| Notional amount | Maturity date | Receive (variable) index | Pay fixed swap rate | Fair value | |
|-----------------|---------------|--------------------------|---------------------|--------------------|-------------------|
| | | | | September 30, 2014 | December 31, 2013 |
| \$ 10,000 | 12/6/2016 | US\$3 Month LIBOR | 0.715% | \$ 40 | \$ 24 |

(7) **Goodwill and Intangible Assets**

US GAAP requires that goodwill and intangible assets with indefinite useful lives not be amortized, but instead be tested for impairment at least annually. Annual evaluations have resulted in no indication of impairment. Bancorp currently has goodwill in the amount of \$682 thousand from the 1996 acquisition of an Indiana bank. This goodwill is assigned to the commercial banking segment of Bancorp.

Bancorp recorded a core deposit intangible totaling \$2.5 million arising from the Oldham acquisition. Through the first quarter of 2014, this intangible asset was being amortized over a ten-year period using an accelerated method which anticipated the life of the underlying deposits to which the intangible asset is attributable. Bancorp reevaluated the deposits and determined that for money market, savings and interest bearing checking accounts, it is more appropriate to amortize the intangible asset using a straight line method over 15 years. This revision was applied prospectively beginning in the second quarter of 2014. At September 30, 2014, the unamortized core deposit intangible was \$1.9 million.

Mortgage servicing rights (MSRs) are initially recognized at fair value when mortgage loans are sold and amortized in proportion to and over the period of estimated net servicing income, considering appropriate prepayment assumptions. MSRs are evaluated quarterly for impairment by comparing carrying value to fair value. The estimated fair values of MSRs at September 30, 2014 and December 31, 2013 were \$3.5 million and \$4.0 million, respectively. The total outstanding principal balances of loans serviced for others were \$427.2 million and \$435.3 million at September 30, 2014, and December 31, 2013, respectively.

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Changes in the net carrying amount of MSRs for the nine months ended September 30, 2014 and 2013 are shown in the following table:

| (in thousands) | For nine months ended September 30, | | | |
|-----------------------------------|--|-------|----|-------|
| | | 2014 | | 2013 |
| Balance at beginning of period | \$ | 1,832 | \$ | 2,088 |
| Additions for mortgage loans sold | | 197 | | 682 |
| Amortization | | (713) | | (755) |
| Balance at September 30 | \$ | 1,316 | \$ | 2,015 |

(8) Defined Benefit Retirement Plan

Bancorp sponsors an unfunded, non-qualified, defined benefit retirement plan for four key officers (two current, and two retired), and has no plans to increase the number of participants. Benefits vest based on 25 years of service. The actuarially determined pension costs are expensed and accrued over the service period, and benefits are paid from Bancorp's assets. The net periodic benefits costs, which include interest cost and amortization of net losses, totaled \$32 thousand and \$36 thousand, for the three months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014 and 2013, the net periodic benefit costs totaled \$95 thousand and \$107 thousand, respectively.

(9) Commitments and Contingent Liabilities

As of September 30, 2014, Bancorp had various commitments outstanding that arose in the normal course of business, including standby letters of credit and commitments to extend credit, which are properly not reflected in the consolidated financial statements. In management's opinion, commitments to extend credit of \$479.4 million including standby letters of credit of \$11.7 million represent normal banking transactions, and no significant losses are anticipated to result from these commitments as of September 30, 2014. Commitments to extend credit were \$464.2 million, including letters of credit of \$15.2 million, as of December 31, 2013. Bancorp's maximum exposure to credit loss in the event of nonperformance by the other party to these commitments is represented by the contractual amount of these instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Commitments to extend credit are mainly comprised of commercial lines of credit, construction and home equity credit lines. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Bancorp uses the same credit and collateral policies in making commitments and conditional guarantees as for on-balance sheet instruments. Bancorp evaluates each customer's creditworthiness on a case by case basis. The amount of collateral obtained is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, equipment, and real estate.

Standby letters of credit and financial guarantees written are conditional commitments issued by Bancorp to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private commercial transactions. Standby letters of credit generally have maturities of one to two years.

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To provide service to commercial accounts, Bancorp aids customers with letters of credits or other financial contracts with other financial institutions. Accordingly, Bancorp has entered into agreements to

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guarantee performance of several customers' contracts with other financial institutions. Bancorp will make payments under these agreements if a customer defaults on its obligations to the other financial institutions. The terms of the agreements range from 1 to 22 months. The maximum potential future payment guaranteed by Bancorp at September 30, 2014 was \$4.4 million. If an event of default on all contracts had occurred at September 30, 2014, Bancorp would have been required to make payments of approximately \$2.9 million. No payments have ever been required as a result of default on these contracts. These agreements are normally secured by collateral acceptable to Bancorp, which limits credit risk associated with the agreements.

Also, as of September 30, 2014, in the normal course of business, there were pending legal actions and proceedings in which claims for damages are asserted. Management, after discussion with legal counsel, believes the ultimate result of these legal actions and proceedings will not have a material adverse effect on the consolidated financial position or results of operations of Bancorp.

(10) Preferred Stock

Bancorp has a class of preferred stock (no par value; 1,000,000 shares authorized), the relative rights, preferences and other terms of which or any series within the class will be determined by the Board of Directors prior to any issuance. None of this stock has been issued to date.

(11) Stock-Based Compensation

The fair value of all awards granted, net of estimated forfeitures, is recognized as compensation expense over the respective service period.

Bancorp currently has one stock-based compensation plan. Initially, in the 2005 Stock Incentive Plan, there were 735,000 shares of common stock reserved for issuance of stock based awards. In 2010, shareholders approved an additional 700,000 shares of common stock for issuance under the plan. As of September 30, 2014, there were 449,428 shares available for future awards. Bancorp's 1995 Stock Incentive Plan expired in 2005; however, options granted under this plan expire as late as 2015.

Options and stock appreciation rights (SARs) granted generally have a vesting schedule of 20% per year. Options and SARs expire ten years after the grant date unless forfeited due to employment termination. No stock options have been granted since 2007.

Restricted shares granted to officers generally vest over five years. All restricted shares have been granted at a price equal to the market value of common stock at the time of grant. Because grantees are entitled to dividend payments during the performance period, the fair value of these restricted shares is equal to the market value of the shares on the date of grant.

Grants of performance stock units (PSUs) to executive officers vest based upon service and a single three-year performance period which begins January 1 of the first year of the performance period. Because grantees are not entitled to dividend payments during the performance period, the

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fair value of these PSUs is estimated based upon the fair value of the underlying shares on the date of grant, adjusted for non-payment of dividends.

Grants of restricted stock units (RSUs) to directors are time-based and vest based upon one year of service. Because grantees are entitled to deferred dividend payments at the end of the vesting period, the fair value of the RSUs are estimated based on the fair value of the underlying shares on the date of grant.

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Bancorp has recognized stock-based compensation expense, within salaries and employee benefits for employees, and within other non-interest expense for directors, in the consolidated statements of income as follows:

| (in thousands) | For three months ended September 30, | | For nine months ended September 30, | |
|--|---|--------|--|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Stock-based compensation expense before income taxes | \$ 691 | \$ 488 | \$ 1,459 | \$ 1,473 |
| Less: deferred tax benefit | (242) | (171) | (510) | (516) |
| Reduction of net income | \$ 449 | \$ 317 | \$ 949 | \$ 957 |

Bancorp expects to record an additional \$499 thousand of stock-based compensation expense in 2014 for equity grants outstanding as of September 30, 2014. As of September 30, 2014, Bancorp has \$3.7 million of unrecognized stock-based compensation expense that is expected to be recorded as compensation expense over the next five years as awards vest. Bancorp received cash of \$1.4 million and \$1.3 million from the exercise of options during the first nine months of 2014 and 2013, respectively.

The fair values of Bancorp's stock options and SARs are estimated at the date of grant using the Black-Scholes option pricing model, a leading formula for calculating the value of stock options and SARs. This model requires the input of subjective assumptions, changes to which can materially affect the fair value estimate. The fair value of restricted shares is determined by Bancorp's closing stock price on the date of grant. The following assumptions were used in SAR valuations at the grant date in each year:

| | 2014 | 2013 |
|-------------------------|-----------|-----------|
| Dividend yield | 2.94% | 2.80% |
| Expected volatility | 23.66% | 22.54% |
| Risk free interest rate | 2.22% | 1.26% |
| Expected life of SARs | 7.0 years | 6.6 years |

Dividend yield and expected volatility are based on historical information corresponding to the expected life of options and SARs granted. Expected volatility is the volatility of the underlying shares for the expected term on a monthly basis. The risk free interest rate is the implied yield currently available on U.S. Treasury issues with a remaining term equal to the expected life of the options. The expected life of SARs is based on actual experience of past like-term options. Bancorp evaluates historical exercise and post-vesting termination behavior when determining the expected life.

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A summary of stock option and SARs activity and related information for the nine months ended September 30, 2014 follows:

| | Options and SARs (in thousands) | Exercise price | Weighted average exercise price | Aggregate intrinsic value (in thousands) | Weighted average fair value | Weighted average remaining contractual life (in years) |
|------------------------|---------------------------------------|-------------------|--|---|--------------------------------------|--|
| At December 31, 2013 | | | | | | |
| Vested and exercisable | 579 | \$ 20.25-26.83 | \$ 23.83 | \$ 4,685 | \$ 5.43 | 3.4 |
| Unvested | 218 | 21.03-24.87 | 22.70 | 2,011 | 4.36 | 7.7 |
| Total outstanding | 797 | 20.25-26.83 | 23.52 | 6,696 | 5.14 | 4.6 |
| Granted | 62 | 29.05-29.16 | 29.05 | 65 | 5.37 | |
| Exercised | (89) | 20.25-26.83 | 22.94 | 656 | 5.23 | |
| Forfeited | (6) | 21.03-23.76 | 22.78 | 46 | 4.43 | |
| At September 30, 2014 | | | | | | |
| Vested and exercisable | 570 | 20.90-26.83 | 23.79 | 3,601 | 5.35 | 3.5 |
| Unvested | 194 | 21.03-29.16 | 24.83 | 1,022 | 4.57 | 8.0 |
| Total outstanding | 764 | 20.90-29.16 | 24.05 | \$ 4,623 | 5.15 | 4.6 |
| Vested year-to-date | 80 | \$ 21.03-24.87 | \$ 22.49 | \$ 611 | \$ 4.63 | |

Intrinsic value for stock options and SARs is defined as the amount by which the current market price of the underlying stock exceeds the exercise or grant price.

For the periods ending December 31, 2013 and September 30, 2014, Bancorp granted shares of restricted common stock as outlined in the following table:

| | Number | Grant date weighted- average cost |
|--|----------|---|
| Unvested at December 31, 2012 | 113,910 | \$ 22.55 |
| Shares awarded | 55,275 | 22.93 |
| Restrictions lapsed and shares released to employees/directors | (39,909) | 22.29 |
| Shares forfeited | (4,720) | 23.45 |
| Unvested at December 31, 2013 | 124,556 | \$ 22.77 |
| Shares awarded | 39,730 | 29.12 |
| Restrictions lapsed and shares released to employees/directors | (44,724) | 22.69 |
| Shares forfeited | (3,164) | 23.29 |
| Unvested at September 30, 2014 | 116,398 | \$ 24.95 |

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Bancorp awarded PSUs to executive officers of Bancorp, the single three-year performance period for which began January 1 of the award year. The following table outlines the PSU grants.

| Grant year | Vesting period in years | Fair value at grant date | Expected shares to be awarded |
|------------|-------------------------|--------------------------|-------------------------------|
| 2012 | 3 | 20.57 | 28,079 |
| 2013 | 3 | 20.38 | 36,792 |
| 2014 | 3 | 26.42 | 16,675 |

In the first quarter of 2014, Bancorp awarded 3,920 RSUs to directors of Bancorp.

(12) Net Income Per Share

The following table reflects, for the three and nine months ended September 30, 2014 and 2013, net income (the numerator) and average shares outstanding (the denominator) for the basic and diluted net income per share computations:

| (In thousands, except per share data) | Three months ended September 30 | | Nine months ended September 30 | |
|--|------------------------------------|----------|-----------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 9,889 | \$ 7,682 | \$ 26,100 | \$ 20,857 |
| Average shares outstanding | 14,574 | 14,408 | 14,542 | 14,144 |
| Dilutive securities | 174 | 148 | 190 | 84 |
| Average shares outstanding including dilutive securities | 14,748 | 14,556 | 14,732 | 14,228 |
| Net income per share, basic | \$ 0.68 | \$ 0.53 | \$ 1.79 | \$ 1.47 |
| Net income per share, diluted | \$ 0.67 | \$ 0.53 | \$ 1.77 | \$ 1.47 |

(13) Segments

Bancorp's principal activities include commercial banking and investment management and trust. Commercial banking provides a full range of loan and deposit products to individual consumers and businesses. Commercial banking also includes Bancorp's mortgage origination and securities brokerage activity. Investment management and trust provides wealth management services including investment management, trust and estate administration, and retirement plan services.

Financial information for each business segment reflects that which is specifically identifiable or allocated based on an internal allocation method. Income taxes are allocated based on the effective federal income tax rate adjusted for any tax exempt activity. All tax exempt activity

and provision for loan losses have been allocated to the commercial banking segment. The measurement of the performance of the business

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segments is based on the management structure of Bancorp and is not necessarily comparable with similar information for any other financial institution. Information presented is also not necessarily indicative of the segments' operations if they were independent entities.

Selected financial information by business segment for the three and nine month periods ended September 30, 2014 and 2013 follows:

| (in thousands) | Commercial banking | Investment management and trust | Total |
|--|-----------------------|---------------------------------------|-----------|
| Three months ended September 30, 2014 | | | |
| Net interest income | \$ 21,317 | \$ 46 | \$ 21,363 |
| (Credit) provision for loan losses | (2,100) | | (2,100) |
| Investment management and trust services | | 4,502 | 4,502 |
| All other non-interest income | 5,348 | | 5,348 |
| Non-interest expense | 15,971 | 2,738 | 18,709 |
| Income before income taxes | 12,794 | 1,810 | 14,604 |
| Tax expense | 4,071 | 644 | 4,715 |
| Net income | \$ 8,723 | \$ 1,166 | \$ 9,889 |
| Three months ended September 30, 2013 | | | |
| Net interest income | \$ 19,978 | \$ 39 | \$ 20,017 |
| Provision for loan losses | 1,325 | | 1,325 |
| Investment management and trust services | | 4,017 | 4,017 |
| All other non-interest income | 5,621 | 14 | 5,635 |
| Non-interest expense | 15,215 | 2,356 | 17,571 |
| Income before income taxes | 9,059 | 1,714 | 10,773 |
| Tax expense | 2,485 | 606 | 3,091 |
| Net income | \$ 6,574 | \$ 1,108 | \$ 7,682 |

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| (in thousands) | Commercial banking | Investment management and trust | Total |
|---|-----------------------|---------------------------------------|-----------|
| Nine months ended September 30, 2014 | | | |
| Net interest income | \$ 62,110 | \$ 136 | \$ 62,246 |
| (Credit) provision for loan losses | (400) | | (400) |
| Investment management and trust services | | 13,825 | 13,825 |
| All other non-interest income | 15,527 | 30 | 15,557 |
| Non-interest expense | 46,036 | 7,918 | 53,954 |
| Income before income taxes | 32,001 | 6,073 | 38,074 |
| Tax expense | 9,814 | 2,160 | 11,974 |
| Net income | \$ 22,187 | \$ 3,913 | \$ 26,100 |
| Nine months ended September 30, 2013 | | | |
| Net interest income | \$ 57,347 | \$ 108 | \$ 57,455 |
| Provision for loan losses | 4,975 | | 4,975 |
| Investment management and trust services | | 12,032 | 12,032 |
| All other non-interest income | 17,114 | 45 | 17,159 |
| Non-interest expense | 45,176 | 6,796 | 51,972 |
| Income before income taxes | 24,310 | 5,389 | 29,699 |
| Tax expense | 6,938 | 1,904 | 8,842 |
| Net income | \$ 17,372 | \$ 3,485 | \$ 20,857 |

(14) Income Taxes

An analysis of the difference between the statutory and effective tax rates for the nine months ended September 30, 2014 and 2013 follows:

| | Nine months ended September 30 | |
|--|--------------------------------|-------|
| | 2014 | 2013 |
| U.S. federal statutory tax rate | 35.0% | 35.0% |
| Tax exempt interest income | (1.5) | (2.0) |
| Tax credits | (1.5) | (2.2) |
| Cash surrender value of life insurance | (1.3) | (1.8) |
| State income taxes | 0.9 | 0.7 |
| Other, net | (0.2) | 0.1 |
| Effective tax rate | 31.4% | 29.8% |

US GAAP provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. As of September 30, 2014 and December 31, 2013, the gross amount of unrecognized tax benefits was \$37 thousand and \$41 thousand, respectively. If recognized, the tax benefits would reduce tax expense and accordingly, increase net income. The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current tax year positions, expiration of open income tax returns due to statutes of limitation, changes in management's judgment about the level of uncertainty, status of examination, litigation and legislative activity and the addition or elimination of uncertain tax positions.

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During the second quarter of 2014, the IRS completed the examination of Bancorp's 2011 corporate income tax return. There were no significant adjustments to taxable income. Federal income tax returns are subject to examination for the years after 2011 and state income tax returns are subject to examination for the years after 2010.

Bancorp's policy is to report interest and penalties, if any, related to unrecognized tax benefits in income tax expense. As of both September 30, 2014 and December 31, 2013, the amount accrued for the potential payment of interest and penalties was \$2 thousand.

(15) Fair Value Measurements

Bancorp follows the provisions of the authoritative guidance for fair value measurements. This guidance is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by US GAAP. The guidance also prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in US GAAP.

The authoritative guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The guidance also establishes a hierarchy to group assets and liabilities carried at fair value in three levels based upon the markets in which the assets and liabilities trade and the reliability of assumptions used to determine fair value. These levels are:

- Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

- Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

- Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions would reflect internal estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques could include pricing models, discounted cash flows and other similar techniques.

Authoritative guidance requires maximization of use of observable inputs and minimization of use of unobservable inputs in fair value measurements. Where there exists limited or no observable market data, Bancorp derives its own estimates by generally considering characteristics of the asset/liability, the current economic and competitive environment and other factors. For this reason, results cannot be determined with precision and may not be realized on an actual sale or immediate settlement of the asset or liability.

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Bancorp's investment securities available-for-sale and interest rate swaps are recorded at fair value on a recurring basis. Other accounts including mortgage loans held for sale, mortgage servicing rights, impaired loans and other real estate owned may be recorded at fair value on a non-recurring basis, generally in the application of lower of cost or market adjustments or write-downs of specific assets.

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The portfolio of investment securities available-for-sale is comprised of U.S. Treasury and other U.S. government obligations, debt securities of U.S. government-sponsored corporations (including mortgage-backed securities), obligations of state and political subdivisions and corporate equity securities. Corporate equity securities, included in the 2014 table, are priced using quoted prices of identical securities in an active market. These measurements are classified as Level 1 in the hierarchy above. All other securities are priced using standard industry models or matrices with various assumptions such as yield curves, volatility, prepayment speeds, default rates, time value, credit rating and market prices for similar instruments. These assumptions are generally observable in the market place and can be derived from or supported by observable data. These measurements are classified as Level 2 in the hierarchy above.

Interest rate swaps are valued using primarily Level 2 inputs. Fair value measurements generally based on dealer quotes, benchmark forward yield curves, and other relevant observable market data. For purposes of potential valuation adjustments to derivative positions, Bancorp evaluates the credit risk of its counterparties as well as its own credit risk. To date, Bancorp has not realized any losses due to a counterparty's inability to perform and the change in value of derivative assets and liabilities attributable to credit risk was not significant during 2014.

Below are the carrying values of assets measured at fair value on a recurring basis.

| (in thousands) | Fair value at September 30, 2014 | | | |
|---|----------------------------------|---------------|-------------------|-----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Assets | | | | |
| Investment securities available-for-sale | | | | |
| Government sponsored enterprise obligations | \$ 205,405 | \$ | \$ 205,405 | \$ |
| Mortgage-backed securities - government agencies | 179,850 | | 179,850 | |
| Obligations of states and political subdivisions | 63,359 | | 63,359 | |
| Corporate equity securities | 958 | 958 | | |
| Total investment securities available-for-sale | 449,572 | 958 | 448,614 | |
| Interest rate swaps | 377 | | 377 | |
| Total assets | \$ 449,949 | \$ 958 | \$ 448,991 | \$ |
| Liabilities | | | | |
| Interest rate swaps | \$ 337 | \$ | \$ 337 | \$ |

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| (in thousands) | Total | Fair value at December 31, 2013 | | |
|---|-------------------|---------------------------------|-------------------|-----------|
| | | Level 1 | Level 2 | Level 3 |
| Assets | | | | |
| Investment securities available-for-sale | | | | |
| U.S. Treasury and other U.S. government obligations | \$ 110,000 | \$ | \$ 110,000 | \$ |
| Government sponsored enterprise obligations | 137,845 | | 137,845 | |
| Mortgage-backed securities - government agencies | 172,693 | | 172,693 | |
| Obligations of states and political subdivisions | 69,493 | | 69,493 | |
| Total investment securities available for sale | 490,031 | | 490,031 | |
| Interest rate swaps | 299 | | 299 | |
| Total assets | \$ 490,330 | \$ | \$ 490,330 | \$ |
| Liabilities | | | | |
| Interest rate swaps | \$ 275 | \$ | \$ 275 | \$ |

Bancorp did not have any financial instruments classified within Level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis at September 30, 2014 or December 31, 2013.

MSRs are recorded at fair value upon capitalization, are amortized to correspond with estimated servicing income, and are quarterly assessed for impairment based on fair value at the reporting date. Fair value is based on a valuation model that calculates the present value of estimated net servicing income. The model incorporates assumptions that market participants would use in estimating future net servicing income. These measurements are classified as Level 3. At September 30, 2014 and December 31, 2013 there was no valuation allowance for the mortgage servicing rights, as the fair value exceeded the amortized cost. Accordingly, the MSRs are not included in either table below for September 30, 2014 or December 31, 2013.

Mortgage loans held for sale are recorded at the lower of cost or market value. The portfolio is comprised of residential real estate loans and fair value is based on specific prices of underlying contracts for sales to investors. These measurements are classified as Level 2. Because the fair value of the loans held for sale exceeded carrying value, mortgage loans held for sale are not included in either table below for September 30, 2014 or December 31, 2013.

Other real estate owned, which is carried at the lower of cost or fair value, is periodically assessed for impairment based on fair value at the reporting date. Fair value is based on appraisals performed by external parties which use judgments and assumptions that are property-specific and sensitive to changes in the overall economic environment. Many of these inputs are not observable and, accordingly, these measurements are classified as Level 3. At September 30, 2014 and December 31, 2013, the carrying value of other real estate owned was \$2.8 million and \$5.6 million, respectively. Other real estate owned is not included in either table below, as the fair value of the properties exceeded their carrying value at September 30, 2014 and December 31, 2013.

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For impaired loans in the table below, the fair value is calculated as the carrying value of only loans with a specific valuation allowance, less the specific allowance. As of September 30, 2014, total impaired loans with a valuation allowance were \$10.6 million, and the specific allowance totaled \$2.1 million, resulting in a fair value of \$8.5 million, compared to total impaired loans with a valuation allowance of \$10.6 million, and the specific allowance allocation totaling \$1.5 million, resulting in a fair value of \$9.1 million at December 31, 2013. The losses represent the change in the specific allowances for the period indicated.

Below are the carrying values of assets measured at fair value on a non-recurring basis.

| (in thousands) | Total | Fair value at September 30, 2014 | | | Losses for 9 month period ended September 30, 2014 |
|----------------|----------|----------------------------------|---------|----------|--|
| | | Level 1 | Level 2 | Level 3 | |
| Impaired loans | \$ 8,470 | \$ | \$ | \$ 8,470 | \$ (1,148) |

| (in thousands) | Total | Fair value at December 31, 2013 | | | Losses for 9 month period ended September 30, 2013 |
|----------------|----------|---------------------------------|---------|----------|--|
| | | Level 1 | Level 2 | Level 3 | |
| Impaired loans | \$ 9,128 | \$ | \$ | \$ 9,128 | \$ (1,181) |

In the case of the securities portfolio, Bancorp monitors the valuation technique utilized by pricing agencies to ascertain when transfers between levels have occurred. The nature of the remaining assets and liabilities is such that transfers in and out of any level are expected to be rare. For the nine months ended September 30, 2014, there were no transfers between Levels 1, 2, or 3.

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US GAAP requires disclosure of the fair value of financial assets and liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or nonrecurring basis. The carrying amounts, estimated fair values, and placement in the fair value hierarchy of Bancorp's financial instruments are as follows:

| (in thousands) September 30, 2014 | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
|---|--------------------|--------------|-----------|--------------|-----------|
| Financial assets | | | | | |
| Cash and short-term investments | \$ 69,567 | \$ 69,567 | \$ 69,567 | \$ | \$ |
| Mortgage loans held for sale | 4,069 | 4,239 | | 4,239 | |
| Federal Home Loan Bank stock and other securities | 6,347 | 6,347 | | 6,347 | |
| Loans, net | 1,758,196 | 1,767,171 | | | 1,767,171 |
| Accrued interest receivable | 5,629 | 5,629 | 5,629 | | |
| Financial liabilities | | | | | |
| Deposits | \$ 2,007,821 | \$ 2,008,818 | \$ | \$ 2,008,818 | \$ |
| Short-term borrowings | 83,251 | 83,251 | | 83,251 | |
| FHLB advances | 36,919 | 37,481 | | 37,481 | |
| Accrued interest payable | 128 | 128 | 128 | | |

| (in thousands) December 31, 2013 | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
|---|--------------------|--------------|-----------|--------------|-----------|
| Financial assets | | | | | |
| Cash and short-term investments | \$ 70,770 | \$ 70,770 | \$ 70,770 | \$ | \$ |
| Mortgage loans held for sale | 1,757 | 1,817 | | 1,817 | |
| Federal Home Loan Bank stock and other securities | 7,347 | 7,347 | | 7,347 | |
| Loans, net | 1,692,828 | 1,703,291 | | | 1,703,291 |
| Accrued interest receivable | 5,712 | 5,712 | 5,712 | | |
| Financial liabilities | | | | | |
| Deposits | \$ 1,980,937 | \$ 1,983,029 | \$ | \$ 1,983,029 | \$ |
| Short-term borrowings | 117,910 | 117,910 | | 117,910 | |
| FHLB advances | 34,329 | 35,166 | | 35,166 | |
| Accrued interest payable | 128 | 128 | 128 | | |

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Management used the following methods and assumptions to estimate the fair value of each class of financial instrument for which it is practicable to estimate the value.

Cash, short-term investments, accrued interest receivable/payable and short-term borrowings

For these short-term instruments, carrying amount is a reasonable estimate of fair value.

Federal Home Loan Bank stock and other securities

For these securities without readily available market values, the carrying amount is a reasonable estimate of fair value.

Mortgage loans held for sale

The fair value of mortgage loans held for sale is determined by market quotes for similar loans based on loan type, term, rate, size and the borrower's credit score.

Loans, net

US GAAP prescribes the exit price concept for estimating fair value of loans. Because there is not an active market (exit price) for trading virtually all types of loans in Bancorp's portfolio, fair value of loans is estimated by discounting future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities (e.g. entrance price).

Deposits

Fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. Fair value of fixed-rate certificates of deposits is estimated by discounting future cash flows using the rates currently offered for deposits of similar remaining maturities.

Federal Home Loan Bank advances

Fair value of FHLB advances is estimated by discounting future cash flows using estimates of current market rate for instruments with similar terms and remaining maturities.

Commitments to extend credit and standby letters of credit

Fair values of commitments to extend credit are estimated using fees currently charged to enter into similar agreements and the creditworthiness of the customers. Fair values of standby letters of credit are based on fees currently charged for similar agreements or estimated cost to terminate them or otherwise settle obligations with counterparties at the reporting date. Fair value of commitments to extend credit, letters of credit and lines of credit is not presented since management believes the fair value to be insignificant.

Limitations

Fair value estimates are made at a specific point in time based on relevant market information and information about financial instruments. Because no market exists for a significant portion of Bancorp's financial instruments, fair value estimates are based on judgments regarding future expected losses, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Therefore, calculated fair value estimates in many instances

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cannot be substantiated by comparison to independent markets and, in many cases, may not be realizable in a current sale of the instrument. Changes in assumptions could significantly affect estimates.

(17) Regulatory Matters

Bancorp and the Bank are subject to various capital requirements prescribed by banking regulations and administered by state and federal banking agencies. Under these requirements, Bancorp and the Bank must meet minimum amounts and percentages of Tier I and total capital, as defined, to risk weighted assets and Tier I capital to average assets. Risk weighted assets are determined by applying certain risk weightings prescribed by the regulations to various categories of assets and off-balance sheet commitments. Capital and risk weighted assets may be further subject to qualitative judgments by regulators as to components, risk weighting and other factors. Failure to meet the capital requirements can result in certain mandatory, and possibly discretionary, corrective actions prescribed by the regulations or determined to be necessary by the regulators, which could materially affect the unaudited consolidated financial statements. Bancorp and the Bank met all capital requirements to which they were subject as of September 30, 2014.

The following table sets forth consolidated Bancorp's and the Bank's risk based capital amounts and ratios as of September 30, 2014 and December 31, 2013.

| (Dollars in thousands) | Actual | | Minimum for adequately capitalized | | Minimum for well capitalized | |
|-------------------------------|------------|--------|------------------------------------|-------|------------------------------|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| September 30, 2014 | | | | | | |
| Total risk-based capital (1) | | | | | | |
| Consolidated | \$ 272,796 | 13.92% | \$ 156,779 | 8.00% | NA | NA |
| Bank | 264,784 | 13.53% | 156,561 | 8.00% | \$ 195,701 | 10.00% |
| Tier I risk-based capital (1) | | | | | | |
| Consolidated | \$ 248,264 | 12.67% | \$ 78,379 | 4.00% | NA | NA |
| Bank | 240,287 | 12.28% | 78,269 | 4.00% | \$ 117,404 | 6.00% |
| Leverage (2) | | | | | | |
| Consolidated | \$ 248,264 | 10.38% | \$ 71,753 | 3.00% | NA | NA |
| Bank | 240,287 | 10.07% | 71,585 | 3.00% | \$ 119,308 | 5.00% |
| December 31, 2013 | | | | | | |
| Total risk-based capital (1) | | | | | | |
| Consolidated | \$ 252,171 | 13.54% | \$ 148,993 | 8.00% | NA | NA |
| Bank | 239,577 | 12.90% | 148,575 | 8.00% | \$ 185,719 | 10.00% |
| Tier I risk-based capital (1) | | | | | | |
| Consolidated | \$ 228,827 | 12.29% | \$ 74,476 | 4.00% | NA | NA |
| Bank | 219,299 | 11.65% | 75,296 | 4.00% | \$ 112,944 | 6.00% |
| Leverage (2) | | | | | | |
| Consolidated | \$ 228,827 | 9.75% | \$ 70,408 | 3.00% | NA | NA |
| Bank | 219,299 | 9.24% | 71,201 | 3.00% | \$ 118,668 | 5.00% |

(1) Ratio is computed in relation to risk-weighted assets.

(2) Ratio is computed in relation to average assets.

NA Not applicable. Regulatory framework does not define well capitalized for holding companies.

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

This item discusses the results of operations for Stock Yards Bancorp, Inc. (Bancorp or Company), and its subsidiary, Stock Yards Bank & Trust Company (Bank) for the three and nine months ended September 30, 2014 and compares these periods with the same periods of the previous year. Unless otherwise indicated, all references in this discussion to the Bank include Bancorp. In addition, the discussion describes the significant changes in the financial condition of Bancorp and the Bank that have occurred during the first nine months of 2014 compared to the year ended December 31, 2013. This discussion should be read in conjunction with the consolidated financial statements and accompanying notes presented in Part 1, Item 1 of this report.

This report contains forward-looking statements under the Private Securities Litigation Reform Act that involve risks and uncertainties. Although Bancorp believes the assumptions underlying the forward-looking statements contained herein are reasonable, any of these assumptions could be inaccurate. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to the following: economic conditions both generally and more specifically in the markets in which Bancorp and the Bank operate; competition for Bancorp's customers from other providers of financial services; government legislation and regulation which change from time to time and over which Bancorp has no control; changes in interest rates; material unforeseen changes in liquidity, results of operations, or financial condition of Bancorp's customers; and other risks detailed in Bancorp's filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond the control of Bancorp.

Overview of 2014 through September 30

Bancorp completed the first nine months of 2014 with record net income of \$26.1 million or 25% more than the comparable period of 2013. Higher net interest income was somewhat offset by higher non-interest expenses and higher income tax expense. Bancorp released reserves in 2014 and recorded a provision for loan losses in 2013. Diluted earnings per share for the first nine months of 2014 were \$1.77, compared to the first nine months of 2013 at \$1.47. Management estimates that the release of \$2.1 million of reserves in the third quarter of 2014 added approximately \$0.09 to diluted earnings per share for the three and nine months ended September 2014. This estimate includes a normalized third quarter provision for loan losses of \$835 thousand based upon Bancorp's historical charge-off trends from the pre-recession period between 2004 and 2007. Also included are the effects of incentive accruals and income taxes.

As is the case with most banks, the primary source of Bancorp's revenue is net interest income and fees from various financial services provided to customers. Net interest income is the difference between interest income earned on loans, investment securities and other interest earning assets less interest expense on deposit accounts and other interest bearing liabilities. Loan volume and the interest rates earned on those loans are critical to overall profitability. Similarly, deposit volume is crucial to funding loans and rates paid on deposits directly impact profitability. Business volumes are influenced by overall economic factors including market interest rates, business spending, consumer confidence and competitive conditions within the marketplace.

Net interest income increased \$4.8 million, or 8.3%, for the first nine months of 2014, compared to the same period in 2013. The net interest margin was 3.78% for the first nine months of 2014 and 2013. Strong year-to-date loan growth was the primary driver of increased interest income, and was partially offset by the effect of declining interest rates earned. In the fourth quarter of 2013, Bancorp redeemed \$30 million of subordinated debentures which carried a rate of 10%; this accounted for the majority of the interest expense savings, and contributed approximately 14 basis points to the net interest margin. To a lesser extent, interest expense declined due to lower costs on deposits and FHLB borrowings arising from lower interest rates and a more favorable deposit mix.

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Also favorably impacting 2014 results, Bancorp released reserves totaling \$400 thousand for the first nine months of 2014, compared to a provision for loan losses of \$5.0 million in the first nine months of 2013. The provision for loan losses is calculated after considering credit quality factors, and ultimately relies on an overall internal analysis of the risk in the loan portfolio. The release of reserves in 2014 reflected continued improvement in overall asset quality metrics and management's specific assessment of risks associated with loans collateralized by undeveloped land. Bancorp's credit quality metrics continued to improve in the third quarter. Over the past year, non-performing loans have declined 33%, while non-performing assets have declined 37%. Accordingly, Bancorp has reduced its provision of loan losses over the past year and determined during the third quarter that it could release some reserves set aside for possible loan losses, particularly for undeveloped land loans. Bancorp's allowance for loan losses was 1.52% of total loans at September 30, 2014, compared to 1.66% of total loans at December 31, 2013, and 1.70% at September 30, 2013.

Total non-interest income in the first nine months of 2014 increased \$191 thousand, or 0.7%, compared to the same period in 2013, and remained consistent at 32% of total revenues. Increases in investment management and bankcard transaction revenue were largely offset by decreases in mortgage banking revenue and brokerage commissions. Results for the first nine months of 2013 included a \$449 thousand gain on acquisition.

Total non-interest expense in the first nine months of 2014 increased \$2.0 million, or 3.8%, compared to the same period in 2013 due to increases in salaries and benefits, net occupancy, data processing and other non-interest expenses. These increases were somewhat offset by gains on sale of foreclosed assets. Results for the first nine months of 2013 included \$1.5 million of acquisition costs related to the Oldham transaction. Bancorp's third quarter 2014 efficiency ratio was 59.48% compared with 58.72% in the third quarter last year. For the first nine months of 2014, the efficiency ratio was 58.42%, compared to 59.46% for the same period in 2013.

Tangible common equity (TCE), a non-GAAP measure, is a measure of a company's capital which is useful in evaluating the quality and adequacy of capital. The ratio of tangible common equity to total tangible assets was 10.35% as of September 30, 2014, compared to 9.50% at December 31, 2013. See the Non-GAAP Financial Measures section for details on reconciliation to US GAAP measures.

The following sections provide more details on subjects presented in this overview.

a) Results Of Operations

Net income of \$9.9 million for the three months ended September 30, 2014 increased \$2.2 million, or 28.7%, from \$7.7 million for the comparable 2013 period. Basic net income per share was \$0.68 for the third quarter of 2014, an increase of 28.3% from the \$0.53 for the third quarter of 2013. Net income per share on a diluted basis was \$0.67 for the third quarter of 2014, an increase of 26.4% from the \$0.53 for the same period in 2013.

Reflecting increased net income, annualized return on average assets and annualized return on average stockholders' equity were 1.64% and 15.79%, respectively, for the third quarter of 2014, compared to 1.35% and 13.70%, respectively, for the same period in 2013.

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Net income of \$26.1 million for the nine months ended September 30, 2014 increased \$5.2 million, or 25.1%, from \$20.9 million for the comparable 2013 period. Basic net income per share was \$1.79 for the first nine months of 2014, an increase of 21.8% from the \$1.47 for the first nine months of 2013. Net income per share on a diluted basis was \$1.77 for the first nine months of 2014, an increase of 20.4% from the \$1.47 for the first nine months of 2013.

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Reflecting increased net income, annualized return on average assets and annualized return on average stockholders' equity were 1.47% and 14.45%, respectively, for the first nine months of 2014, compared to 1.27% and 12.86%, respectively, for the same period in 2013.

Management estimates that the release of \$2.1 million of reserves in the third quarter added approximately \$0.09 to diluted earnings per share for the third quarter and nine months ended September 30, 2014. This estimate includes a normalized third quarter provision for loan losses of \$835 thousand based upon Bancorp's historical charge-off trends from the pre-recession period between 2004 and 2007. Also included are the effects of incentive accruals and income taxes.

Basic and diluted net income per share did not increase at the same rate as net income due to the issuance of 531,288 shares in the second quarter of 2013 for the Oldham transaction. Also, Bancorp's higher average stock price for the third quarter and first nine months of 2014, as compared to the same periods in 2013, is the primary factor for more dilutive shares. See Note 12 for additional information related to net income per share.

Net Interest Income

The following tables present the average balance sheets for the three and nine month periods ended September 30, 2014 and 2013 along with the related calculation of tax-equivalent net interest income, net interest margin and net interest spread for the related periods. See the notes following the tables for further explanation.

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Average Balances and Interest Rates Taxable Equivalent Basis

| (Dollars in thousands) | Three months ended September 30 | | | | | |
|---|---------------------------------|---------------|--------------|---------------------|---------------|--------------|
| | 2014 | | | 2013 | | |
| | Average Balances | Interest | Average Rate | Average Balances | Interest | Average Rate |
| Earning assets: | | | | | | |
| Federal funds sold | \$ 86,252 | \$ 73 | 0.34% | \$ 75,705 | \$ 63 | 0.33% |
| Mortgage loans held for sale | 4,934 | 54 | 4.34% | 5,685 | 57 | 3.98% |
| Securities: | | | | | | |
| Taxable | 322,306 | 1,781 | 2.19% | 301,413 | 1,554 | 2.05% |
| Tax-exempt | 57,896 | 415 | 2.84% | 58,642 | 412 | 2.79% |
| FHLB stock and other securities | 6,347 | 64 | 4.00% | 7,347 | 72 | 3.89% |
| Loans, net of unearned income | 1,779,944 | 20,546 | 4.58% | 1,674,049 | 20,362 | 4.83% |
| Total earning assets | 2,257,679 | 22,933 | 4.03% | 2,122,841 | 22,520 | 4.21% |
| Less allowance for loan losses | 30,115 | | | 33,038 | | |
| | 2,227,564 | | | 2,089,803 | | |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 38,854 | | | 34,213 | | |
| Premises and equipment | 39,124 | | | 39,910 | | |
| Accrued interest receivable and other assets | 89,732 | | | 101,011 | | |
| Total assets | \$ 2,395,274 | | | \$ 2,264,937 | | |
| Interest bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest bearing demand deposits | \$ 460,803 | \$ 113 | 0.10% | \$ 402,246 | \$ 88 | 0.09% |
| Savings deposits | 109,023 | 10 | 0.04% | 100,532 | 11 | 0.04% |
| Money market deposits | 633,179 | 326 | 0.20% | 590,895 | 313 | 0.21% |
| Time deposits | 322,959 | 616 | 0.76% | 359,861 | 797 | 0.88% |
| Securities sold under agreements to repurchase | 64,985 | 37 | 0.23% | 64,652 | 38 | 0.23% |
| Fed funds purchased and other short term borrowings | 17,789 | 8 | 0.18% | 19,628 | 9 | 0.18% |
| FHLB advances | 36,747 | 219 | 2.36% | 31,970 | 221 | 2.74% |
| Long-term debt | | | | 30,900 | 773 | 9.92% |
| Total interest bearing liabilities | 1,645,485 | 1,329 | 0.32% | 1,600,684 | 2,250 | 0.56% |
| Non-interest bearing liabilities: | | | | | | |
| Non-interest bearing demand deposits | 474,513 | | | 413,695 | | |
| | 26,864 | | | 28,030 | | |

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| | | | | |
|--|--------------|-------|--------------|-------|
| Accrued interest payable and other liabilities | | | | |
| Total liabilities | 2,146,862 | | 2,042,409 | |
| Stockholders equity | 248,412 | | 222,528 | |
| Total liabilities and stockholders equity | \$ 2,395,274 | | \$ 2,264,937 | |
| Net interest income | \$ 21,604 | | \$ 20,270 | |
| Net interest spread | | 3.71% | | 3.65% |
| Net interest margin | | 3.80% | | 3.79% |

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| (Dollars in thousands) | Nine months ended September 30 | | | | | |
|---|--------------------------------|---------------|--------------|---------------------|---------------|--------------|
| | Average Balances | 2014 Interest | Average Rate | Average Balances | 2013 Interest | Average Rate |
| Earning assets: | | | | | | |
| Federal funds sold | \$ 86,764 | \$ 215 | 0.33% | \$ 93,664 | \$ 215 | 0.31% |
| Mortgage loans held for sale | 4,059 | 128 | 4.22% | 6,661 | 177 | 3.55% |
| Securities: | | | | | | |
| Taxable | 322,797 | 5,312 | 2.20% | 269,288 | 4,193 | 2.08% |
| Tax-exempt | 59,030 | 1,266 | 2.87% | 53,860 | 1,220 | 3.03% |
| FHLB stock and other securities | 6,893 | 194 | 3.76% | 6,771 | 195 | 3.85% |
| Loans, net of unearned income | 1,749,432 | 59,929 | 4.58% | 1,628,261 | 59,150 | 4.86% |
| Total earning assets | 2,228,975 | 67,044 | 4.02% | 2,058,505 | 65,150 | 4.23% |
| Less allowance for loan losses | 29,432 | | | 33,046 | | |
| | 2,199,543 | | | 2,025,459 | | |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 36,739 | | | 33,212 | | |
| Premises and equipment | 39,338 | | | 38,255 | | |
| Accrued interest receivable and other assets | 90,988 | | | 96,084 | | |
| Total assets | \$ 2,366,608 | | | \$ 2,193,010 | | |
| Interest bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest bearing demand deposits | \$ 471,839 | \$ 368 | 0.10% | \$ 375,408 | \$ 274 | 0.10% |
| Savings deposits | 107,026 | 30 | 0.04% | 94,807 | 29 | 0.04% |
| Money market deposits | 626,974 | 957 | 0.20% | 574,991 | 911 | 0.21% |
| Time deposits | 336,943 | 1,964 | 0.78% | 369,247 | 2,619 | 0.95% |
| Securities sold under agreements to repurchase | 59,441 | 100 | 0.22% | 58,881 | 106 | 0.24% |
| Fed funds purchased and other short term borrowings | 18,855 | 23 | 0.16% | 20,370 | 26 | 0.17% |
| FHLB advances | 35,321 | 621 | 2.35% | 31,904 | 657 | 2.75% |
| Long-term debt | | | | 30,900 | 2,318 | 10.03% |
| Total interest bearing liabilities | 1,656,399 | 4,063 | 0.33% | 1,556,508 | 6,940 | 0.60% |
| Non-interest bearing liabilities: | | | | | | |
| Non-interest bearing demand deposits | 442,810 | | | 393,319 | | |
| Accrued interest payable and other liabilities | 25,890 | | | 26,304 | | |
| Total liabilities | 2,125,099 | | | 1,976,131 | | |
| Stockholders equity | 241,509 | | | 216,879 | | |

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| | | | | | | |
|--|----|-----------|--------|----|-----------|--------|
| Total liabilities and stockholders equity | \$ | 2,366,608 | | \$ | 2,193,010 | |
| Net interest income | | \$ | 62,981 | | \$ | 58,210 |
| Net interest spread | | | 3.69% | | 3.63% | |
| Net interest margin | | | 3.78% | | 3.78% | |

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Notes to the average balance and interest rate tables:

- Net interest income, the most significant component of the Bank's earnings is total interest income less total interest expense. The level of net interest income is determined by the mix and volume of interest earning assets, interest bearing deposits and borrowed funds, and changes in interest rates.
- Net interest spread is the difference between the taxable equivalent rate earned on interest earning assets less the rate expensed on interest bearing liabilities.
- Net interest margin represents net interest income on a taxable equivalent basis as a percentage of average interest earning assets. Net interest margin is affected by both the interest rate spread and the level of non-interest bearing sources of funds, primarily consisting of demand deposits and stockholders' equity.
- Interest income on a fully tax equivalent basis includes the additional amount of interest income that would have been earned if investments in certain tax-exempt interest earning assets had been made in assets subject to federal taxes yielding the same after-tax income. Interest income on municipal securities and loans have been calculated on a fully tax equivalent basis using a federal income tax rate of 35%. The approximate tax equivalent adjustments to interest income were \$241 thousand and \$344 thousand, respectively, for the three month periods ended September 30, 2014 and 2013 and \$735 thousand and \$755 thousand, respectively, for the nine month periods ended September 30, 2014 and 2013.
- Average balances for loans include the principal balance of non-accrual loans and exclude participation loans accounted for as secured borrowings.

Fully taxable equivalent net interest income of \$21.6 million for the three months ended September 30, 2014 increased \$1.3 million, or 6.6%, from \$20.3 million when compared to the same period last year. Net interest spread and net interest margin were 3.71% and 3.80%, respectively, for the third quarter of 2014 and 3.65% and 3.79%, respectively, for the third quarter of 2013.

Fully taxable equivalent net interest income of \$63.0 million for the nine months ended September 30, 2014 increased \$4.8 million, or 8.2%, from \$58.2 million when compared to the same period last year. Net interest spread and net interest margin were 3.69% and 3.78%, respectively, for the first nine months of 2014 and 3.63% and 3.78%, respectively, for the first nine months of 2013.

Approximately \$638 million, or 36%, of Bancorp's loans are variable rate; most of these loans are indexed to the prime rate and may reprice as that rate changes. However, approximately \$332 million of variable rate loans have reached their contractual floor of 4% or higher. Approximately \$132 million of variable rate loans have contractual floors below 4%. The remaining \$174 million of variable rate loans have no contractual floor. Bancorp intends to establish floors whenever possible upon acquisition of new customers. Bancorp's variable rate loans are primarily comprised of commercial lines of credit and real estate loans. At inception, most of Bancorp's fixed rate loans are priced in relation to

the five year Treasury bond.

Average earning assets increased \$170.5 million or 8.3%, to \$2.23 billion for the first nine months of 2014 compared to 2013, reflecting growth in the loan portfolio and investment securities. Average interest bearing liabilities increased \$99.9 million, or 6.4%, to \$1.66 billion for the first nine months of 2014 compared to 2013 primarily due to increases in interest bearing demand, savings and money market

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deposits, FHLB advances and securities sold under agreements to repurchase, partially offset by decreases in long-term debt, certificates of deposits and federal funds purchased.

Asset/Liability Management and Interest Rate Risk

Managing interest rate risk is fundamental for the financial services industry. The primary objective of interest rate risk management is to neutralize effects of interest rate changes on net income. By considering both on and off-balance sheet financial instruments, management evaluates interest rate sensitivity while attempting to optimize net interest income within the constraints of prudent capital adequacy, liquidity needs, market opportunities and customer requirements.

Interest Rate Simulation Sensitivity Analysis

Bancorp uses an earnings simulation model to estimate and evaluate the impact of an immediate change in interest rates on earnings in a one year forecast. The simulation model is designed to reflect the dynamics of interest earning assets, interest bearing liabilities and off-balance sheet financial instruments. By estimating the effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. The simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and does not indicate actual expected results.

The September 30, 2014 simulation analysis, which shows very little interest rate sensitivity, indicates that an increase in interest rates of 100 to 200 basis points would have a negative effect on net interest income, and a decrease of 100 basis points in interest rates would also have a negative impact. These estimates are summarized below.

| | Net interest income change |
|----------------|---------------------------------------|
| Increase 200bp | (4.92)% |
| Increase 100bp | (3.58) |
| Decrease 100bp | (2.05) |
| Decrease 200bp | N/A |

Loans indexed to the prime rate, with floors of 4% or higher, comprise approximately 19% of total loans. Since the prime rate is currently 3.25%, rates would have to increase more than 75 bp before the rates on such loans will rise. This effect, captured in the simulation analysis above, negatively impacts the effect of rising rates.

The scenario of rates decreasing 200 bp is not reasonably possible given current low rates for short-term instruments and most deposits.

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Undesignated derivative instruments described in Note 6 are recognized on the consolidated balance sheet at fair value, with changes in fair value, due to changes in prevailing interest rates, recorded in other non-interest income. Because of matching terms of offsetting contracts, in addition to collateral provisions which mitigate the impact of non-performance risk, changes in fair value subsequent to initial recognition have a minimal effect on earnings, and are therefore not included in the simulation analysis results above.

Derivatives designated as cash flow hedges described in Note 6 are recognized on the consolidated balance sheet at fair value, with changes in fair value, due to changes in prevailing interest rates, recorded net of tax in other comprehensive income.

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Provision for Loan Losses

Bancorp released reserves of \$2.1 million for the third quarter of 2014 compared to a provision for loan losses of \$1.3 million for the same period of 2013. The third quarter 2014 release of reserves, combined with provisions in the first two quarters, resulted in a net credit totaling \$400 thousand for the first nine months of 2014, compared to a provision of \$5.0 million for the same period of 2013. The allowance for loan losses is calculated after considering credit quality factors, and ultimately relies on an overall internal analysis of the risk in the loan portfolio. Based on this analysis, provisions for loan losses are determined and recorded. The provision reflects an allowance methodology that is driven by risk ratings, historical losses, and qualitative factors. Many key indicators of loan quality continue to show improvement and overall credit metrics continue to improve. Actions to forego a provision for loan losses and release reserves were deemed appropriate based on continued improvement in overall asset quality metrics and management's specific assessment of risks associated with loans collateralized by undeveloped land. Due to the magnitude of 2013 charge-offs in this segment for loans originated prior to the recession, management had allocated a proportionally high allowance to this category. This was based largely on swings in collateral values for this segment over the last several years and the aforementioned concentrated losses. There has been little to no growth in this portfolio during 2014, and management does not expect it to be a focus for loan growth in the next few years. Beyond the single relationship with charge-offs in 2013, which is currently classified as nonperforming, and on which management estimates minimal additional loss exposure, loans in this portfolio are granular in size and graded pass. The segment has experienced net recoveries in 2014. Based upon improving real estate values and increased absorption, management reviewed the loans in this segment including the underlying collateral values and concluded that current credit risk supports a lower allowance allocation. Over the past year, non-performing loans have declined 33%, while non-performing assets have declined 37%. Accordingly, Bancorp has reduced its provision of loan losses over the past year and determined during the third quarter that it could release some reserves set aside for possible loan losses. Because risk in the portfolio is evaluated each quarter and internal and external conditions that affect the assessment of this risk are likely to change, Bancorp cannot predict if further releases of reserves will occur. Bancorp intends to continue with its historically conservative stance toward credit quality, remaining cautious in assessing the potential risk in the loan portfolio.

Management utilizes loan grading procedures which result in specific allowance allocations for the estimated inherent risk of loss. For all loans graded, but not individually reviewed, a general allowance allocation is computed using factors typically developed over time based on actual loss experience. The specific and general allocations plus consideration of qualitative factors represent management's best estimate of probable losses contained in the loan portfolio at the evaluation date. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb any credit losses. Based on this detailed analysis of credit risk, management considers the allowance for loan losses adequate to cover probable losses inherent in the loan portfolio at September 30, 2014.

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An analysis of the changes in the allowance for loan losses and selected ratios for the three and nine month periods ended September 30, 2014 and 2013 follows:

| (Dollars in thousands) | Three months ended September 30 | | Nine months ended September 30 | |
|--|---------------------------------|--------------|--------------------------------|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at the beginning of the period | \$ 29,761 | \$ 31,980 | \$ 28,522 | \$ 31,881 |
| Provision (credit) for loan losses | (2,100) | 1,325 | (400) | 4,975 |
| Loan charge-offs, net of recoveries | (537) | (4,315) | (998) | (7,866) |
| Balance at the end of the period | \$ 27,124 | \$ 28,990 | \$ 27,124 | \$ 28,990 |
| Average loans, net of unearned income | \$ 1,788,786 | \$ 1,684,714 | \$ 1,758,592 | \$ 1,638,133 |
| Provision for loan losses to average loans (1) | -0.12% | 0.08% | -0.02% | 0.30% |
| Net loan charge-offs to average loans (1) | 0.03% | 0.26% | 0.06% | 0.48% |
| Allowance for loan losses to average loans | 1.52% | 1.72% | 1.54% | 1.77% |
| Allowance for loan losses to period-end loans | 1.52% | 1.70% | 1.52% | 1.70% |

(1) Amounts not annualized

Loans are charged off when deemed uncollectible and a loss is identified or after underlying collateral has been liquidated; however, collection efforts may continue and future recoveries may occur. Periodically, loans are partially charged off to the net realizable value based upon collateral analysis.

An analysis of net charge-offs by loan category for the three and nine month periods ended September 30, 2014 and 2013 follows:

| (in thousands) | Three months ended September 30 | | Nine months ended September 30 | |
|--|---------------------------------|-----------------|--------------------------------|-----------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net loan charge-offs (recoveries) | | | | |
| Commercial and industrial | \$ 356 | \$ (193) | \$ 371 | \$ (177) |
| Construction and development, excluding undeveloped land | | 26 | | (138) |
| Undeveloped land | (99) | 4,414 | (136) | 6,414 |
| Real estate mortgage - commercial investment | 248 | (83) | 397 | 752 |
| Real estate mortgage - owner occupied commercial | (7) | | 78 | 357 |
| Real estate mortgage - 1-4 family residential | 5 | 60 | 177 | 528 |
| Home equity | (3) | (8) | 60 | 27 |
| Consumer | 37 | 99 | 51 | 103 |
| Total net loan charge-offs | \$ 537 | \$ 4,315 | \$ 998 | \$ 7,866 |

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The following table sets forth the major components of non-interest income and expenses for the three and nine month periods ended September 30, 2014 and 2013

| (In thousands) | Three months ended September 30 | | | % Change | Nine months ended September 30 | | |
|--|------------------------------------|------------------|-------------|------------------|-----------------------------------|-------------|----------|
| | 2014 | 2013 | | | 2014 | 2013 | % Change |
| Non-interest income: | | | | | | | |
| Investment management and trust services | \$ 4,502 | \$ 4,017 | 12.1% | \$ 13,825 | \$ 12,032 | 14.9% | |
| Service charges on deposit accounts | 2,294 | 2,348 | -2.3% | 6,620 | 6,592 | 0.4% | |
| Bankcard transaction revenue | 1,182 | 1,087 | 8.7% | 3,466 | 3,068 | 13.0% | |
| Mortgage banking revenue | 641 | 995 | -35.6% | 1,951 | 3,370 | -42.1% | |
| Loss on sales of securities available for sale | | | 0.0% | (9) | (5) | 80.0% | |
| Brokerage commissions and fees | 539 | 456 | 18.2% | 1,506 | 1,693 | -11.0% | |
| Bank owned life insurance income | 229 | 260 | -11.9% | 699 | 771 | -9.3% | |
| Gain on acquisition | | | 0.0% | | 449 | -100.0% | |
| Other | 463 | 489 | -5.3% | 1,324 | 1,221 | 8.4% | |
| Total non-interest income | \$ 9,850 | \$ 9,652 | 2.1% | \$ 29,382 | \$ 29,191 | 0.7% | |
| Non-interest expenses: | | | | | | | |
| Salaries and employee benefits | \$ 11,855 | \$ 10,508 | 12.8% | \$ 33,697 | \$ 30,186 | 11.6% | |
| Net occupancy expense | 1,422 | 1,522 | -6.6% | 4,431 | 4,188 | 5.8% | |
| Data processing expense | 1,591 | 1,520 | 4.7% | 4,869 | 4,695 | 3.7% | |
| Furniture and equipment expense | 269 | 269 | 0.0% | 796 | 846 | -5.9% | |
| FDIC insurance expense | 340 | 348 | -2.3% | 1,032 | 1,055 | -2.2% | |
| Loss (gain) on other real estate owned | 7 | 475 | -98.5% | (342) | 366 | -193.4% | |
| Acquisition costs | | | 0.0% | | 1,548 | -100.0% | |
| Other | 3,225 | 2,929 | 10.1% | 9,471 | 9,088 | 4.2% | |
| Total non-interest expenses | \$ 18,709 | \$ 17,571 | 6.5% | \$ 53,954 | \$ 51,972 | 3.8% | |

Total non-interest income increased \$198 thousand, or 2.1%, for the third quarter of 2014 and \$191 thousand, or 0.7% for the first nine months of 2014, compared to the same periods in 2013.

Approximately 47% of non-interest income is investment management and trust revenue. The magnitude of investment management and trust revenue distinguishes Bancorp from other community banks of similar asset size. Along with the effects of improving investment market conditions in 2013 and 2014, this source of revenue continued to grow through attraction of new business. Trust assets under management totaled \$2.23 billion at September 30, 2014, compared to \$2.14 billion at September 30, 2013. Investment management and trust revenue increased \$0.5 million, or 12.1%, in the third quarter of 2014, and \$1.8 million, or 14.9% for the first nine months, as compared to the same periods in 2013, primarily due to an increased market value of assets under management and an increase in executor fees. Recurring fees, which

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generally comprise over 95% of the investment management and trust revenue, increased 11% for the third quarter and 12% for the first nine months of 2014, compared to the same periods of 2013. Most recurring fees earned for managing accounts are based on a percentage of market value on a monthly basis. While fees are based on market values, they typically do not fluctuate directly with the overall stock market, as accounts usually contain fixed income and equity asset classes, which generally react inversely to each other. Some revenues of the investment management and trust department, most notably executor,

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insurance, and some employee benefit plan-related fees, are non-recurring in nature and the timing of these revenues corresponds with the related administrative activities. Non-recurring fees, such as executor fees, increased \$65 thousand for the third quarter and \$354 thousand for the first nine months of 2014, compared to the same periods of 2013.

Service charges on deposit accounts decreased \$54 thousand, or 2.3%, in the third quarter of 2014, and increased \$28 thousand, or 0.4%, for the first nine months of 2014, as compared to the same periods in 2013. Service charge income is driven by transaction volume, which can fluctuate throughout the year. A significant component of service charges is related to fees earned on overdrawn checking accounts. While this source of income has experienced a modest increase, management expects it to experience a slight downward trend over time due to anticipated changes in customer behavior and increased regulatory restrictions.

Bankcard transaction revenue increased \$95 thousand, or 8.7%, in the third quarter of 2014, and \$398 thousand, or 13.0% for the first nine months of 2014, compared to the same periods in 2013, and primarily represents income the Bank derives from customers' use of debit cards. This category reflects a change in the manner in which bankcard revenue and expense are received and recorded by Bancorp, related to the selection of a new bankcard processor. In 2013, Bancorp moved processing of its bankcard transactions to a new vendor which provides more detailed information regarding related income and expense. As a result, beginning in mid-2013, information previously recorded as net revenue has been grossed up to more accurately reflect income and expense. This more detailed information is not available for prior periods and thus impacts the comparability of the information on an absolute basis for revenue and expense. It is, however, comparable on a net basis. Bankcard income, net of bankcard expenses which are recorded in data processing expenses, was \$757 thousand and \$771 thousand for the third quarter of 2014 and 2013, and was \$2.2 million for the first nine months of both 2014 and 2013. The net amounts in 2014 primarily reflect an increase in volume of transactions, offset by a decrease in the interchange rates received. Most of this revenue is interchange income based on rates set by service providers in a competitive market. Beginning in October 2011, this rate was set by the Federal Reserve for banks with over \$10 billion in assets. While this threshold indicates Bancorp will not be directly affected, this change has affected Bancorp and other similarly sized institutions as merchants gravitate to lower cost interchanges. Volume, which is dependent on consumer behavior, is expected to continue to increase slowly. However, management expects interchange rates to decrease, resulting in income from this source to remain consistent with levels experienced in 2013.

Mortgage banking revenue primarily includes gains on sales of mortgage loans. Bancorp's mortgage banking department originates residential mortgage loans to be sold in the secondary market. Interest rates on the loans sold are locked with the borrower and investor prior to closing the loans, thus Bancorp bears no interest rate risk related to these loans. The department offers conventional, VA and FHA financing, for purchases and refinances, as well as programs for first time home buyers. Interest rates on mortgage loans directly impact the volume of business transacted by the mortgage banking division. Mortgage banking revenue decreased \$354 thousand, or 35.6%, in the third quarter of 2014, and \$1.4 million, or 42.1%, for the first nine months of 2014, as compared to the same periods in 2013. Market rates for mortgage loans increased since the first quarter of 2013, resulting in lower volume of refinance activity in 2014 compared to 2013. Declines in refinance activity reflect national trends, as fewer borrowers remain in the marketplace with incentive to refinance.

In the second quarter of 2014, Bancorp sold securities with total par value of \$7.4 million, generating a net loss of \$9 thousand. These securities consisted of mortgage-backed securities with small remaining balances, obligations of state and political subdivisions, and agency securities. In the second quarter of

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2013, Bancorp sold obligations of state and political subdivisions with total par value of \$685 thousand, generating a loss of \$5 thousand. These sales were made in the ordinary course of portfolio management.

Brokerage commissions and fees increased \$83 thousand, or 18.2%, in the third quarter of 2014, and decreased \$187 thousand or 11.0% for the first nine months of 2014, as compared to the same periods in 2013, corresponding to overall brokerage volume. Brokerage commissions and fees earned consist primarily of stock, bond and mutual fund sales as well as wrap fees on accounts. Wrap fees are charges for investment programs that bundle together a suite of services, such as brokerage, advisory, research, and management, and based on a percentage of assets.

Bank Owned Life Insurance (BOLI) income totaled \$229 thousand and \$260 thousand for the third quarter of 2014 and 2013, respectively, and totaled \$699 thousand and \$771 thousand for the first nine months of 2014 and 2013, respectively, due to a lower interest crediting rate in 2014. BOLI represents the cash surrender value for life insurance policies on certain key employees who have provided consent for Bancorp to be the beneficiary of a portion of such policies. Any proceeds received under the policies and the related change in cash surrender value are recorded as non-interest income. This income helps offset the cost of various employee benefits.

The Oldham transaction was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration transferred were recorded at estimated fair value on the acquisition date. The fair value adjustments resulted in net assets acquired in excess of the consideration paid. Consequently, a non-taxable gain of \$449 thousand was recognized in the second quarter of 2013.

Other non-interest income decreased \$26 thousand, or 5.3%, in the third quarter of 2014, and increased \$103 thousand, or 8.4%, in the first nine months of 2014, as compared to the same periods in 2013, due to a variety of other factors, none of which are individually significant.

Total non-interest expenses increased \$1.1 million, or 6.5%, for the third quarter of 2014, and \$2.0 million, or 3.8%, for the first nine months of 2014, as compared to the same periods in 2013.

Salaries and employee benefits increased \$1.3 million, or 12.8%, for the third quarter of 2014, and \$3.5 million, or 11.6% for the first nine months of 2014, as compared to the same periods of 2013, largely due to increased staffing levels, higher incentive accruals, normal increases in salaries, higher health insurance costs and higher stock-based compensation expense. Increased staffing levels included senior staff with higher per capita salaries in investment management and trust, lending and operational functions as well as staff increases resulting from the Oldham transaction. At September 30, 2014, Bancorp had 527 full-time equivalent employees compared to 510 at September 30, 2013.

Net occupancy expense decreased \$100 thousand, or 6.6%, in the third quarter of 2014, and increased \$243 thousand, or 5.8% in the first nine months of 2014, as compared to the same periods of 2013. The increase for the first nine months of 2014 is largely due to a \$150 thousand non-recurring rent refund on a leased facility which lowered rent expense in the first quarter of 2013.

Data processing expense increased \$71 thousand, or 4.7% in the third quarter of 2014, and \$174 thousand, or 3.7% for the first nine months of 2014, compared to the same periods of 2013. As noted above during 2013, Bancorp began recording bankcard revenue and expense gross; this information was previously conveyed net. The reported expense related to bank card activity increased \$394 thousand for the first nine months

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of 2014 compared to the same period in 2013 due to this change. This is partially offset by decreases in ongoing computer equipment maintenance and depreciation expenses.

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Furniture and equipment expense was unchanged for the third quarter of 2014, and decreased \$50 thousand, or 5.9% for the first nine months of 2014, as compared to the same periods in 2013. These fluctuations relate to a variety of factors, none of which were individually significant.

FDIC insurance expense decreased \$8 thousand, or 2.3%, for the third quarter of 2014, and \$23 thousand or 2.2% for the first nine months of 2014, as compared to the same periods in 2013. The assessment is calculated by the FDIC and adjusted quarterly. The decline in expense is due primarily to a reduction in the assessment rate, which was driven by improved credit metrics.

Loss on other real estate owned (OREO) decreased \$468 thousand, or 98.5%, for the third quarter of 2014, as compared to the same period of 2013. Net gains on OREO totaled \$342 thousand for the first nine months of 2014 compared to losses totaling \$366 thousand for the same period in 2013. Bancorp liquidated several properties at prices greater than their carrying values in the first quarter of 2014 resulting in gains on foreclosed assets.

In connection with the Oldham acquisition in 2013, Bancorp incurred \$1.5 million in expenses related to executing the transaction and integrating and conforming acquired operations with and into Bancorp. Those expenses consisted largely of systems conversions and/or integration of operations.

A summary of acquisition costs included in the consolidated statement of income in the second quarter of 2013 follows:

| (in thousands) | Amount |
|--------------------------------|----------|
| Data conversion expenses | \$ 906 |
| Consulting | 262 |
| Salaries and employee benefits | 103 |
| Legal | 96 |
| All other | 181 |
| Total acquisition costs | \$ 1,548 |

Other non-interest expenses increased \$296 thousand or 10.1% in the third quarter of 2014, and \$383 thousand or 4.2% for the first nine months of 2014, as compared to the same periods in 2013. The increases are largely due to a one-time decrease of \$505 thousand in marketing expense related to a debit card rewards program in the third quarter of 2013. This category also includes legal and professional fees, advertising, printing, mail and telecommunications, none of which had individually significant variances.

Income Taxes

In the third quarter of 2014, Bancorp recorded income tax expense of \$4.7 million, compared to \$3.1 million for the same period in 2013. The effective rate for the three month period was 32.3% in 2014 and 28.7% in 2013. Bancorp recorded income tax expense of \$12.0 million for the first nine months of 2014, compared to \$8.8 million for the same period in 2013. The effective rate for the nine month period was 31.4% in 2014 and 29.8% in 2013. See Note 14 for an analysis of the difference between the statutory and effective tax rates.

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Commitments

Bancorp uses a variety of financial instruments in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. A discussion of Bancorp's commitments is included in Note 9.

Other commitments discussed in Bancorp's Annual Report on Form 10-K for the year ended December 31, 2013, have not materially changed since that report was filed, relative to qualitative and quantitative disclosures of fixed and determinable contractual obligations.

b) Financial Condition

Balance Sheet

Total assets increased \$18.6 million, or 0.8%, from \$2.39 billion on December 31, 2013 to \$2.41 billion on September 30, 2014. The most significant contributor to the increase was loans, which increased \$64.0 million during the first nine months of 2014. Securities available-for-sale decreased \$40.5 million, primarily a result of a decrease in the amount of short-term securities. These securities, with maturities of 30 days or less, totaled \$35 million and \$110 million for September 30, 2014 and December 31, 2013, respectively. Bancorp invests excess funds in short-term investment securities at each quarter end as part of a state tax minimization strategy. Mortgage loans held for sale increased \$2.3 million, cash and due from banks increased \$3.8 million, and federal funds sold decreased \$5.0 million. Other assets decreased \$6.0 million, driven primarily by a \$2.8 million decline in other real estate owned.

Total liabilities decreased \$3.4 million, or 0.2%, from \$2.160 billion December 31, 2013 to \$2.156 billion on September 30, 2014. Deposits increased \$26.9 million or 1.4%. Federal funds purchased decreased \$39.0 million, or 70.5% and Federal Home Loan Bank advances increased \$2.6 million or 7.5%. Bancorp utilizes short-term lines of credit to manage its overall liquidity position, and longer term FHLB advances to manage its overall interest rate risk position. Securities sold under agreement to repurchase increased \$4.3 million or 6.9%, while other liabilities increased \$1.8 million or 6.8%.

Table of Contents**Elements of Loan Portfolio**

The following table sets forth the major classifications of the loan portfolio.

| (in thousands) | | |
|--|---------------------|---------------------|
| Loans by Type | September 30, 2014 | December 31, 2013 |
| Commercial and industrial | \$ 550,487 | \$ 510,739 |
| Construction and development, excluding undeveloped land | 93,964 | 99,719 |
| Undeveloped land (1) | 27,177 | 29,871 |
| Real estate mortgage: | | |
| Commercial investment | 445,512 | 430,047 |
| Owner occupied commercial | 343,218 | 329,422 |
| 1-4 family residential | 192,282 | 183,700 |
| Home equity - first lien | 39,344 | 40,251 |
| Home equity - junior lien | 65,181 | 63,403 |
| Subtotal: Real estate mortgage | 1,085,537 | 1,046,823 |
| Consumer | 28,155 | 34,198 |
| Total Loans | \$ 1,785,320 | \$ 1,721,350 |

(1) Undeveloped land consists of land initially acquired for development by the borrower, but for which no development has taken place.

Bancorp occasionally enters into loan participation agreements with other banks to diversify credit risk. For certain sold participation loans, Bancorp has retained effective control of the loans, typically by restricting the participating institutions from pledging or selling their share of the loan without permission from Bancorp. US GAAP requires the participated portion of these loans to be recorded as secured borrowings. These participated loans are included in the commercial and industrial and real estate mortgage loan totals above, and a corresponding liability is recorded in other liabilities. At September 30, 2014 and December 31, 2013, the total participated portions of loans of this nature were \$8.3 million and \$9.4 million, respectively.

Table of Contents**Non-performing Loans and Assets**

Information summarizing non-performing assets, including non-accrual loans follows:

| (dollars in thousands) | September 30, 2014 | December 31, 2013 |
|---|--------------------|-------------------|
| Non-accrual loans | \$ 13,845 | \$ 15,259 |
| Troubled debt restructurings | 6,456 | 7,249 |
| Loans past due 90 days or more and still accruing | 207 | 437 |
| Non-performing loans | 20,508 | 22,945 |
| Foreclosed real estate | 2,768 | 5,592 |
| Non-performing assets | \$ 23,276 | \$ 28,537 |
| Non-performing loans as a percentage of total loans | 1.15% | 1.33% |
| Non-performing assets as a percentage of total assets | 0.97% | 1.19% |

The following table sets forth the major classifications of non-accrual loans:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|--|--------------------|-------------------|
| Non-accrual loans by type | | |
| Commercial and industrial | \$ 2,825 | \$ 847 |
| Construction and development, excluding undeveloped land | 516 | 26 |
| Undeveloped land | 6,722 | 7,340 |
| Real estate mortgage - commercial investment | 497 | 1,921 |
| Real estate mortgage - owner occupied commercial | 2,028 | 2,582 |
| Real estate mortgage - 1-4 family residential | 1,175 | 2,391 |
| Home equity and consumer loans | 82 | 152 |
| Total non-accrual loans | \$ 13,845 | \$ 15,259 |

Bancorp has two relationships in its primary market which accounts for \$8.9 million or 64% of total non-accrual loans at September 30, 2014. Each of the loans in these relationships is secured by acceptable collateral. The remaining balance of non-accrual loans, totaling \$4.9 million, is comprised of a number of borrowers with smaller balances. Each non-accrual loan is individually evaluated for impairment in conjunction with the overall allowance methodology.

c) **Liquidity**

The role of liquidity management is to ensure funds are available to meet depositors' withdrawal and borrowers' credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity is provided by short-term liquid assets that can be converted to cash, investment securities available-for-sale, various lines of credit

available to Bancorp, and the ability to attract funds from external sources, principally deposits.

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Management believes it has the ability to increase deposits at any time by offering rates slightly higher than the market rate.

Bancorp's most liquid assets are comprised of cash and due from banks, available-for-sale marketable investment securities and federal funds sold. Federal funds sold totaled \$31.3 million at September 30, 2014. These investments normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available-for-sale investment portfolio was \$449.6 million at September 30, 2014. The portfolio includes maturities of approximately \$52.9 million over the next twelve months, including \$35 million of short-term securities which matured in October 2014. Combined with federal funds sold, these offer substantial resources to meet either new loan demand or reductions in Bancorp's deposit funding base. Bancorp pledges portions of its investment securities portfolio to secure public fund deposits, cash balances of certain investment management and trust accounts, and securities sold under agreements to repurchase. At September 30, 2014, total investment securities pledged for these purposes comprised 47% of the available-for-sale investment portfolio, leaving \$240.3 million of unpledged securities.

Bancorp has a large base of core customer deposits, defined as demand, savings, and money market deposit accounts. At September 30, 2014, such deposits totaled \$1.69 billion and represented 84% of Bancorp's total deposits. Because these core deposits are less volatile and are often tied to other products of Bancorp through long lasting relationships they do not put heavy pressure on liquidity. However, many of Bancorp's overall deposit balances are historically high. When market conditions improve, these balances will likely decrease, putting some strain on Bancorp's liquidity position. As of September 30, 2014, Bancorp had only \$1.5 million or 0.1% of total deposits, in brokered deposits.

Other sources of funds available to meet daily needs include the sales of securities under agreements to repurchase. Also, Bancorp is a member of the FHLB of Cincinnati. As a member of the FHLB, Bancorp has access to credit products of the FHLB. Bancorp views these borrowings as a low cost alternative to other time deposits. At September 30, 2014, the amount of available credit from the FHLB totaled \$422.9 million. Additionally, Bancorp had available federal funds purchased lines with correspondent banks totaling \$85 million.

Bancorp's principal source of cash revenues is dividends paid to it as the sole shareholder of the Bank. At September 30, 2014, the Bank may pay up to \$43.7 million in dividends to Bancorp without regulatory approval subject to the ongoing capital requirements of the Bank.

d) Capital Resources

At September 30, 2014, stockholders' equity totaled \$251.4 million, an increase of \$22.0 million since December 31, 2013. See the Consolidated Statement of Changes in Stockholders' Equity for further detail of the changes in equity since the end of 2013. One component of equity is accumulated other comprehensive income (loss) which, for Bancorp, consists of net unrealized gains or losses on securities available-for-sale and hedging instruments, as well as a minimum pension liability, each net of taxes. Accumulated other comprehensive income was \$622 thousand at September 30, 2014 compared to a loss of \$2.2 million at December 31, 2013. The \$2.8 million increase is primarily a reflection of the positive effect of the decreasing interest rate environment during the first nine months of 2014 on the valuation of Bancorp's portfolio of securities available-for-sale.

Bank holding companies and their subsidiary banks are required by regulators to meet risk based capital standards. These standards, or ratios, measure the relationship of capital to a combination of balance sheet and off-balance sheet risks. The values of both balance sheet and off-balance sheet items are adjusted to

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reflect credit risks. To be categorized as well capitalized, the Bank must maintain a total risk-based capital ratio of at least 10%; a Tier 1 ratio of at least 6%; and a leverage ratio of at least 5%.

The following table sets forth Bancorp's and the Bank's risk based capital ratios as of September 30, 2014 and December 31, 2013.

| | September 30, 2014 | December 31, 2013 |
|--------------------------------------|-----------------------|----------------------|
| Total risk-based capital (1) | | |
| Consolidated | 13.92% | 13.54% |
| Bank | 13.53% | 12.90% |
| Tier I risk-based capital (1) | | |
| Consolidated | 12.67% | 12.29% |
| Bank | 12.28% | 11.65% |
| Leverage (2) | | |
| Consolidated | 10.38% | 9.75% |
| Bank | 10.07% | 9.24% |

(1) Ratio is computed in relation to risk-weighted assets.

(2) Ratio is computed in relation to average assets.

Bancorp intends to maintain capital ratios at these historically high levels at least until such time as the economy demonstrates sustained improvement and to remain well positioned to pursue expansion and other opportunities that may arise.

e) ***Non-GAAP Financial Measures***

In addition to capital ratios defined by banking regulators, Bancorp considers various ratios when evaluating capital adequacy, including tangible common equity to tangible assets, and tangible common equity per share, all of which are non-GAAP measures. Bancorp believes these ratios are important because of their widespread use by investors as means to evaluate capital adequacy, as they reflect the level of capital available to withstand unexpected market conditions. Because US GAAP does not include capital ratio measures, there are no US GAAP financial measures comparable to these ratios.

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The following table reconciles Bancorp's calculation of the measures to amounts reported under US GAAP.

| (in thousands, except per share data) | September 30, 2014 | | December 31, 2013 | |
|--|--------------------|-----------|-------------------|-----------|
| Total equity | \$ | 251,446 | \$ | 229,444 |
| Less core deposit intangible | | (1,878) | | (2,151) |
| Less goodwill | | (682) | | (682) |
| Tangible common equity | \$ | 248,886 | \$ | 226,611 |
| Total assets | \$ | 2,407,871 | \$ | 2,389,262 |
| Less core deposit intangible | | (1,878) | | (2,151) |
| Less goodwill | | (682) | | (682) |
| Total tangible assets | \$ | 2,405,311 | \$ | 2,386,429 |
| Total shareholders' equity to total assets | | 10.44% | | 9.60% |
| Tangible common equity ratio | | 10.35% | | 9.50% |
| Number of outstanding shares | | 14,704 | | 14,609 |
| Book value per share | \$ | 17.10 | \$ | 15.71 |
| Tangible common equity per share | | 16.93 | | 15.51 |

f) **Recently Issued Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which outlines a single comprehensive model for use in accounting for revenue arising from contracts with customers, and supersedes most current revenue recognition guidance. The ASU is effective for fiscal years and interim periods beginning after December 15, 2016. The adoption of ASU 2014-09 is not expected to have a significant impact on Bancorp's operations or financial statements.

In June 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings and Disclosures*, which changes the accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting. The ASU requires additional disclosures of transactions that are economically similar to repurchase agreements and information about collateral pledged in repurchase agreements. The ASU is effective for fiscal years and interim periods beginning after December 15, 2014. Because Bancorp does not utilize repurchase-to-maturity transactions or linked repurchase financings, the adoption of ASU 2014-11 is not expected to have an impact on Bancorp's operations or financial statements. Because Bancorp utilizes repurchase agreements, the adoption of ASU 2014-11 is expected to result in additional disclosures in Bancorp's financial statements.

Table of ContentsItem 3. Quantitative and Qualitative Disclosures about Market Risk

Information required by this item is included in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 4. Controls and Procedures

Bancorp maintains disclosure controls and procedures designed to ensure that it is able to collect the information it is required to disclose in reports it files with the Securities and Exchange Commission (SEC), and to record, process, summarize and report this information within the time periods specified in the rules and forms of the SEC. Based on their evaluation of Bancorp's disclosure controls and procedures as of the end of the quarterly period covered by this report, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that Bancorp is able to collect, process and disclose the information it is required to disclose in reports it files with the SEC within the required time periods.

Based on the evaluation of Bancorp's disclosure controls and procedures by the Chief Executive and Chief Financial Officers, there were no significant changes during the quarter ended September 30, 2014 in Bancorp's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Bancorp's internal control over financial reporting.

PART II OTHER INFORMATION

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

The following table shows information relating to the repurchase of shares of common stock by Bancorp during the three months ended September 30, 2014.

| | Total number of Shares Purchased (1) | Average price Paid Per Share | Total number of Shares Purchased as Part of Publicly Announced Plan (2) | Maximum Number of Shares that May Yet Be Purchased Under the Plan |
|----------------------------|--|------------------------------------|--|--|
| July 1 - July 31 | 3,592 | \$ 29.96 | | |
| August 1 - August 31 | 6,745 | 29.83 | | |
| September 1 - September 30 | 65 | 30.38 | | |
| Total | 10,402 | \$ 29.88 | | |

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(1) Activity represents shares of stock withheld to pay the exercise price of stock options or to pay taxes due upon the exercise of stock appreciation rights. This activity has no impact on the number of shares that may be purchased under a Board-approved plan.

(2) Since 2008, there has been no share buyback plan.

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Item 6. Exhibits

The following exhibits are filed or furnished as a part of this report:

| Exhibit Number | Description of exhibit |
|---------------------------|--|
| 31.1 | Certifications pursuant to Section 302 of the Sarbanes-Oxley Act by David P. Heintzman |
| 31.2 | Certifications pursuant to Section 302 of the Sarbanes-Oxley Act by Nancy B. Davis |
| 32 | Certifications pursuant to 18 U.S.C. Section 1350 |
| 101 | The following financial statements from the Stock Yards Bancorp, Inc. September 30, 2014 Quarterly Report on Form 10-Q, filed on November 5, 2014, formatted in eXtensible Business Reporting Language (XBRL): |
| (1) | Consolidated Balance Sheets |
| (2) | Consolidated Statements of Income |
| (3) | Consolidated Statements of Comprehensive Income |
| (4) | Consolidated Statement of Changes in Stockholders' Equity |
| (5) | Consolidated Statements of Cash Flows |
| (6) | Notes to Consolidated Financial Statements |

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SIGNATURES

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

STOCK YARDS BANCORP, INC.

Date: November 5, 2014

By: */s/ David P. Heintzman*
David P. Heintzman, Chairman

and Chief Executive Officer

Date: November 5, 2014

By: */s/ Nancy B. Davis*
Nancy B. Davis, Executive Vice President,

Treasurer and Chief Financial Officer