

SUMMIT FINANCIAL GROUP INC
Form 10-Q
August 04, 2016
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 June 30, 2016

or
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from _____ to _____.

Commission File Number 0-16587

Summit Financial Group, Inc.
(Exact name of registrant as specified in its charter)
West Virginia 55-0672148
(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)
300 North Main Street
Moorefield, West Virginia 26836
(Address of principal executive offices) (Zip Code)
(304) 530-1000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities and 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 definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

Yes No

Indicate the number of shares outstanding of each of the issuer’s classes of Common Stock as of the latest practicable date.

Common Stock, \$2.50 par value
10,692,320 shares outstanding as of July 31, 2016

Table of Contents

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated balance sheets June 30, 2016 (unaudited), December 31, 2015, and June 30, 2015 (unaudited)	<u>4</u>
Consolidated statements of income for the three months and six months ended June 30, 2016 and 2015 (unaudited)	<u>5</u>
Consolidated statements of comprehensive income for the three months and six months ended June 30, 2016 and 2015 (unaudited)	<u>6</u>
Consolidated statements of shareholders' equity for the six months ended June 30, 2016 and 2015 (unaudited)	<u>7</u>
Consolidated statements of cash flows for the six months ended June 30, 2016 and 2015 (unaudited)	<u>8</u>
Notes to consolidated financial statements (unaudited)	<u>10</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>44</u>
Item 3. Quantitative and Qualitative Disclosures about Market Risk	<u>54</u>
Item 4. Controls and Procedures	<u>55</u>

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings	<u>56</u>
Item 1A. Risk Factors	<u>56</u>
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	None
Item 3. Defaults upon Senior Securities	None
Item 4. Mine Safety Disclosures	None
Item 5. Other Information	None
Item 6. Exhibits	<u>56</u>

SIGNATURES	<u>57</u>
------------	-----------

EXHIBIT INDEX	<u>58</u>
---------------	-----------

Consolidated Balance Sheets (unaudited)

	June 30, 2016 (unaudited)	December 31, 2015 (*)	June 30, 2015 (unaudited)
Dollars in thousands			
ASSETS			
Cash and due from banks	\$4,161	\$3,625	\$3,988
Interest bearing deposits with other banks	8,897	5,862	9,274
Cash and cash equivalents	13,058	9,487	13,262
Securities available for sale	261,633	280,792	276,661
Other investments	12,233	8,949	8,583
Loans held for sale, net	245	779	—
Loans, net	1,166,723	1,079,331	1,064,472
Property held for sale	23,425	25,567	31,500
Premises and equipment, net	21,405	21,572	20,490
Accrued interest receivable	5,352	5,544	5,473
Intangible assets	7,398	7,498	7,598
Cash surrender value of life insurance policies	38,246	37,732	37,222
Other assets	15,463	15,178	14,708
Total assets	\$1,565,181	\$1,492,429	\$1,479,969
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Deposits			
Non interest bearing	\$120,845	\$119,010	\$113,256
Interest bearing	975,700	947,699	940,054
Total deposits	1,096,545	1,066,709	1,053,310
Short-term borrowings	205,553	171,394	174,599
Long-term borrowings	74,625	75,581	76,536
Subordinated debentures	—	—	2,500
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	18,200	15,412	13,363
Total liabilities	1,414,512	1,348,685	1,339,897
Commitments and Contingencies			
Shareholders' Equity			
Preferred stock, \$1.00 par value, authorized 250,000 shares	—	—	—
Common stock and related surplus, \$2.50 par value; authorized 20,000,000 shares; issued: 10,856,356 shares 2016, 10,853,566 shares December 2015 and 10,843,676 shares June 2015; outstanding: 10,692,320 shares 2016, 10,671,744 shares December 2015 and 10,843,676 shares June 2015	45,967	45,741	45,563
Unallocated common stock held by Employee Stock Ownership Plan - 2016 - 164,036 shares, December 2015 - 181,822 shares	(1,772)	(1,964)	—
Retained earnings	106,594	100,423	94,318
Accumulated other comprehensive income	(120)	(456)	191
Total shareholders' equity	150,669	143,744	140,072

Total liabilities and shareholders' equity	\$1,565,181	\$ 1,492,429	\$1,479,969
--	-------------	--------------	-------------

(*) - December 31, 2015 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

Table of Contents

4

Consolidated Statements of Income (unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Dollars in thousands, except per share amounts				
Interest income				
Interest and fees on loans				
Taxable	\$13,488	\$12,854	\$26,779	\$25,588
Tax-exempt	134	118	280	233
Interest and dividends on securities				
Taxable	1,063	1,092	2,146	2,368
Tax-exempt	594	593	1,236	1,211
Interest on interest bearing deposits with other banks	4	1	7	2
Total interest income	15,283	14,658	30,448	29,402
Interest expense				
Interest on deposits	2,154	2,074	4,324	4,145
Interest on short-term borrowings	419	126	659	238
Interest on long-term borrowings and subordinated debentures	976	1,000	1,952	2,041
Total interest expense	3,549	3,200	6,935	6,424
Net interest income	11,734	11,458	23,513	22,978
Provision for loan losses	250	500	500	750
Net interest income after provision for loan losses	11,484	10,958	23,013	22,228
Other income				
Insurance commissions	1,090	1,080	2,014	2,208
Service fees related to deposit accounts	1,059	1,072	2,038	2,048
Realized securities gains	383	170	775	650
Bank owned life insurance income	258	261	514	522
Other	255	277	511	571
Total other income	3,045	2,860	5,852	5,999
Other expense				
Salaries, commissions, and employee benefits	4,764	4,442	9,446	8,629
Net occupancy expense	512	489	1,051	988
Equipment expense	686	560	1,342	1,095
Professional fees	429	372	901	707
Amortization of intangibles	50	50	100	100
FDIC premiums	300	320	600	650
Merger expense	153	—	265	—
Foreclosed properties expense	93	158	217	366
(Gain) loss on sale of foreclosed properties	(276)) 103	(282)) 253
Write-down of foreclosed properties	259	160	369	732
Other	1,467	1,407	2,982	2,746
Total other expense	8,437	8,061	16,991	16,266
Income before income taxes	6,092	5,757	11,874	11,961
Income tax expense	1,849	1,747	3,569	3,667
Net Income	\$4,243	\$4,010	\$8,305	\$8,294
Basic earnings per common share	\$0.40	\$0.38	\$0.78	\$0.85
Diluted earnings per common share	\$0.40	\$0.38	\$0.78	\$0.78

See Notes to Consolidated Financial Statements

Table of Contents

5

Consolidated Statement of Comprehensive Income (unaudited)

	For the Three Months Ended June 30,	
Dollars in thousands	2016	2015
Net income	\$4,243	\$4,010
Other comprehensive income (loss):		
Net unrealized gain (loss) on cashflow hedge of:		
2016 - (\$759), net of deferred taxes of (\$281); 2015 - \$379, net of deferred taxes of \$140	(478) 239
Net unrealized gain (loss) on available for sale debt securities of:		
2016 - \$2,570, net of deferred taxes of \$951 and reclassification adjustment for net realized gains included in net income of \$383; 2015 - (\$2,683), net of deferred taxes of (\$993) and reclassification adjustment for net realized gains included in net income of \$170	1,619	(1,690)
Total comprehensive income	\$5,384	\$2,559

	For the Six Months Ended June 30,	
Dollars in thousands	2016	2015
Net income	\$8,305	\$8,294
Other comprehensive income (loss):		
Net unrealized loss on cashflow hedge of:		
2016 - (\$3,079), net of deferred taxes of (\$1,139); 2015 - (\$1,030), net of deferred taxes of (\$381)	(1,940) (649)
Net unrealized gain (loss) on available for sale debt securities of:		
2016 - \$3,613, net of deferred taxes of \$1,337 and reclassification adjustment for net realized gains included in net income of \$775; 2015 - (\$1,956), net of deferred taxes of (\$724) and reclassification adjustment for net realized gains included in net income of \$650	2,276	(1,232)
Total comprehensive income	\$8,641	\$6,413

See Notes to Consolidated Financial Statements

Table of Contents

6

Consolidated Statements of Shareholders' Equity (unaudited)

Dollars in thousands, except per share amounts	Series 2009 Preferred Stock and Related Surplus	Series 2011 Preferred Stock and Related Surplus	Common Stock and Related Surplus	Unallocated Common Stock Held by ESOP	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2015	\$—	\$—	\$45,741	\$ (1,964)	\$100,423	\$ (456)	\$143,744
Six Months Ended June 30, 2016							
Comprehensive income:							
Net income	—	—	—	—	8,305	—	8,305
Other comprehensive income	—	—	—	—	—	336	336
Total comprehensive income	—	—	—	—	—	—	8,641
Stock compensation expense	—	—	100	—	—	—	100
Unallocated ESOP shares committed to be released - 17,786 shares	—	—	79	192	—	—	271
Common stock issuances from reinvested dividends	—	—	47	—	(47)	—	—
Common stock cash dividends declared (\$0.20 per share)	—	—	—	—	(2,087)	—	(2,087)
Balance, June 30, 2016	\$—	\$—	\$45,967	\$ (1,772)	\$106,594	\$ (120)	\$150,669
Balance, December 31, 2014	\$3,419	\$5,764	\$32,670	\$—	\$87,719	\$2,072	\$131,644
Six Months Ended June 30, 2015							
Comprehensive income:							
Net income	—	—	—	—	8,294	—	8,294
Other comprehensive loss	—	—	—	—	—	(1,881)	(1,881)
Total comprehensive income	—	—	—	—	—	—	6,413
Stock compensation expense	—	—	50	—	—	—	50
Conversion of Series 2009 Preferred Stock to common stock	(3,419)	—	3,405	—	—	—	(14)
Conversion of Series 2011 Preferred Stock to common stock	—	(5,764)	5,749	—	—	—	(15)
Issuance of 496,335 shares of common stock	—	—	4,769	—	—	—	4,769
Repurchase and retirement of 100,000 shares of common stock	—	—	(1,080)	—	—	—	(1,080)
Common stock cash dividends declared (\$0.16 per share)	—	—	—	—	(1,695)	—	(1,695)
Balance, June 30, 2015	\$—	\$—	\$45,563	\$—	\$94,318	\$191	\$140,072

See Notes to Consolidated Financial Statements

Table of Contents

7

Consolidated Statements of Cash Flows (unaudited)

Dollars in thousands	Six Months Ended	
	June 30, 2016	June 30, 2015
Cash Flows from Operating Activities		
Net income	\$8,305	\$8,294
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	587	523
Provision for loan losses	500	750
Stock compensation expense	100	50
Deferred income tax expense (benefit)	(159)	360
Loans originated for sale	(3,727)	(1,417)
Proceeds from loans sold	4,260	1,944
Securities gains	(775)	(650)
(Gain) loss on disposal of assets	(312)	255
Write down of foreclosed properties	369	732
Amortization of securities premiums (accretion of discounts), net	2,210	2,603
Amortization of intangibles, net	106	106
Decrease in accrued interest receivable	193	365
Increase in cash surrender value of bank owned life insurance	(514)	(522)
Increase in other assets	(1,076)	(847)
Decrease in other liabilities	(1,274)	(296)
Net cash provided by operating activities	8,793	12,250
Cash Flows from Investing Activities		
Proceeds from maturities and calls of securities available for sale	55	615
Proceeds from sales of securities available for sale	52,052	40,593
Principal payments received on securities available for sale	17,946	20,380
Purchases of securities available for sale	(48,716)	(59,324)
Purchases of other investments	(9,531)	(6,072)
Proceeds from sales & redemptions of other investments	6,247	3,672
Net loans made to customers	(86,808)	(46,372)
Purchases of premises and equipment	(433)	(954)
Proceeds from disposal of premises and equipment	43	—
Proceeds from sales of other repossessed assets & property held for sale	2,973	6,482
Net cash (used in) investing activities	(66,172)	(40,980)
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposit, NOW and savings accounts	31,169	(9,902)
Net increase (decrease) in time deposits	(1,333)	1,869
Net increase in short-term borrowings	34,158	50,966
Repayment of long-term borrowings	(956)	(954)
Repayment of subordinated debt	—	(14,300)
Net proceeds from issuance of common stock	—	4,741
Retirement of common stock	—	(1,080)
Dividends paid on common stock	(2,088)	(1,667)
Dividends paid on preferred stock	—	(191)
Net cash provided by financing activities	60,950	29,482
Increase in cash and cash equivalents	3,571	752
Cash and cash equivalents:		

Beginning	9,487	12,510
Ending	\$13,058	\$13,262

(Continued)

See Notes to Consolidated Financial Statements

Table of Contents

8

Consolidated Statements of Cash Flows (unaudited) - continued

Dollars in thousands	Six Months Ended	
	June 30, 2016	June 30, 2015
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$6,999	\$ 6,456
Income taxes	\$3,814	\$ 3,632
 Supplemental Schedule of Noncash Investing and Financing Activities		
Real property and other assets acquired in settlement of loans	\$ 172	\$ 713

See Notes to Consolidated Financial Statements

Table of Contents

9

NOTE 1. BASIS OF PRESENTATION

We, Summit Financial Group, Inc. and subsidiaries, prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for annual year end financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature.

The presentation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates.

The results of operations for the quarter and six months ended June 30, 2016 are not necessarily indicative of the results to be expected for the full year. The consolidated financial statements and notes included herein should be read in conjunction with our 2015 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2015 and June 30, 2015, as previously presented, have been reclassified to conform to current year classifications.

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) - Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 was effective for us January 1, 2016, and did not have a significant impact on our financial statements.

ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30) - Simplifying the Presentation of Debt Issuance Costs specifies that debt issuance costs related to a recognized liability are to be reported in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. ASU 2015-03 was effective for us January 1, 2016 and did not have a material impact on our financial statements.

The guidance of ASU No. 2015-03 did not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance for debt issuance costs related to line-of-credit arrangements within the update, in ASU 2015-15, Interest—Imputation of Interest (Subtopic 835-30) - Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting), issued in August 2015, the SEC staff stated that they would not object to any entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.

ASU 2015-16, Business Combinations (Topic 805) – Simplifying the Accounting for Measurement-Period Adjustments requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at

the acquisition date reflecting the portion of the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. Under previous guidance, adjustments to provisional amounts identified during the measurement period are to be recognized retrospectively. ASU 2015-16 became effective for us on January 1, 2016 and did not have a significant impact on our financial statements.

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to

Table of Contents

10

be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-01 will be effective for us on January 1, 2018 and is not expected to have a significant impact on our financial statements.

ASU 2016-02, Leases (Topic 842) will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model and ASC Topic 606, Revenue from Contracts with Customers. ASU 2016-02 will be effective for us on January 1, 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. We are currently evaluating the potential impact of ASU 2016-02 on our financial statements.

ASU 2016-05, Derivatives and Hedging (Topic 815) Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships, clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under ASC Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. ASU 2016-05 will be effective for us on January 1, 2017 and is not expected to have a significant impact on our financial statements.

ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, requires that all excess tax benefits and tax deficiencies related to share-based payment awards be recognized as income tax expense or benefit in the income statement during the period in which they occur. Previously, such amounts were recorded in the pool of excess tax benefits included in additional paid-in capital, if such pool was available. Because excess tax benefits are no longer recognized in additional paid-in capital, the assumed proceeds from applying the treasury stock method when computing earnings per share should exclude the amount of excess tax benefits that would have previously been recognized in additional paid-in capital. Additionally, excess tax benefits should be classified along with other income tax cash flows as an operating activity rather than a financing activity, as was previously the case. ASU 2016-09 also provides that an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. ASU 2016-09 changes the threshold to qualify for equity classification (rather than as a liability) to permit withholding up to the maximum statutory tax rates (rather than the minimum as was previously the case) in the applicable jurisdictions. ASU 2016-09 will be effective on January 1, 2017 and is not expected to have a significant impact on our financial statements.

ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 will be effective on January 1, 2020. We are currently evaluating the potential impact of ASU 2016-13 on our financial statements.

NOTE 3. FAIR VALUE MEASUREMENTS

ASC Topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Accordingly, securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, and impaired loans held for investment. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-Sale Securities: Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities.

Derivative Financial Instruments: Derivative financial instruments are recorded at fair value on a recurring basis. Fair value measurement is based on pricing models run by a third-party, utilizing observable market-based inputs. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. As a result, we classify interest rate swaps as Level 2.

Loans Held for Sale: Loans held for sale are carried at the lower of cost or market value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, we classify loans subject to nonrecurring fair value adjustments as Level 2.

Loans: We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the original contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, Accounting by Creditors for Impairment of a Loan. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the discounted cash flows or collateral value exceeds the recorded investments in such loans. These loans are carried at recorded loan investment, and therefore are not included in the following tables of loans measured at fair value. Impaired loans internally graded as substandard, doubtful, or loss are evaluated using the fair value of collateral method. All other impaired loans are measured for impairment using the discounted cash flows method. In accordance with ASC Topic 310, impaired loans where an allowance is established based on the fair value of collateral requires classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When a current appraised value is not available and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

When impaired loans are deemed required to be included in the fair value hierarchy, management immediately begins the process of evaluating the estimated fair value of the underlying collateral to determine if a related specific

allowance for loan losses or charge-off is necessary. Current appraisals are ordered once a loan is deemed impaired if the existing appraisal is more than twelve months old, or more frequently if there is known deterioration in value. For recently identified impaired loans, a current appraisal may not be available at the financial statement date. Until the current appraisal is obtained, the original appraised value is discounted, as appropriate, to compensate for the estimated depreciation in the value of the loan's underlying collateral since the date of the original appraisal. Such discounts are generally estimated based upon management's knowledge of sales of similar collateral within the applicable market area and its knowledge of other real estate market-related data as well as general economic trends. When a new appraisal is received (which generally are received within 3 months of a loan being identified as impaired), management then re-evaluates the fair value of the collateral and adjusts any specific allocated allowance for loan losses, as appropriate. In addition, management also assigns a discount of 7–10% for the estimated costs to sell the collateral.

Table of Contents

12

Foreclosed properties: Foreclosed properties consists of real estate acquired in foreclosure or other settlement of loans. Such assets are carried on the balance sheet at the lower of the investment in the real estate or its fair value less estimated selling costs. The fair value of foreclosed properties is determined on a nonrecurring basis generally utilizing current appraisals performed by an independent, licensed appraiser applying an income or market value approach using observable market data (Level 2). Updated appraisals of foreclosed properties are generally obtained if the existing appraisal is more than 18 months old or more frequently if there is a known deterioration in value. However, if a current appraisal is not available, the original appraised value is discounted, as appropriate, to compensate for the estimated depreciation in the value of the real estate since the date of its original appraisal. Such discounts are generally estimated based upon management's knowledge of sales of similar property within the applicable market area and its knowledge of other real estate market-related data as well as general economic trends (Level 3). Upon foreclosure, any fair value adjustment is charged against the allowance for loan losses. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest expense in the consolidated statements of income.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

Dollars in thousands	Balance at June 30, 2016	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 17,885	\$-17,885	\$—	
Mortgage backed securities:				
Government sponsored agencies	139,365	—139,365	—	
Nongovernment sponsored entities	6,285	—6,285	—	
State and political subdivisions	250	—250	—	
Corporate debt securities	19,528	—8,276	11,252	
Other equity securities	77	—77	—	
Tax-exempt state and political subdivisions	78,243	—78,243	—	
Total available for sale securities	\$261,633	\$-250,381	\$11,252	
Derivative financial liabilities				
Interest rate swaps	\$9,408	\$-9,408	\$—	
Dollars in thousands	Balance at December 31, 2015	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 21,475	\$-21,475	\$—	
Mortgage backed securities:				
Government sponsored agencies	146,734	—146,734	—	
Nongovernment sponsored entities	7,885	—7,885	—	
State and political subdivisions	1,953	—1,953	—	
Corporate debt securities	14,226	—8,367	5,859	
Other equity securities	77	—77	—	
Tax-exempt state and political subdivisions	88,442	—88,442	—	
Total available for sale securities	\$ 280,792	\$-274,933	\$5,859	

Derivative financial liabilities

Interest rate swaps	\$ 5,072	\$-\$5,072	\$—
---------------------	----------	------------	-----

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis are included in the table below.

Table of Contents

13

Dollars in thousands	Balance at June 30, 2016	Fair Value Measurements Using:	
		Level 1	Level 2 Level 3
Residential mortgage loans held for sale	\$245	\$-\$245	\$—
Collateral-dependent impaired loans			
Commercial	\$—	\$-\$—	\$—
Commercial real estate	400	—400	—
Construction and development	1,013	—1,013	—
Residential real estate	121	—121	—
Total collateral-dependent impaired loans	\$1,534	\$-\$1,534	\$—
Foreclosed properties			
Commercial real estate	\$976	\$-\$552	\$424
Construction and development	20,267	—19,546	721
Residential real estate	340	—340	—
Total foreclosed properties	\$21,583	\$-\$20,438	\$1,145

Dollars in thousands	Balance at December 31, 2015	Fair Value Measurements Using:	
		Level 1	Level 2 Level 3
Residential mortgage loans held for sale	\$ 779	\$-\$779	\$—
Collateral-dependent impaired loans			
Commercial	\$ —	—\$—	\$—
Commercial real estate	627	—	627
Construction and development	1,054	—	1,054
Residential real estate	279	—279	—
Total collateral-dependent impaired loans	\$ 1,960	\$-\$279	\$1,681
Foreclosed properties			
Commercial real estate	\$ 1,103	\$-\$1,103	\$—
Construction and development	18,477	—18,419	58
Residential real estate	314	—314	—
Total foreclosed properties	\$ 19,894	\$-\$19,836	\$58

ASC Topic 825, Financial Instruments, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The following summarizes the methods and significant assumptions we used in estimating our fair value disclosures for financial instruments.

Cash and cash equivalents: The carrying values of cash and cash equivalents approximate their estimated fair value.

Interest bearing deposits with other banks: The carrying values of interest bearing deposits with other banks approximate their estimated fair values.

Federal funds sold: The carrying values of Federal funds sold approximate their estimated fair values.

Securities: Estimated fair values of securities are based on quoted market prices, where available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable securities.

Loans held for sale: The carrying values of loans held for sale approximate their estimated fair values.

Loans: The estimated fair values for loans are computed based on scheduled future cash flows of principal and interest, discounted at interest rates currently offered for loans with similar terms to borrowers of similar credit quality. No prepayments of principal are assumed.

Table of Contents

14

Accrued interest receivable and payable: The carrying values of accrued interest receivable and payable approximate their estimated fair values.

Deposits: The estimated fair values of demand deposits (i.e. non-interest bearing checking, NOW, money market and savings accounts) and other variable rate deposits approximate their carrying values. Fair values of fixed maturity deposits are estimated using a discounted cash flow methodology at rates currently offered for deposits with similar remaining maturities. Any intangible value of long-term relationships with depositors is not considered in estimating the fair values disclosed.

Short-term borrowings: The carrying values of short-term borrowings approximate their estimated fair values.

Long-term borrowings: The fair values of long-term borrowings are estimated by discounting scheduled future payments of principal and interest at current rates available on borrowings with similar terms.

Subordinated debentures: The carrying values of subordinated debentures approximate their estimated fair values.

Subordinated debentures owed to unconsolidated subsidiary trusts: The carrying values of subordinated debentures owed to unconsolidated subsidiary trusts approximate their estimated fair values.

Derivative financial instruments: The fair value of the interest rate swaps is valued using independent pricing models.

Off-balance sheet instruments: The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit standing of the counter parties. The amounts of fees currently charged on commitments and standby letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values are not shown below.

The carrying values and estimated fair values of our financial instruments are summarized below:

Dollars in thousands	June 30, 2016		December 31, 2015	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	\$13,058	\$13,058	\$9,487	\$9,487
Securities available for sale	261,633	261,633	280,792	280,792
Other investments	12,233	12,233	8,949	8,949
Loans held for sale, net	245	245	779	779
Loans, net	1,166,723	1,177,526	1,079,331	1,084,955
Accrued interest receivable	5,352	5,352	5,544	5,544
	\$1,459,244	\$1,470,047	\$1,384,882	\$1,390,506
Financial liabilities				
Deposits	\$1,096,545	\$1,108,899	\$1,066,709	\$1,077,510
Short-term borrowings	205,553	205,553	171,394	171,394
Long-term borrowings	74,625	78,896	75,581	80,506
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589	19,589
Accrued interest payable	762	762	826	826
Derivative financial liabilities	9,408	9,408	5,072	5,072
	\$1,406,482	\$1,423,107	\$1,339,171	\$1,354,897

[Table of Contents](#)

NOTE 4. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

Dollars in thousands, except per share amounts	For the Three Months Ended June 30, 2016			2015		
	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share
Net income	\$4,243			\$4,010		
Basic EPS	\$4,243	10,681,995	\$0.40	\$4,010	10,667,892	\$0.38
Effect of dilutive securities:						
Stock options		9,008			8,582	
Stock appreciation rights		10,014			—	
Diluted EPS	\$4,243	10,701,017	\$0.40	\$4,010	10,676,474	\$0.38

Dollars in thousands, except per share amounts	For the Six Months Ended June 30, 2016			2015		
	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share
Net income	\$8,305			\$8,294		
Basic EPS	\$8,305	10,676,925	\$0.78	\$8,294	9,747,042	\$0.85
Effect of dilutive securities:						
Stock options		8,365			8,574	
Stock appreciation rights		—			—	
Series 2011 convertible preferred stock	—	—		—	575,953	
Series 2009 convertible preferred stock	—	—		—	253,842	
Diluted EPS	\$8,305	10,685,290	\$0.78	\$8,294	10,585,411	\$0.78

Stock option and stock appreciation right (SAR) grants and the convertible preferred shares are disregarded in this computation if they are determined to be anti-dilutive. Our anti-dilutive stock options at June 30, 2016 and 2015 totaled 57,000 shares and 136,900 shares, respectively, and our anti-dilutive SARs for the six months ended June 30, 2016 and both the three and six months ended June 30, 2015 were 166,717.

[Table of Contents](#)

NOTE 5. SECURITIES

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at June 30, 2016, December 31, 2015, and June 30, 2015 are summarized as follows:

Dollars in thousands	June 30, 2016			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Available for Sale				
Taxable debt securities				
U.S. Government and agencies and corporations	\$16,815	\$1,123	\$53	\$17,885
Residential mortgage-backed securities:				
Government-sponsored agencies	136,821	2,862	318	139,365
Nongovernment-sponsored entities	6,265	61	41	6,285
State and political subdivisions				
Water and sewer revenues	250	—	—	250
Corporate debt securities	19,928	60	460	19,528
Total taxable debt securities	180,079	4,106	872	183,313
Tax-exempt debt securities				
State and political subdivisions				
General obligations	41,282	2,788	4	44,066
Water and sewer revenues	7,535	360	—	7,895
Lease revenues	6,267	458	—	6,725
Sales tax revenues	2,889	182	—	3,071
Other revenues	15,542	944	—	16,486
Total tax-exempt debt securities	73,515	4,732	4	78,243
Equity securities	77	—	—	77
Total available for sale securities	\$253,671	\$8,838	\$876	\$261,633
December 31, 2015				
Dollars in thousands	AmortizedUnrealized			Estimated Fair Value
	Cost	Gains	Losses	
Available for Sale				
Taxable debt securities				
U.S. Government and agencies and corporations	\$20,461	\$1,063	\$49	\$21,475
Residential mortgage-backed securities:				
Government-sponsored agencies	145,586	1,943	795	146,734
Nongovernment-sponsored entities	7,836	82	33	7,885
State and political subdivisions				
Water and sewer revenues	250	—	—	250
Other revenues	1,729	—	26	1,703
Corporate debt securities	14,494	—	268	14,226
Total taxable debt securities	190,356	3,088	1,171	192,273
Tax-exempt debt securities				
State and political subdivisions				
General obligations	52,490	1,767	41	54,216
Water and sewer revenues	7,614	172	—	7,786
Lease revenues	8,671	187	1	8,857
Special tax revenues	4,532	72	—	4,604
Other revenues	12,703	290	14	12,979

Total tax-exempt debt securities	86,010	2,488	56	88,442
Equity securities	77	—	—	77
Total available for sale securities	\$276,443	\$5,576	\$1,227	\$280,792

Table of Contents

17

Dollars in thousands	June 30, 2015			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Available for Sale				
Taxable debt securities:				
U.S. Government and agencies and corporations	\$24,336	\$1,093	\$40	\$25,389
Residential mortgage-backed securities:				
Government-sponsored agencies	150,675	3,005	737	152,943
Nongovernment-sponsored agencies	9,880	116	34	9,962
State and political subdivisions:				
Water and sewer revenues	500	3	—	503
Lottery/casino revenues	1,218	—	37	1,181
Corporate debt securities	11,896	—	90	11,806
Total taxable debt securities	198,505	4,217	938	201,784
Tax-exempt debt securities:				
State and political subdivisions:				
General obligations	49,067	1,463	586	49,944
Water and sewer revenues	7,982	52	33	8,001
Special tax revenues	4,548	30	72	4,506
Lottery/casino revenues	3,576	58	74	3,560
Other revenues	8,729	162	32	8,859
Total tax-exempt debt securities	73,902	1,765	797	74,870
Equity securities	7	—	—	7
Total available for sale securities	\$272,414	\$5,982	\$1,735	\$276,661

The below information is relative to the five states where issuers with the highest volume of state and political subdivision securities held in our portfolio are located. We own no such securities of any single issuer which we deem to be a concentration.

Dollars in thousands	June 30, 2016			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Illinois	\$12,925	\$781	\$4	\$13,702
Michigan	11,216	609	—	11,825
West Virginia	8,732	213	—	8,945
Texas	6,132	461	—	6,593
Indiana	4,724	361	—	5,085

Management performs pre-purchase and ongoing analysis to confirm that all investment securities meet applicable credit quality standards. Prior to July 1, 2013, we principally used credit ratings from Nationally Recognized Statistical Rating Organizations (“NRSROs”) to support analyses of our portfolio of securities issued by state and political subdivisions, as we generally do not purchase securities that are rated below the six highest NRSRO rating categories. Beginning July 1, 2013, in addition to considering a security’s NRSRO rating, we now also assess or confirm through an internal review of an issuer’s financial information and other applicable information that: 1) the issuer’s risk of default is low; 2) the characteristics of the issuer’s demographics and economic environment are satisfactory; and 3) the issuer’s budgetary position and stability of tax or other revenue sources are sound.

The maturities, amortized cost and estimated fair values of securities at June 30, 2016, are summarized as follows:

Dollars in thousands	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 56,757	\$ 57,762
Due from one to five years	91,359	93,272
Due from five to ten years	16,653	17,304
Due after ten years	88,825	93,218
Equity securities	77	77
	\$ 253,671	\$ 261,633

Table of Contents

18

The proceeds from sales, calls and maturities of available for sale securities, including principal payments received on mortgage-backed obligations, and the related gross gains and losses realized, for the six months ended June 30, 2016 are as follows:

Dollars in thousands	Proceeds from			Gross realized	
	Sales	Calls and Maturities	Principal Payments	Gains	Losses
Securities available for sale	\$52,052	\$ 55	\$ 17,946	\$950	\$ 175

We held 38 available for sale securities having an unrealized loss at June 30, 2016. We do not intend to sell these securities, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost bases. We believe that this decline in value is primarily attributable to the lack of market liquidity and to changes in market interest rates and not due to credit quality. Accordingly, no other-than-temporary impairment charge to earnings is warranted at this time.

Provided below is a summary of securities available for sale which were in an unrealized loss position at June 30, 2016 and December 31, 2015.

Dollars in thousands	June 30, 2016					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Temporarily impaired securities						
Taxable debt securities						
U.S. Government agencies and corporations	\$878	\$ (5)	\$2,911	\$ (48)	\$3,789	\$ (53)
Residential mortgage-backed securities:						
Government-sponsored agencies	17,694	(206)	11,424	(112)	29,118	(318)
Nongovernment-sponsored entities	—	—	3,723	(41)	3,723	(41)
Corporate debt securities	4,082	(184)	3,134	(276)	7,216	(460)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	1,128	(4)	—	—	1,128	(4)
Total temporarily impaired securities	23,782	(399)	21,192	(477)	44,974	(876)
Total other-than-temporarily impaired securities	—	—	—	—	—	—
Total	\$23,782	\$ (399)	\$21,192	\$ (477)	\$44,974	\$ (876)

Table of Contents

Dollars in thousands	December 31, 2015					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Temporarily impaired securities						
Taxable debt securities						
U.S. Government agencies and corporations	\$2,104	\$ (2)	\$3,151	\$ (47)	\$5,255	\$ (49)
Residential mortgage-backed securities:						
Government-sponsored agencies	52,970	(569)	8,672	(226)	61,642	(795)
Nongovernment-sponsored entities	2,298	—	2,819	(33)	5,117	(33)
State and political subdivisions:						
Other revenues	1,702	(26)	—	—	1,702	(26)
Corporate debt securities	8,367	(268)	—	—	8,367	(268)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	5,977	(41)	—	—	5,977	(41)
Lease revenues	576	(1)	—	—	576	(1)
Other revenues	1,218	(14)	—	—	1,218	(14)
Total temporarily impaired securities	75,212	(921)	14,642	(306)	89,854	(1,227)
Total other-than-temporarily impaired securities	—	—	—	—	—	—
Total	\$75,212	\$ (921)	\$14,642	\$ (306)	\$89,854	\$ (1,227)

NOTE 6. LOANS

Loans are generally stated at the amount of unpaid principal, reduced by unearned discount and allowance for loan losses. Interest on loans is accrued daily on the outstanding balances. Loan origination fees and certain direct loan origination costs are deferred and amortized as adjustments of the related loan yield over its contractual life. We categorize residential real estate loans in excess of \$600,000 as jumbo loans.

Generally, loans are placed on nonaccrual status when principal or interest is greater than 90 days past due based upon the loan's contractual terms. Interest is accrued daily on impaired loans unless the loan is placed on nonaccrual status. Impaired loans are placed on nonaccrual status when the payments of principal and interest are in default for a period of 90 days, unless the loan is both well-secured and in the process of collection. Interest on nonaccrual loans is recognized primarily using the cost-recovery method. Loans may be returned to accrual status when repayment is reasonably assured and there has been demonstrated performance under the terms of the loan or, if applicable, the terms of the restructured loans.

Commercial-related loans or portions thereof (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination is made on a case by case basis considering many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity. We deem a loss confirmed when a loan or a portion of a loan is classified "loss" in accordance with bank regulatory classification guidelines, which state, "Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted".

Consumer-related loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), which ever is

earlier. Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Loans are summarized as follows:

Table of Contents

20

Dollars in thousands	June 30, 2016	December 31, 2015	June 30, 2015
Commercial	\$101,521	\$ 97,201	\$97,284
Commercial real estate			
Owner-occupied	190,534	203,555	191,743
Non-owner occupied	348,099	337,294	331,056
Construction and development			
Land and land development	65,702	65,500	64,435
Construction	8,506	9,970	18,214
Residential real estate			
Non-jumbo	225,919	221,750	220,199
Jumbo	52,105	50,313	49,203
Home equity	75,904	74,300	72,504
Mortgage warehouse lines	80,282	—	—
Consumer	19,520	19,251	18,683
Other	10,008	11,669	12,423
Total loans, net of unearned fees	1,178,100	1,090,803	1,075,744
Less allowance for loan losses	11,377	11,472	11,272
Loans, net	\$1,166,723	\$ 1,079,331	\$1,064,472

The following table presents the contractual aging of the recorded investment in past due loans by class as of June 30, 2016 and 2015 and December 31, 2015.

Dollars in thousands	At June 30, 2016			Total	Current	> 90 days and Accruing
	Past Due 30-59 days	60-89 days	> 90 days			
Commercial	\$318	\$107	\$211	\$636	\$100,885	\$ —
Commercial real estate						
Owner-occupied	157	—	1,278	1,435	189,099	—
Non-owner occupied	180	14	—	194	347,905	—
Construction and development						
Land and land development	45	475	4,748	5,268	60,434	—
Construction	—	—	—	—	8,506	—
Residential mortgage						
Non-jumbo	3,978	950	2,466	7,394	218,525	—
Jumbo	—	—	—	—	52,105	—
Home equity	—	77	447	524	75,380	—
Mortgage warehouse lines	—	—	—	—	80,282	—
Consumer	145	52	84	281	19,239	—
Other	—	—	—	—	10,008	—
Total	\$4,823	\$1,675	\$9,234	\$15,732	\$1,162,368	\$ —

Table of Contents

21

Dollars in thousands	At December 31, 2015				Current	> 90 days and Accruing
	Past Due			Total		
	30-59 days	60-89 days	> 90 days			
Commercial	\$ 345	\$ 26	\$ 632	\$ 1,003	\$ 96,198	\$ —
Commercial real estate						
Owner-occupied	158	386	437	981	202,574	—
Non-owner occupied	1	—	856	857	336,437	—
Construction and development						
Land and land development	1,182	194	4,547	5,923	59,577	—
Construction	—	—	—	—	9,970	—
Residential mortgage						
Non-jumbo	2,276	2,647	1,591	6,514	215,236	—
Jumbo	—	—	—	—	50,313	—
Home equity	374	172	100	646	73,654	—
Consumer	155	41	92	288	18,963	9
Other	—	—	—	—	11,669	—
Total	\$ 4,491	\$ 3,466	\$ 8,255	\$ 16,212	\$ 1,074,591	\$ 9

Dollars in thousands	At June 30, 2015				Current	> 90 days and Accruing
	Past Due			Total		
	30-59 days	60-89 days	> 90 days			
Commercial	\$ 344	\$ —	\$ 661	\$ 1,005	\$ 96,279	\$ —
Commercial real estate						
Owner-occupied	118	—	630	748	190,995	—
Non-owner occupied	320	5,629	309	6,258	324,798	—
Construction and development						
Land and land development	—	21	5,228	5,249	59,186	—
Construction	—	—	—	—	18,214	—
Residential mortgage						
Non-jumbo	2,263	1,335	2,137	5,735	214,464	—
Jumbo	—	1,111	724	1,835	47,368	—
Home equity	171	195	37	403	72,101	—
Consumer	204	27	42	273	18,410	8
Other	—	—	—	—	12,423	—
Total	\$ 3,420	\$ 8,318	\$ 9,768	\$ 21,506	\$ 1,054,238	\$ 8

Nonaccrual loans: The following table presents the nonaccrual loans included in the net balance of loans at June 30, 2016, December 31, 2015 and June 30, 2015.

Dollars in thousands	June 30,		December
	2016	2015	31, 2015
Commercial	\$ 399	\$ 1,065	\$ 853
Commercial real estate			
Owner-occupied	1,278	880	437
Non-owner occupied	4,495	1,541	5,518
Construction and development			
Land & land development	5,400	5,627	5,623
Construction	—	—	—

Residential mortgage			
Non-jumbo	2,937	3,501	2,987
Jumbo	—	724	—
Home equity	594	208	258
Mortgage warehouse lines	—	—	—
Consumer	91	37	83
Total	\$15,194	\$13,583	\$15,759

Table of Contents

22

Impaired loans: Impaired loans include the following:

Loans which we risk-rate (consisting of loan relationships having aggregate balances in excess of \$2.5 million, or loans exceeding \$500,000 and exhibiting credit weakness) through our normal loan review procedures and which, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement. Risk-rated loans with insignificant delays or insignificant short falls in the amount of payments expected to be collected are not considered to be impaired.

Loans that have been modified in a troubled debt restructuring.

Both commercial and consumer loans are deemed impaired upon being contractually modified in a troubled debt restructuring. Troubled debt restructurings typically result from our loss mitigation activities and occur when we grant a concession to a borrower who is experiencing financial difficulty in order to minimize our economic loss and to avoid foreclosure or repossession of collateral. Once restructured in a troubled debt restructuring, a loan is generally considered impaired until its maturity, regardless of whether the borrower performs under the modified terms. Although such a loan may be returned to accrual status if the criteria set forth in our accounting policy are met, the loan would continue to be evaluated for an asset-specific allowance for loan losses and we would continue to report the loan in the impaired loan table below.

The table below sets forth information about our impaired loans.

Method Used to Measure Impairment of Impaired Loans

Dollars in thousands

Loan Category	June 30,		December	Method used to measure impairment
	2016	2015	31, 2015	
Commercial	\$655	\$41	\$ 41	Fair value of collateral
	162	302	201	Discounted cash flow
Commercial real estate				
Owner-occupied	1,103	5,654	783	Fair value of collateral
	7,084	9,015	7,616	Discounted cash flow
Non-owner occupied	4,691	1,607	5,728	Fair value of collateral
	7,638	6,140	7,722	Discounted cash flow
Construction and development				
Land & land development	6,373	9,002	6,597	Fair value of collateral
	2,145	2,270	2,177	Discounted cash flow
Residential mortgage				
Non-jumbo	1,735	1,791	1,753	Fair value of collateral
	4,477	4,475	4,378	Discounted cash flow
Jumbo	3,711	5,655	3,869	Fair value of collateral
	864	880	871	Discounted cash flow
Home equity	186	186	186	Fair value of collateral
	523	523	523	Discounted cash flow
Consumer	1	—	—	Fair value of collateral
	52	75	68	Discounted cash flow
Total	\$41,400	\$47,616	\$ 42,513	

Table of Contents

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

The following tables present loans individually evaluated for impairment at June 30, 2016, December 31, 2015 and June 30, 2015.

Dollars in thousands	June 30, 2016			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$ 798	\$ 798	\$ —	\$ 199	\$ 9
Commercial real estate					
Owner-occupied	5,305	5,305	—	5,375	208
Non-owner occupied	10,469	10,470	—	10,912	297
Construction and development					
Land & land development	7,364	7,365	—	7,408	162
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	3,866	3,880	—	3,780	169
Jumbo	3,713	3,711	—	3,725	177
Home equity	709	709	—	709	21
Mortgage warehouse lines	—	—	—	—	—
Consumer	53	53	—	57	5
Total without a related allowance	\$ 32,277	\$ 32,291	\$ —	\$ 32,165	\$ 1,048
With a related allowance					
Commercial	\$ 19	\$ 19	\$ 19	\$ —	\$ —
Commercial real estate					
Owner-occupied	2,882	2,882	13	2,906	112
Non-owner occupied	1,859	1,859	144	1,850	72
Construction and development					
Land & land development	1,153	1,153	141	1,152	—
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,331	2,332	179	2,335	112
Jumbo	864	864	28	866	43
Home equity	—	—	—	—	—
Mortgage warehouse lines	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$ 9,108	\$ 9,109	\$ 524	\$ 9,109	\$ 339
Total					
Commercial	\$ 29,849	\$ 29,851	\$ 317	\$ 29,802	\$ 860
Residential real estate	11,483	11,496	207	11,415	522
Consumer	53	53	—	57	5
Total	\$ 41,385	\$ 41,400	\$ 524	\$ 41,274	\$ 1,387

Table of Contents

24

Dollars in thousands	December 31, 2015			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$242	\$242	\$ —	\$319	\$ 17
Commercial real estate					
Owner-occupied	5,401	5,402	—	5,438	191
Non-owner occupied	10,740	10,741	—	9,982	310
Construction and development					
Land & land development	7,635	7,635	—	9,497	263
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	3,590	3,600	—	3,316	160
Jumbo	3,871	3,869	—	4,412	181
Home equity	709	709	—	709	32
Consumer	68	68	—	72	6
Total without a related allowance	\$32,256	\$32,266	\$ —	\$33,745	\$ 1,160
With a related allowance					
Commercial	\$—	\$—	\$ —	\$—	\$ —
Commercial real estate					
Owner-occupied	2,997	2,997	45	3,003	135
Non-owner occupied	2,709	2,709	386	2,728	72
Construction and development					
Land & land development	1,139	1,139	85	1,154	—
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,530	2,531	226	2,552	114
Jumbo	871	871	34	878	43
Home equity	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$10,246	\$10,247	\$ 776	\$10,315	\$ 364
Total					
Commercial	\$30,863	\$30,865	\$ 516	\$32,121	\$ 988
Residential real estate	11,571	11,580	260	11,867	530
Consumer	68	68	—	72	6
Total	\$42,502	\$42,513	\$ 776	\$44,060	\$ 1,524

Table of Contents

Dollars in thousands	June 30, 2015			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$343	\$343	\$ —	\$362	\$ 42
Commercial real estate					
Owner-occupied	10,101	10,100	—	8,156	598
Non-owner occupied	6,938	6,940	—	6,333	566
Construction and development					
Land & land development	11,139	11,139	—	11,916	672
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	3,307	3,316	—	3,345	318
Jumbo	4,933	4,931	—	7,472	474
Home equity	710	709	—	709	61
Consumer	74	75	—	77	14
Total without a related allowance	\$37,545	\$37,553	\$ —	\$38,370	\$ 2,745
With a related allowance					
Commercial	\$—	\$—	\$ —	\$—	\$ —
Commercial real estate					
Owner-occupied	4,569	4,569	232	4,577	378
Non-owner occupied	806	807	64	799	55
Construction and development					
Land & land development	133	133	133	534	63
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,948	2,950	331	2,959	239
Jumbo	1,600	1,604	71	1,600	89
Home equity	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$10,056	\$10,063	\$ 831	\$10,469	\$ 824
Total					
Commercial	\$34,029	\$34,031	\$ 429	\$32,677	\$ 2,374
Residential real estate					
Consumer	74	75	—	77	14
Total	\$47,601	\$47,616	\$ 831	\$48,839	\$ 3,569

A modification of a loan is considered a troubled debt restructuring (“TDR”) when a borrower is experiencing financial difficulty and the modification constitutes a concession that we would not otherwise consider. This may include a transfer of real estate or other assets from the borrower, a modification of loan terms, or a combination of both. A loan continues to be classified as a TDR for the life of the loan. Included in impaired loans are TDRs of \$29.9 million, of which \$28.6 million were current with respect to restructured contractual payments at June 30, 2016, and \$30.5 million, of which \$28.9 million were current with respect to restructured contractual payments at December 31, 2015. There were no commitments to lend additional funds under these restructurings at either balance sheet date.

The following table presents by class the TDRs that were restructured during the three and six months ended June 30, 2016, there were no loans restructured during the three and six months ended June 30, 2015 . Generally, the modifications were extensions of term, modifying the payment terms from principal and interest to interest only for an extended period, or reduction in interest rate. All TDRs are evaluated individually for allowance for loan loss purposes.

Table of Contents

26

Dollars in thousands	For the Three Months Ended June 30, 2016		For the Six Months Ended June 30, 2016	
	Number of Modifications	Post-modification Recorded Investment	Number of Modifications	Post-modification Recorded Investment
Commercial	—	\$ —	—	\$ —
Commercial real estate				
Owner-occupied	—	—	—	—
Non-owner occupied	—	—	—	—
Construction and development				
Land & land development	—	—	—	—
Construction	—	—	—	—
Residential real estate				
Non-jumbo	2 145	145	3 395	395
Jumbo	—	—	—	—
Home equity	—	—	—	—
Mortgage warehouse lines	—	—	—	—
Consumer	1 2	2	1 2	2
Total	3 \$ 147	\$ 147	4 \$ 397	\$ 397

The following table presents defaults during the stated period of TDRs that were restructured during the past twelve months. For purposes of these tables, a default is considered as either the loan was past due 30 days or more at any time during the period, or the loan was fully or partially charged off during the period.

Dollars in thousands	For the Three Months Ended June 30, 2016	For the Six Months Ended June 30, 2016
	Recorded Number of Investment at Default Date	Recorded Number of Investment at Default Date
Commercial	—	—
Commercial real estate		
Owner-occupied	—	—
Non-owner occupied	—	—
Construction and development		
Land & land development	1 1,182	1 1,182
Construction	—	—
Residential real estate		
Non-jumbo	2 145	2 145
Jumbo	—	—
Home equity	—	—
Mortgage warehouse lines	—	—
Consumer	1 2	1 2
Total	4 \$ 1,329	4 \$ 1,329

[Table of Contents](#)

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

The following table details the activity regarding TDRs by loan type for the three months and six months ended June 30, 2016, and the related allowance on TDRs.

For the Three Months Ended June 30, 2016

Dollars in thousands	Construction & Land Development		Commercial Real Estate		Residential Real Estate						Total	
	Land Development	Construction	Commercial	Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity	Mortgage Warehouse Lines	Consumer		Other
Troubled debt restructurings												
Balance April 1, 2016	\$ 3,997	\$ —	\$ 200	\$ 9,282	\$ 6,014	\$ 5,664	\$ 4,607	\$ 523	\$ —	\$ 62	\$ —	\$ 30,349
Additions	—	—	—	—	—	145	—	—	—	1	—	146
Charge-offs	—	—	—	(127)	—	—	—	—	—	—	—	(127)
Net (paydowns) advances	(41)	—	(2)	(37)	(13)	(352)	(32)	—	—	(9)	—	(486)
Transfer into foreclosed properties	—	—	—	—	—	—	—	—	—	—	—	—
Refinance out of TDR status	—	—	—	—	—	—	—	—	—	—	—	—
Balance, June 30, 2016	\$ 3,956	\$ —	\$ 198	\$ 9,118	\$ 6,001	\$ 5,457	\$ 4,575	\$ 523	\$ —	\$ 54	\$ —	\$ 29,882
Allowance related to troubled debt restructurings	\$ —	\$ —	\$ —	\$ 149	\$ 7	\$ 179	\$ 28	\$ —	\$ —	\$ —	\$ —	\$ 363

For the Six Months Ended June 30, 2016

Dollars in thousands	Construction & Land Development		Commercial Real Estate		Residential Real Estate						Total	
	Land Development	Construction	Commercial	Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity	Mortgage Warehouse Lines	Consumer		Other
Troubled debt restructurings												
Balance January 1, 2016	\$ 4,188	\$ —	\$ 242	\$ 9,314	\$ 6,059	\$ 5,496	\$ 4,634	\$ 523	\$ —	\$ 68	\$ —	\$ 30,524
Additions	—	—	—	—	—	395	—	—	—	1	—	396
Charge-offs	—	—	—	(127)	—	(52)	—	—	—	—	—	(179)
Net (paydowns) advances	(232)	—	(44)	(69)	(58)	(382)	(59)	—	—	(15)	—	(859)
Transfer into foreclosed properties	—	—	—	—	—	—	—	—	—	—	—	—
Refinance out of TDR status	—	—	—	—	—	—	—	—	—	—	—	—
Balance, June 30, 2016	\$ 3,956	\$ —	\$ 198	\$ 9,118	\$ 6,001	\$ 5,457	\$ 4,575	\$ 523	\$ —	\$ 54	\$ —	\$ 29,882
Allowance related to troubled debt restructurings	\$ —	\$ —	\$ —	\$ 149	\$ 7	\$ 179	\$ 28	\$ —	\$ —	\$ —	\$ —	\$ 363

Allowance related to
troubled debt
restructurings

We categorize loans into 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, among other factors. We analyze loans individually by classifying the loans as to credit risk. We internally grade all commercial loans at the time of loan origination. In addition, we perform an annual loan review on all non-homogenous commercial loan relationships with an aggregate exposure of \$2.5 million, at which time these loans are re-graded.

We use the following definitions for our risk grades:

Table of Contents

28

Pass: Loans graded as Pass are loans to borrowers of acceptable credit quality and risk. They are higher quality loans that do not fit any of the other categories described below.

OLEM (Special Mention): Commercial loans categorized as OLEM are potentially weak. The credit risk may be relatively minor yet represent a risk given certain specific circumstances. If the potential weaknesses are not monitored or mitigated, the asset may weaken or inadequately protect our position in the future.

Substandard: Commercial loans categorized as Substandard are inadequately protected by the borrower's ability to repay, equity, and/or the collateral pledged to secure the loan. These loans have identified weaknesses that could hinder normal repayment or collection of the debt. These loans are characterized by the distinct possibility that we will sustain some loss if the identified weaknesses are not mitigated.

Doubtful: Commercial loans categorized as Doubtful have all the weaknesses inherent in those loans classified as Substandard, with the added elements that the full collection of the loan is improbable and the possibility of loss is high.

Loss: Loans classified as loss are considered to be non-collectible and of such little value that their continuance as a bankable asset is not warranted. This does not mean that the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future.

The following table presents the recorded investment in construction and development, commercial, and commercial real estate loans which are generally evaluated based upon the internal risk ratings defined above.

Loan Risk Profile by Internal Risk Rating

	Construction and Development				Commercial Real Estate				Mortgage Warehouse Lines			
	Land and Land Development	Construction	Commercial	Commercial	Owner Occupied	Non-Owner Occupied	Owner Occupied	Non-Owner Occupied	Owner Occupied	Non-Owner Occupied		
Dollars in thousands	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015
Pass	\$57,398	\$57,155	\$8,506	\$9,970	\$99,462	\$95,174	\$188,201	\$202,226	\$342,383	\$329,861	\$80,282	\$—
OLEM (Special Mention)	1,611	1,598	—	—	1,162	1,295	726	546	914	1,602	—	—
Substandard	6,693	6,747	—	—	897	732	1,607	783	4,802	5,831	—	—
Doubtful	—	—	—	—	—	—	—	—	—	—	—	—
Loss	—	—	—	—	—	—	—	—	—	—	—	—
Total	\$65,702	\$65,500	\$8,506	\$9,970	\$101,521	\$97,201	\$190,534	\$203,555	\$348,099	\$337,294	\$80,282	\$—

The following table presents the recorded investment in consumer, residential real estate, and home equity loans, which are generally evaluated based on the aging status of the loans, which was previously presented, and payment activity.

	Performing		Nonperforming			
	6/30/2016	12/31/2015	6/30/2015	6/30/2016	12/31/2015	6/30/2015
Dollars in thousands						
Residential real estate						
Non-jumbo	\$222,982	\$218,763	\$216,698	\$2,937	\$2,987	\$3,501
Jumbo	52,105	50,313	48,479	—	—	724
Home Equity	75,310	74,042	72,296	594	258	208
Consumer	19,418	19,149	18,637	102	102	46
Other	10,008	11,669	12,423	—	—	—
Total	\$379,823	\$373,936	\$368,533	\$3,633	\$3,347	\$4,479

Loan commitments: ASC Topic 815, Derivatives and Hedging, requires that commitments to make mortgage loans should be accounted for as derivatives if the loans are to be held for sale, because the commitment represents a written option and accordingly is recorded at the fair value of the option liability.

NOTE 7. ALLOWANCE FOR LOAN LOSSES

We maintain the allowance for loan losses at a level considered adequate to provide for estimated probable credit losses inherent in the loan portfolio. The allowance is comprised of three distinct reserve components: (1) specific reserves related to loans individually evaluated, (2) quantitative reserves related to loans collectively evaluated, and (3) qualitative reserves related to loans collectively evaluated. A summary of the methodology we employ on a quarterly basis with respect to each of these components in order to evaluate the overall adequacy of our allowance for loan losses is as follows:

Table of Contents

29

Specific Reserve for Loans Individually Evaluated

First, we identify loan relationships having aggregate balances in excess of \$500,000 and that may also have credit weaknesses. Such loan relationships are identified primarily through our analysis of internal loan evaluations, past due loan reports, and loans adversely classified by regulatory authorities. Each loan so identified is then individually evaluated to determine whether it is impaired – that is, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the contractual terms of the underlying loan agreement. Substantially all of our impaired loans historically have been collateral dependent, meaning repayment of the loan is expected or is considered to be provided solely from the sale of the loan's underlying collateral. For such loans, we measure impairment based on the fair value of the loan's collateral, which is generally determined utilizing current appraisals. A specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over the fair value of its underlying collateral, less estimated costs to sell. Our policy is to re-evaluate the fair value of collateral dependent loans at least every twelve months unless there is a known deterioration in the collateral's value, in which case a new appraisal is obtained. Beginning in 2014, for purposes of loans that have been modified in a troubled debt restructuring and not internally graded as substandard, doubtful, or loss ("performing TDRs") we began measuring impairment using the discounted cash flows method. Under this method, a specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over its discounted cash flows.

Quantitative Reserve for Loans Collectively Evaluated

Second, we stratify the loan portfolio into the following eleven loan pools: land and land development, construction, commercial, commercial real estate -- owner-occupied, commercial real estate -- non-owner occupied, conventional residential mortgage, jumbo residential mortgage, home equity, mortgage warehouse lines, consumer, and other. Quantitative reserves relative to each loan pool are established as follows: for all loan segments detailed above an allocation equaling 100% of the respective pool's average 12 month historical net loan charge-off rate (determined based upon the most recent twelve quarters) is applied to the aggregate recorded investment in the pool of loans.

Qualitative Reserve for Loans Collectively Evaluated

Third, we consider the necessity to adjust our average historical net loan charge-off rates relative to each of the above eleven loan pools for potential risks factors that could result in actual losses deviating from prior loss experience. For example, if we observe a significant increase in delinquencies within the conventional mortgage loan pool above historical trends, an additional allocation to the average historical loan charge-off rate is applied. Such qualitative risk factors considered are: (1) levels of and trends in delinquencies and impaired loans, (2) levels of and trends in charge-offs and recoveries, (3) trends in volume and term of loans, (4) effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practice, (5) experience, ability, and depth of lending management and other relevant staff, (6) national and local economic trends and conditions, (7) industry conditions, and (8) effects of changes in credit concentrations.

Table of Contents

30

An analysis of the allowance for loan losses for the six month periods ended June 30, 2016 and 2015, and for the year ended December 31, 2015 is as follows:

	Six Months Ended June 30,		Year Ended December 31, 2015
Dollars in thousands	2016	2015	2015
Balance, beginning of year	\$11,472	\$11,167	\$ 11,167
Losses:			
Commercial	260	77	77
Commercial real estate			
Owner occupied	166	269	559
Non-owner occupied	121	—	178
Construction and development			
Land and land development	—	434	457
Construction	—	—	—
Residential real estate			
Non-jumbo	118	284	417
Jumbo	—	—	208
Home equity	10	76	76
Mortgage warehouse lines	—	—	—
Consumer	57	48	69
Other	92	56	110
Total	824	1,244	2,151
Recoveries:			
Commercial	62	4	10
Commercial real estate			
Owner occupied	17	5	290
Non-owner occupied	6	4	13
Construction and development			
Land and land development	12	322	456
Construction	—	—	—
Real estate - mortgage			
Non-jumbo	48	63	107
Jumbo	6	96	96
Home equity	2	2	3
Mortgage warehouse lines	—	—	—
Consumer	34	68	105
Other	42	35	126
Total	229	599	1,206
Net losses	595	645	945
Provision for loan losses	500	750	1,250
Balance, end of period	\$11,377	\$11,272	\$ 11,472

Table of Contents

31

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Activity in the allowance for loan losses by loan class during the first six months of 2016 is as follows:

Dollars in thousands	Construction & Land Development		Commercial	Commercial Real Estate		Residential Real Estate			Mortgage Warehouse Lines	Consumer	Other	Total
	Land Development	Construction		Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity				
Allowance for loan losses												
Beginning balance	\$2,852	\$15	\$780	\$1,589	\$2,977	\$1,253	\$1,593	\$253	\$—	\$60	\$100	\$11,000
Charge-offs	—	—	260	166	121	118	—	10	—	57	92	824
Recoveries	12	—	62	17	6	48	6	2	—	34	42	229
Provision	(1,251)	62	476	512	(31)	1,018	(834)	365	—	165	18	500
Ending balance	\$1,613	\$77	\$1,058	\$1,952	\$2,831	\$2,201	\$765	\$610	\$—	\$202	\$68	\$11,000

Allowance related to:

Loans individually evaluated for impairment	\$141	\$—	\$19	\$13	\$144	\$179	\$28	\$—	\$—	\$—	\$—	\$520
Loans collectively evaluated for impairment	1,472	77	1,039	1,939	2,687	2,022	737	610	—	202	68	10,000
Total	\$1,613	\$77	\$1,058	\$1,952	\$2,831	\$2,201	\$765	\$610	\$—	\$202	\$68	\$11,000

Loans individually evaluated for impairment	\$8,518	\$—	\$817	\$8,187	\$12,329	\$6,212	\$4,575	\$709	\$—	\$53	\$—	\$41,000
Loans collectively evaluated for impairment	57,184	8,506	100,704	182,347	335,770	219,707	47,530	75,195	80,282	19,467	10,008	\$1,000,000
Total	\$65,702	\$8,506	\$101,521	\$190,534	\$348,099	\$225,919	\$52,105	\$75,904	\$80,282	\$19,520	\$10,008	\$1,000,000

NOTE 8. GOODWILL AND OTHER INTANGIBLE ASSETS

The following tables present our goodwill by reporting unit at June 30, 2016 and other intangible assets by reporting unit at June 30, 2016 and December 31, 2015.

Dollars in thousands	Goodwill Activity		Total
	Communi-ty Banking	Insurance Services	

Balance, January 1, 2016	\$1,488	\$ 4,710	\$6,198
Acquired goodwill, net	—	—	—
Balance, June 30, 2016	\$1,488	\$ 4,710	\$6,198

Dollars in thousands	Other Intangible Assets June 30, 2016			December 31, 2015		
	Communi- Banking	Insurance Services	Total	Communi- Banking	Insurance Services	Total
Unidentifiable intangible assets						
Gross carrying amount	\$2,268	\$ —	\$2,268	\$2,268	\$ —	\$2,268
Less: accumulated amortization	2,268	—	2,268	2,268	—	2,268
Net carrying amount	\$—	\$ —	\$—	\$—	\$ —	\$—
Identifiable intangible assets						
Gross carrying amount	\$—	\$ 3,000	\$3,000	\$—	\$ 3,000	\$3,000
Less: accumulated amortization	—	1,800	1,800	—	1,700	1,700
Net carrying amount	\$—	\$ 1,200	\$1,200	\$—	\$ 1,300	\$1,300

We recorded amortization expense of approximately \$100,000 for the six months ended June 30, 2016 relative to our other intangible assets. Annual amortization is expected to approximate \$200,000 for each of the years ending 2016 through 2020.

Table of Contents

NOTE 9. DEPOSITS

The following is a summary of interest bearing deposits by type as of June 30, 2016 and 2015 and December 31, 2015:

Dollars in thousands	June 30, 2016	December 31, 2015	June 30, 2015
Demand deposits, interest bearing	\$205,095	\$ 215,721	\$202,957
Savings deposits	306,785	266,825	246,949
Time deposits	463,820	465,153	490,148
Total	\$975,700	\$ 947,699	\$940,054

Included in time deposits are deposits acquired through a third party (“brokered deposits”) totaling \$138.1 million, \$126.5 million and \$135.3 million at June 30, 2016, December 31, 2015, and June 30, 2015, respectively.

A summary of the scheduled maturities for all time deposits as of June 30, 2016 is as follows:

Dollars in thousands	
Six month period ending December 31, 2016	\$ 114,537
Year ending December 31, 2017	145,412
Year ending December 31, 2018	71,393
Year ending December 31, 2019	44,729
Year ending December 31, 2020	42,003
Thereafter	45,746
Total	\$463,820

The following is a summary of the maturity distribution of all certificates of deposit in denominations of \$100,000 or more as of June 30, 2016:

Dollars in thousands	Amount	Percent
Three months or less	\$30,202	8.7 %
Three through six months	48,430	13.9 %
Six through twelve months	70,790	20.3 %
Over twelve months	198,840	57.1 %
Total	\$348,262	100.00%

NOTE 10. BORROWED FUNDS

Short-term borrowings: A summary of short-term borrowings is presented below:

Dollars in thousands	Six Months Ended June 30,			
	2016		2015	
	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit
Balance at June 30	\$202,100	\$ 3,453	\$171,160	\$ 3,439
Average balance outstanding for the period	172,662	3,448	143,781	5,988
Maximum balance outstanding at any month end during period	218,950	3,453	171,160	7,438
Weighted average interest rate for the period	0.59 %	0.50 %	0.32 %	0.25 %
Weighted average interest rate for balances outstanding at June 30	0.58 %	0.50 %	0.32 %	0.25 %

Table of Contents

33

Dollars in thousands	Year Ended December 31, 2015			
	Short-term FHLB Advances	Federal Funds Purchased	and Lines of Credit	
Balance at December 31	\$ 167,950	\$ 3,444		
Average balance outstanding for the period	146,412	4,690		
Maximum balance outstanding at any month end during period	171,160	7,438		
Weighted average interest rate for the period	0.43	% 0.50	%	
Weighted average interest rate for balances outstanding at December 31	0.35	% 0.26	%	

Long-term borrowings: Our long-term borrowings of \$74.6 million, \$75.6 million and \$76.5 million at June 30, 2016, December 31, 2015, and June 30, 2015 respectively, consisted primarily of advances from the Federal Home Loan Bank (“FHLB”) and structured reverse repurchase agreements with two unaffiliated institutions. All FHLB advances are collateralized primarily by similar amounts of residential mortgage loans, certain commercial loans, mortgage backed securities and securities of U. S. Government agencies and corporations.

Dollars in thousands	Balance at		
	Balance at June 30, 2016	2015	at December 31, 2015
Long-term FHLB advances	\$ 820	\$ 925	\$ 873
Long-term reverse repurchase agreements	72,000	72,000	72,000
Term loan	1,805	3,611	2,708
Total	\$ 74,625	\$ 76,536	\$ 75,581

The term loan at June 30, 2016 is secured by the common stock of our subsidiary bank and bears a variable interest rate of prime minus 50 basis points with a final maturity of 2017. Our long term FHLB borrowings and reverse repurchase agreements bear both fixed and variable rates and mature in varying amounts through the year 2026.

The average interest rate paid on long-term borrowings for the six month period ended June 30, 2016 was 4.41% compared to 4.34% for the first six months of 2015.

Subordinated debentures owed to unconsolidated subsidiary trusts: We have three statutory business trusts that were formed for the purpose of issuing mandatorily redeemable securities (the “capital securities”) for which we are obligated to third party investors and investing the proceeds from the sale of the capital securities in our junior subordinated debentures (the “debentures”). The debentures held by the trusts are their sole assets. Our subordinated debentures totaled \$19.6 million at June 30, 2016, December 31, 2015, and June 30, 2015.

In October 2002, we sponsored SFG Capital Trust I, in March 2004, we sponsored SFG Capital Trust II, and in December 2005, we sponsored SFG Capital Trust III, of which 100% of the common equity of each trust is owned by us. SFG Capital Trust I issued \$3.5 million in capital securities and \$109,000 in common securities and invested the proceeds in \$3.61 million of debentures. SFG Capital Trust II issued \$7.5 million in capital securities and \$232,000 in common securities and invested the proceeds in \$7.73 million of debentures. SFG Capital Trust III issued \$8.0 million in capital securities and \$248,000 in common securities and invested the proceeds in \$8.25 million of debentures. Distributions on the capital securities issued by the trusts are payable quarterly at a variable interest rate equal to 3 month LIBOR plus 345basis points for SFG Capital Trust I, 3 month LIBOR plus 280basis points for SFG Capital Trust II, and 3 month LIBOR plus 145basis points for SFG Capital Trust III, and equals the interest rate

earned on the debentures held by the trusts, and is recorded as interest expense by us. The capital securities are subject to mandatory redemption in whole or in part, upon repayment of the debentures. We have entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of the guarantee. The debentures of each Capital Trust are redeemable by us quarterly.

The capital securities held by SFG Capital Trust I, SFG Capital Trust II, and SFG Capital Trust III qualify as Tier 1 capital under Federal Reserve Board guidelines. In accordance with these Guidelines, trust preferred securities generally are limited to 25% of Tier 1 capital elements, net of goodwill. The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital.

A summary of the maturities of all long-term borrowings and subordinated debentures for the next five years and thereafter is as follows:

Table of Contents

34

Dollars in thousands	Long-term borrowings	Subordinated debentures owed to unconsolidated subsidiary trusts
Year Ending December 31, 2016	\$ 27,955	\$ —
2017	918	—
2018	45,017	—
2019	18	—
2020	19	—
Thereafter	698	19,589
	\$ 74,625	\$ 19,589

NOTE 11. SHARE-BASED COMPENSATION

The 2014 Long-Term Incentive Plan (“2014 LTIP”) was adopted by our shareholders in May 2014 to enhance the ability of the Company to attract and retain exceptionally qualified individuals to serve as key employees. The LTIP provides for the issuance of up to 500,000 shares of common stock, in the form of equity awards including stock options, restricted stock, restricted stock units, stock appreciation rights (“SARs”), performance units, other stock-based awards or any combination thereof, to our key employees.

Stock options awarded under the 2009 Officer Stock Option Plan and the 1998 Officer Stock Option Plan (collectively, the “Plans”) were not altered by the 2014 LTIP, and remain subject to the terms of the Plans. However, under the terms of the 2014 LTIP, all shares of common stock remaining issuable under the Plans at the time the 2014 LTIP was adopted ceased to be available for future issuance.

Under the 2014 LTIP and the Plans, stock options and SARs have generally been granted with an exercise price equal to the fair value of Summit's common stock on the grant date. We periodically grant employee stock options to individual employees. During second quarter 2015, we granted 166,717 SARs that become exercisable ratably over five years (20% per year) and expire ten years after the grant date. There were no grants of stock options or SARs during the first six months of 2016.

The fair value of our employee stock options and SARs granted under the Plans is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options and SARs granted but are not considered by the model. Because our employee stock options and SARs have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options and SARs at the time of grant. The assumptions used to value SARs issued during 2015 were a risk-free interest rate of 1.96%, an expected dividend yield of 2.75%, an expected common stock volatility of 61.84%, and an expected life of 10 years.

We recognize compensation expense based on the estimated number of stock awards expected to actually vest, exclusive of the awards expected to be forfeited. During the first six months of 2016 and 2015, our stock compensation expense and related deferred taxes were insignificant.

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

A summary of activity in our Plans during the first six months of 2016 and 2015 is as follows:

	For the Six Months Ended June 30,			
	2016		2015	
	Options/SARS	Weighted-Average Exercise Price	Options/SARS	Weighted-Average Exercise Price
Outstanding, January 1	244,147	\$ 14.05	157,170	\$ 20.43
Granted	—	—	166,717	12.01
Exercised	—	—	—	—
Forfeited	—	—	—	—
Expired	—	—	—	—
Outstanding, June 30	244,147	\$ 14.05	323,887	\$ 16.10

Table of Contents

35

Other information regarding awards outstanding and exercisable at June 30, 2016 is as follows:

Range of exercise price	Options/SARs Outstanding				Options/SARs Exercisable			
	# of awards	WAEP	Wted. Avg. Remaining Contractual Life (yrs)	Aggregate Intrinsic Value (in thousands)	# of awards	WAEP	Aggregate Intrinsic Value (in thousands)	
\$2.54 - \$6.00	7,750	\$ 3.75	4.68	\$ 107	7,750	\$ 3.75	\$ 107	
6.01 - 10.00	12,680	8.71	2.15	111	12,680	8.71	111	
10.01 - 17.50	166,717	12.01	8.82	915	33,343	12.01	183	
17.51 - 20.00	23,400	17.80	1.51	—	23,400	17.80	—	
20.01 - 25.93	33,600	25.93	1.94	—	33,600	25.93	—	
	244,147	14.05		\$ 1,133	110,773	16.50	\$ 401	

NOTE 12. COMMITMENTS AND CONTINGENCIES

Off-Balance Sheet Arrangements

We are a party to certain financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial position. The contract amounts of these instruments reflect the extent of involvement that we have in this class of financial instruments.

Many of our lending relationships contain both funded and unfunded elements. The funded portion is reflected on our balance sheet. The unfunded portion of these commitments is not recorded on our balance sheet until a draw is made under the loan facility. Since many of the commitments to extend credit may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash flow requirements.

A summary of the total unfunded, or off-balance sheet, credit extension commitments follows:

Dollars in thousands	June 30, 2016
Commitments to extend credit:	
Revolving home equity and credit card lines	\$61,678
Construction loans	29,199
Other loans	82,399
Standby letters of credit	2,737
Total	\$176,013

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 and may require payment of a fee. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if we deem necessary upon extension of credit, is based on our credit evaluation. Collateral held varies but may include accounts receivable, inventory, equipment or real estate.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of the underlying contract with the third party.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments.

Legal Contingencies

On May 13, 2014, the ResCap Liquidating Trust (“ResCap”), as successor to Residential Funding Company, LLC f/k/a Residential Funding Corporation (“RFC”), filed a complaint against Summit Financial Mortgage, LLC (“Summit Mortgage”), a former

Table of Contents

36

residential mortgage subsidiary of Summit whose operations were discontinued in 2007, in the United States Bankruptcy Court for the Southern District of New York and subsequently amended its complaint on July 25, 2014. The Amended Complaint asserts the following three causes of action related to Summit Mortgage's origination and subsequent sale of mortgage loans to Residential Funding Corporation: 1) Summit Mortgage breached its representations and warranties made in the contract governing the sale of the mortgage loans to RFC; 2) an indemnification claim against Summit Mortgage for damages paid by ResCap to settle claims in RFC's bankruptcy proceeding which allegedly relate to mortgage loans Summit Mortgage sold to RFC; 3) a claim for damages against Summit Community Bank, Inc., former parent of Summit Mortgage, arising out of a guaranty in which the Bank guaranteed Summit Mortgage's full performance under the contract governing the sale of mortgage loans to RFC. Summit has filed a motion to dismiss the case. Based upon the applicable statute of limitations, the Court granted our motion to dismiss the breach of contract claim with respect to loans Summit sold to RFC prior to March 14, 2006. The court otherwise denied our motion to dismiss on the grounds that the other arguments raised factual questions that could not be decided on a motion to dismiss. An estimate as to possible loss resulting from the Amended Complaint cannot be provided at this time because such an estimate cannot be made. Summit intends to defend these claims vigorously.

We are not a party to any other litigation except for matters that arise in the normal course of business. While it is impossible to ascertain the ultimate resolution or range of financial liability with respect to these contingent matters, in the opinion of management, the outcome of these matters will not have a significant adverse effect on the consolidated financial statements.

NOTE 13. REGULATORY MATTERS

We and our subsidiaries are subject to various regulatory capital requirements administered by the banking regulatory agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we and each of our subsidiaries must meet specific capital guidelines that involve quantitative measures of our and our subsidiaries' assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. We and each of our subsidiaries' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us and each of our subsidiaries to maintain minimum amounts and ratios of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). We believe, as of June 30, 2016, that we and each of our subsidiaries met all capital adequacy requirements to which they were subject.

The most recent notifications from the banking regulatory agencies categorized us and each of our subsidiaries as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, we and each of our subsidiaries must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below.

The Basel III Capital Rules became effective for us on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2016, our capital levels remained characterized as "well-capitalized" under the new rules. See the Capital Requirements section included in Part I Item 1 Business of our 2015 Annual Report on Form 10-K for further discussion of Basel III.

Table of Contents

37

The following table presents Summit's, as well as our subsidiary, Summit Community Bank's ("Summit Community"), actual and required minimum capital amounts and ratios as of June 30, 2016 and December 31, 2015 under the Basel III Capital Rules. The minimum required capital levels presented below reflect the minimum required capital levels (inclusive of the full capital conservation buffers) that will be effective as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual		Minimum Required Capital - Basel III Fully Phased-in		Minimum Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Dollars in thousands						
As of June 30, 2016						
CET1 (to risk weighted assets)						
Summit	\$144,321	11.5%	\$87,848	7.0 %	\$81,573	6.5 %
Summit Community	162,700	13.0%	87,608	7.0 %	81,350	6.5 %
Tier I Capital (to risk weighted assets)						
Summit	161,073	12.9%	106,133	8.5 %	99,890	8.0 %
Summit Community	162,700	13.0%	106,381	8.5 %	100,123	8.0 %
Total Capital (to risk weighted assets)						
Summit	172,450	13.8%	131,212	10.5 %	124,964	10.0%
Summit Community	174,077	13.9%	131,497	10.5 %	125,235	10.0%
Tier I Capital (to average assets)						
Summit	161,073	10.5%	61,361	4.0 %	76,701	5.0 %
Summit Community	162,700	10.6%	61,396	4.0 %	76,745	5.0 %

	Actual		Minimum Required Capital - Basel III Fully Phased-in		Minimum Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Dollars in thousands						
As of December 31, 2015						
CET1 (to risk weighted assets)						
Summit	137,849	11.8%	81,775	7.0 %	75,934	6.5 %
Summit Community	158,081	13.6%	81,365	7.0 %	75,553	6.5 %
Tier I Capital (to risk weighted assets)						
Summit	156,849	13.4%	99,494	8.5 %	93,641	8.0 %
Summit Community	158,081	13.6%	98,801	8.5 %	92,989	8.0 %
Total Capital (to risk weighted assets)						
Summit	168,321	14.4%	122,734	10.5 %	116,890	10.0%
Summit Community	169,553	14.5%	122,780	10.5 %	116,933	10.0%
Tier I Capital (to average assets)						
Summit	156,849	10.7%	58,635	4.0 %	73,294	5.0 %
Summit Community	158,081	10.8%	58,549	4.0 %	73,186	5.0 %

NOTE 14. SEGMENT INFORMATION

We operate two business segments: community banking and insurance & financial services. These segments are primarily identified by the products or services offered. The community banking segment consists of our full service banks which offer customers traditional banking products and services through various delivery channels. The insurance & financial services segment includes three insurance agency offices that sell insurance products. The accounting policies discussed throughout the notes to the consolidated financial statements apply to each of our business segments.

Table of Contents

38

Inter-segment revenue and expense consists of management fees allocated to the community banking and the insurance & financial services segments for all centralized functions that are performed by the parent, including overall direction in the areas of strategic planning, investment portfolio management, asset/liability management, financial reporting and other financial and administrative services. Information for each of our segments is included below:

Dollars in thousands	Six Months Ended June 30, 2016				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income (loss)	\$23,831	\$ —	\$(318)	\$—	\$23,513
Provision for loan losses	500	—	—	—	500
Net interest income (loss) after provision for loan losses	23,331	—	(318)	—	23,013
Other income	3,617	2,235	777	(777)	5,852
Other expenses	14,487	2,104	1,177	(777)	16,991
Income (loss) before income taxes	12,461	131	(718)	—	11,874
Income tax expense (benefit)	3,741	56	(228)	—	3,569
Net income (loss)	\$8,720	\$ 75	\$(490)	\$—	\$8,305
Inter-segment revenue (expense)	\$(721)	\$(56)	\$777	\$—	\$—
Average assets	\$1,542,733	\$ 5,924	\$171,455	\$(198,995)	\$1,521,117

Dollars in thousands	Six Months Ended June 30, 2015				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income (loss)	\$23,392	\$ —	\$(414)	\$—	\$22,978
Provision for loan losses	750	—	—	—	750
Net interest income (loss) after provision for loan losses	22,642	—	(414)	—	22,228
Other income	3,818	2,181	566	(566)	5,999
Other expenses	13,676	1,928	1,228	(566)	16,266
Income (loss) before income taxes	12,784	253	(1,076)	—	11,961
Income tax expense (benefit)	3,939	100	(372)	—	3,667
Net income (loss)	\$8,845	\$ 153	\$(704)	\$—	\$8,294
Inter-segment revenue (expense)	\$(523)	\$(43)	\$566	\$—	\$—
Average assets	\$1,493,162	\$ 5,924	\$168,146	\$(206,859)	\$1,460,373

Table of Contents

Dollars in thousands	Three Months Ended June 30, 2016				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income (loss)	\$11,893	\$ —	\$(159)	\$—	\$11,734
Provision for loan losses	250	—	—	—	250
Net interest income (loss) after provision for loan losses	11,643	—	(159)	—	11,484
Other income	1,860	1,185	388	(388)	3,045
Other expenses	7,213	1,048	564	(388)	8,437
Income (loss) before income taxes	6,290	137	(335)	—	6,092
Income tax expense (benefit)	1,898	57	(106)	—	1,849
Net income (loss)	\$4,392	\$ 80	\$(229)	\$—	\$4,243
Inter-segment revenue (expense)	\$(360)	\$(28)	\$388	\$—	\$—
Average assets	\$1,558,542	\$ 5,982	\$171,881	\$(199,285)	\$1,537,120

Dollars in thousands	Three Months Ended June 30, 2015				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income (loss)	\$11,641	\$ —	\$(183)	\$—	\$11,458
Provision for loan losses	500	—	—	—	500
Net interest income (loss) after provision for loan losses	11,141	—	(183)	—	10,958
Other income	1,969	891	283	(283)	2,860
Other expenses	6,820	872	652	(283)	8,061
Income (loss) before income taxes	6,290	19	(552)	—	5,757
Income tax expense (benefit)	1,903	36	(192)	—	1,747
Net income (loss)	\$4,387	\$(17)	\$(360)	\$—	\$4,010
Inter-segment revenue (expense)	\$(268)	\$(15)	\$283	\$—	\$—
Average assets	\$1,498,161	\$ 5,954	\$167,348	\$(204,860)	\$1,466,603

NOTE 15. DERIVATIVE FINANCIAL INSTRUMENTS

We use derivative instruments primarily to protect against the risk of adverse interest rate movements on the cash flows of certain liabilities and the fair values of certain assets. Derivative instruments represent contracts between parties that usually require little or no initial net investment and result in one party delivering cash or another type of asset to the other party based upon a notional amount and an underlying as specified in the contract. A notional amount represents the number of units of a specific item, such as currency units. An underlying represents a variable, such as an interest rate or price index. The amount of cash or other asset delivered from one party to the other is determined based upon the interaction of the notional amount of the contract with the underlying. Derivatives can also be implicit in certain contracts and commitments.

As with any financial instrument, derivative instruments have inherent risks, primarily market and credit risk. Market risk associated with changes in interest rates is managed by establishing and monitoring limits as to the degree of risk that may be undertaken as part of our overall market risk monitoring process. Credit risk occurs when a counterparty to a derivative

Table of Contents

40

contract with an unrealized gain fails to perform according to the terms of the agreement. Credit risk is managed by monitoring the size and maturity structure of the derivative portfolio, and applying uniform credit standards to all activities with credit risk.

In accordance with ASC 815, Derivatives and Hedging, all derivative instruments are recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, depending on the type of hedge transaction.

Fair-value hedges – For transactions in which we are hedging changes in fair value of an asset, liability, or a firm commitment, changes in the fair value of the derivative instrument are generally offset in the income statement by changes in the hedged item’s fair value.

Cash-flow hedges – For transactions in which we are hedging the variability of cash flows related to a variable-rate asset, liability, or a forecasted transaction, changes in the fair value of the derivative instrument are reported in other comprehensive income. The gains and losses on the derivative instrument, which are reported in comprehensive income, are reclassified to earnings in the periods in which earnings are impacted by the variability of cash flows of the hedged item.

The ineffective portion of all hedges is recognized in current period earnings.

Other derivative instruments – For risk management purposes that do not meet the hedge accounting criteria and, therefore, do not qualify for hedge accounting. These derivative instruments are accounted for at fair value with changes in fair value recorded in the income statement.

We have entered into three forward-starting, pay-fixed/receive LIBOR interest rate swaps. \$40 million notional with an effective date of July 18, 2016, was designated as a cash flow hedge of \$40 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of this swap we will pay a fixed rate of 2.98% for a 3 year period. \$30 million notional with an effective date of April 18, 2016, was designated as a cash flow hedge of \$30 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of this swap we will pay a fixed rate of 2.89% for a 4.5 year period. \$40 million notional with an effective date of October 18, 2016, was designated as a cash flow hedge of \$40 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of the swap we will pay a fixed rate of 2.84% for a 3 year period.

We have entered into two pay fixed/receive variable interest rate swaps to hedge fair value variability of two commercial fixed rate loans with the same principal, amortization, and maturity terms of the underlying loans, which are designated as fair value hedges. Under the terms of a \$9.95 million notional swap with an effective date of January 15, 2015, we will pay a fixed rate of 4.33% for a 10 year period. Under the terms of a \$11.3 million notional swap with an effective date of December 18, 2015, we will pay a fixed rate of 4.30% for a 10 year period.

A summary of our derivative financial instruments as of June 30, 2016 and December 31, 2015 follows:

	June 30, 2016		
	Notional Amount	Derivative Fair Value As a Liability	Net Ineffective Hedge Gains/(Losses)
Dollars in thousands			
CASH FLOW HEDGES			
Pay-fixed/receive-variable interest rate swaps			
Short term borrowings	\$ 110,000	\$ -8,151	\$ —

FAIR VALUE HEDGES

Pay-fixed/receive-variable interest rate swaps

Commercial real estate loans \$21,250 \$-\$ 1,257 \$ —

Table of Contents

41

Dollars in thousands	December 31, 2015		Net Ineffective Hedge Gains/(Losses)
	Notional Amount	Derivative Fair Value Asset/Liability	
CASH FLOW HEDGES			
Pay-fixed/receive-variable interest rate swaps			
Short term borrowings	\$ 110,000	\$— \$ 5,071	\$ —
FAIR VALUE HEDGES			
Pay-fixed/receive-variable interest rate swaps			
Commercial real estate loans	\$ 21,250	\$ 94 \$ 95	\$ —

NOTE 16. EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP")

On July 30, 2015, our ESOP purchased 225,000 shares of Summit Financial Group Inc. common stock in a privately negotiated transaction, at \$10.80 per share for a total purchase price of \$2,430,000. On July 21, 2015, our Board of Directors approved the company lending to our ESOP \$2,250,000 to partially finance the purchase, and was used to purchase 208,333 unallocated shares.

In accordance with ASC 718, Compensation - Stock Compensation, this purchase of unallocated ESOP shares will be shown as a reduction of shareholders' equity, similar to a purchase of treasury stock. The loan receivable from the ESOP to the Company is not reported as an asset nor is the debt of the ESOP reported as a liability on the Company's Consolidated Balance Sheets. Cash dividends on allocated shares (those credited to ESOP participants' accounts) are recorded as a reduction of shareholders' equity and distributed directly to participants' accounts. Cash dividends on unallocated shares (those held by the ESOP not yet credited to participants' accounts) are used to pay a portion of the ESOPs debt service requirements.

Unallocated ESOP shares will be allocated to ESOP participants ratably as the ESOP's loan is repaid. When the shares are committed to be released and become available for allocation to plan participants, the then fair value of such shares will be charged to compensation expense. Unallocated shares owned by the Company's ESOP are not considered to be outstanding for the purpose of computing earnings per share.

The ESOP shares as of June 30 as are follows:

ESOP Shares	At June 30,	
	2016	2015
Allocated shares	406,371	366,258
Shares committed to be released	17,786	—
Unallocated shares	164,036	—
Total ESOP shares	588,193	366,258
Market value of unallocated shares (in thousands)	\$ 2,871	\$ —

NOTE 17. PENDING ACQUISITIONS

On February 29, 2016, we entered into a Definitive Merger Agreement between Summit Community Bank, Inc., a wholly-owned subsidiary of Summit, and Highland County Bankshares, Inc. ("HCB"). Pursuant to the terms of the merger agreement, Summit Community Bank, Inc. will acquire all of the outstanding shares of common stock of HCB in exchange for cash in the amount of \$38.00 per share, subject to an adjustment if HCB's adjusted shareholders' equity

as of the effective date of the merger deviates materially from the target determined by the parties. HCB's assets approximated \$123 million at June 30, 2016.

The acquisition has received all necessary regulatory and shareholder approvals and is expected to close on October 1, 2016. Following the consummation of the merger, HCB's wholly-owned subsidiary First and Citizens Bank will be consolidated with Summit Community Bank.

On June 1, 2016, we entered into a Definitive Merger Agreement between Summit Community Bank, Inc., a wholly-owned subsidiary of Summit, and First Century Bankshares, Inc. ("FCB"). Pursuant to the terms of the merger agreement, Summit Community Bank, Inc. will acquire all of the outstanding shares of common stock of FCB in exchange for cash in the amount

Table of Contents

42

of \$22.50 per share or 1.2433 shares of Summit common stock. FCB shareholders will have a right to receive cash, Summit's common stock, or a combination of cash and Summit stock, subject to proration to result in approximately 35% cash and 65% stock consideration in the aggregate, subject to an adjustment if FCB's adjusted shareholders' equity as of the effective date of the merger deviates materially from the target determined by the parties. FCB's assets approximated \$410 million at June 30, 2016.

We anticipate the acquisition will close at the beginning of the year 2017, subject to customary closing conditions, including regulatory approval and approval of FCB's shareholders. Following the consummation of the merger, FCB's wholly-owned subsidiary First Century Bank will be consolidated with Summit Community Bank.

Table of Contents

43

Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

The following discussion and analysis focuses on significant changes in our financial condition and results of operations of Summit Financial Group, Inc. ("Company" or "Summit") and our operating segments, Summit Community Bank ("Summit Community"), and Summit Insurance Services, LLC for the periods indicated. See Note 14 of the accompanying consolidated financial statements for our segment information. This discussion and analysis should be read in conjunction with our 2015 audited financial statements and Annual Report on Form 10-K.

The Private Securities Litigation Act of 1995 indicates that the disclosure of forward-looking information is desirable for investors and encourages such disclosure by providing a safe harbor for forward-looking statements by us. Our following discussion and analysis of financial condition and results of operations contains certain forward-looking statements that involve risk and uncertainty. In order to comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed in those forward-looking statements.

OVERVIEW

Our primary source of income is net interest income from loans and deposits. Business volumes tend to be influenced by the overall economic factors including market interest rates, business spending, and consumer confidence, as well as competitive conditions within the marketplace.

Interest earning assets increased by 5.01% for the first six months in 2016 compared to the same period of 2015 while our net interest earnings on a tax equivalent basis increased 2.41%. Our tax equivalent net interest margin decreased 9 basis points as our yield on interest earning assets declined 7 basis points while our cost of interest bearing funds increased 5 basis points.

BUSINESS SEGMENT RESULTS

We are organized and managed along two major business segments, as described in Note 14 of the accompanying consolidated financial statements. The results of each business segment are intended to reflect each segment as if it were a stand alone business. Net income by segment follows:

Dollars in thousands	Three Months		Six Months	
	Ended June 30, 2016	Ended June 30, 2015	Ended June 30, 2016	Ended June 30, 2015
Community banking	\$4,392	\$4,387	\$8,720	\$8,845
Insurance & financial services	80	(17)	75	153
Parent	(229)	(360)	(490)	(704)
Consolidated net income	\$4,243	\$4,010	\$8,305	\$8,294

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the financial services industry. Application of these principles requires us to make estimates, assumptions, and judgments that affect the amounts reported in our financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported.

Our most significant accounting policies are presented in the notes to the consolidated financial statements of our 2015 Annual Report on Form 10-K. These policies, along with the other disclosures presented in the financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, we have identified the determination of the allowance for loan losses, the valuation of goodwill, fair value measurements and deferred tax assets to be the accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

Allowance for Loan Losses: The allowance for loan losses represents our estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it

Table of Contents

44

requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on our consolidated balance sheet. To the extent actual outcomes differ from our estimates, additional provisions for loan losses may be required that would negatively impact earnings in future periods. Note 6 to the consolidated financial statements of our 2015 Annual Report on Form 10-K describes the methodology used to determine the allowance for loan losses and a discussion of the factors driving changes in the amount of the allowance for loan losses is included in the Asset Quality section of the financial review of the 2015 Annual Report on Form 10-K.

Goodwill: Goodwill is subject to an analysis by reporting unit at least annually to determine whether write-downs of the recorded balances are necessary. Initially, an assessment of qualitative factors (Step 0) is performed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test is unnecessary. However, if we conclude otherwise, then we are required to perform the first step (Step 1) of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the fair value is less than the carrying value, an expense may be required on our books to write down the goodwill to the proper carrying value. Step 2 of impairment testing, which is necessary only if the reporting unit does not pass Step 1, compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination.

Community Banking – During third quarter 2015, we performed the Step 0 assessment of our goodwill of our community banking reporting unit and determined that it was not more likely than not that the fair value was less than its carrying value. In performing the qualitative Step 0 assessments, we considered certain events and circumstances such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the fair value is less than its carrying amount. No indicators of impairment were noted as of September 30, 2015.

Insurance Services – During third quarter 2015, we performed the Step 0 assessment of our goodwill of our insurance services reporting unit. We considered certain events and circumstances specific to the reporting unit, such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the fair value of our insurance services reporting unit is less than its carrying value and deemed it necessary to perform the further 2-step impairment test. We performed an internal valuation utilizing the income approach to determine the fair value of our insurance services reporting unit. This methodology consisted of discounting the expected future cash flows of this unit based upon a forecast of its operations considering long-term key business drivers such as anticipated commission revenue growth. The long term growth rate used in determining the terminal value was estimated at 2%, and a discount rate of 10.0% was applied to the insurance services unit's estimated future cash flows. We did not fail this Step 1 test as of September 30, 2015, therefore Step 2 testing was not necessary.

We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Note 9 of the consolidated financial statements of our Annual Report on Form 10-K for further discussion of our intangible assets, which include goodwill.

Fair Value Measurements: ASC Topic 820 Fair Value Measurements and Disclosures provides a definition of fair value, establishes a framework for measuring fair value, and requires expanded disclosures about fair value measurements. Fair value is the price that could be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Based on the observability of the inputs used in the valuation techniques, we

classify our financial assets and liabilities measured and disclosed at fair value in accordance with the three-level hierarchy (e.g., Level 1, Level 2 and Level 3) established under ASC Topic 820. Fair value determination in accordance with this guidance requires that we make a number of significant judgments. In determining the fair value of financial instruments, we use market prices of the same or similar instruments whenever such prices are available. We do not use prices involving distressed sellers in determining fair value. If observable market prices are unavailable or impracticable to obtain, then fair value is estimated using modeling techniques such as discounted cash flow analyses. These modeling techniques incorporate our assessments regarding assumptions that market participants would use in pricing the asset or the liability, including assumptions about the risks inherent in a particular valuation technique and the risk of nonperformance.

Table of Contents

45

Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Additionally, fair value is used on a non-recurring basis to evaluate assets or liabilities for impairment or for disclosure purposes in accordance with ASC Topic 825 Financial Instruments.

Deferred Income Tax Assets: At June 30, 2016, we had net deferred tax assets of \$11.6 million. Based on our ability to offset the net deferred tax asset against taxable income in carryback years and expected future taxable income in carryforward years, there was no impairment of the deferred tax asset at June 30, 2016. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. However, our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryback/carryforward periods available under applicable law is not sufficient to cover the amount of net deferred tax assets, such assets may become impaired.

RESULTS OF OPERATIONS

Earnings Summary

Net income applicable to common shares for the six months ended June 30, 2016 increased to \$8.31 million, or \$0.78 per diluted share as compared to \$8.29 million or \$0.78 per diluted share for the same period of 2015. Net income for the quarter ended June 30, 2016 increased to \$4.2 million, or \$0.40 per diluted share, compared to \$4.0 million, or \$0.38 per diluted share for the same period of 2015. Earnings for the both the quarter and six months ended June 30, 2016, compared to the same periods of 2015, were positively impacted by increased net interest income, increased realized securities gains, and increased gains on sales of foreclosed properties, while being negatively impacted by higher personnel costs and other noninterest expenses. Included in earnings for the six months ended June 30, 2016 was \$775,000 in realized securities gains, \$282,000 in gains on the sales of foreclosed properties, and \$369,000 of charges resulting from the write-down of a portion of our foreclosed properties to fair value. Returns on average equity and assets for the first six months of 2016 were 11.29% and 1.09%, respectively, compared with 12.22% and 1.14% for the same period of 2015.

Net Interest Income

Net interest income is the principal component of our earnings and represents the difference between interest and fee income generated from earning assets and the interest expense paid on deposits and borrowed funds. Fluctuations in interest rates as well as changes in the volume and mix of earning assets and interest bearing liabilities can materially impact net interest income.

Our net interest income on a fully tax-equivalent basis totaled \$24.3 million for the six months ended June 30, 2016, or \$571,000 or 2.41% more than the \$23.7 million for the same period of 2015. Our tax-equivalent earnings on interest earning assets increased \$1,082,000, while the cost of interest bearing liabilities also increased \$511,000 (see Table II).

Average interest earning assets increased 5.0% from \$1.35 billion during the first six months of 2015 to \$1.42 billion for the first six months of 2016, while average interest bearing liabilities increased 3.4% from \$1.20 billion at June 30, 2015 to \$1.24 billion at June 30, 2016. The growth in interest earning assets outpaced the growth in interest bearing liabilities, and was funded primarily by reductions in property held for sale, growth in deposits, increased short term borrowings, and growth in equity.

Our consolidated net interest margin decreased to 3.45% for the six months ended June 30, 2016, compared to 3.54% for the same period in 2015, as the yields on earning assets decreased 7 basis points, while the cost of our interest bearing funds increased by 5 basis points.

Assuming no significant change in market interest rates and excluding the impact of pending acquisitions, we anticipate modest growth in our net interest income to continue over the near term due to growth in the volume of interest earning assets, primarily loans, coupled with expected moderate improvement in net interest margin over the same period. We continue to monitor the net interest margin through net interest income simulation to minimize the potential for any significant negative impact. See the “Market Risk Management” section for further discussion of the impact changes in market interest rates could have on us. Further analysis of our yields on interest earning assets and interest bearing liabilities are presented in Tables I and II below.

Table of Contents

46

Table I - Average Balance Sheet and Net Interest Income Analysis

Dollars in thousands	June 30, 2016			June 30, 2015		
	Average Balance	Earnings/ Expense	Yield/ Rate	Average Balance	Earnings/ Expense	Yield/ Rate
Interest earning assets						
Loans, net of unearned fees (1)						
Taxable	\$1,107,801	\$ 26,778	4.86 %	\$1,040,935	\$ 25,588	4.96 %
Tax-exempt (2)	15,189	424	5.61 %	12,516	353	5.69 %
Securities						
Taxable	210,494	2,146	2.05 %	213,252	2,368	2.24 %
Tax-exempt (2)	75,482	1,873	4.99 %	75,744	1,835	4.89 %
Federal funds sold and interest bearing deposits with other banks	8,621	7	0.16 %	7,504	2	0.05 %
Total interest earning assets	1,417,587	31,228	4.43 %	1,349,951	30,146	4.50 %
Noninterest earning assets						
Cash & due from banks	3,757			3,827		
Premises and equipment	21,556			20,307		
Property held for sale	24,898			35,257		
Other assets	64,810			62,197		
Allowance for loan losses	(11,491)			(11,166)		
Total assets	\$1,521,117			\$1,460,373		
Interest bearing liabilities						
Interest bearing demand deposits	\$207,487	\$ 162	0.16 %	203,237	118	0.12 %
Savings deposits	286,399	1,055	0.74 %	253,093	857	0.68 %
Time deposits	471,470	3,106	1.32 %	486,187	3,169	1.31 %
Short-term borrowings	176,111	659	0.75 %	149,769	238	0.32 %
Long-term borrowings and capital trust securities	94,811	1,952	4.14 %	103,148	2,041	3.99 %
Total interest bearing liabilities	1,236,278	6,934	1.13 %	1,195,434	6,423	1.08 %
Noninterest bearing liabilities and shareholders' equity						
Demand deposits	120,291			114,761		
Other liabilities	17,485			14,435		
Total liabilities	1,374,054			1,324,630		
Shareholders' equity - preferred	—			3,602		
Shareholders' equity - common	147,063			132,141		
Total liabilities and shareholders' equity	\$1,521,117			\$1,460,373		
Net interest earnings		\$ 24,294			\$ 23,723	
Net yield on interest earning assets			3.45 %			3.54 %

(1)- For purposes of this table, nonaccrual loans are included in average loan balances.

- Interest income on tax-exempt securities and loans has been adjusted assuming an effective tax rate of 34% for all (2) periods presented. The tax equivalent adjustment resulted in an increase in interest income of \$780,000 and \$744,000 for the periods ended June 30, 2016 and 2015, respectively.

Table of Contents

47

Table II - Changes in Interest Margin Attributable to Rate and Volume

Dollars in thousands	For the Six Months Ended June 30, 2016 versus June 30, 2015		
	Increase (Decrease) Due to Change in:		
	Volume	Rate	Net
Interest earned on:			
Loans			
Taxable	\$1,681	\$(491)	\$1,190
Tax-exempt	76	(5)	71
Securities			
Taxable	(30)	(192)	(222)
Tax-exempt	(5)	43	38
Federal funds sold and interest bearing deposits with other banks	—	5	5
Total interest earned on interest earning assets	1,722	(640)	1,082
Interest paid on:			
Interest bearing demand deposits	2	42	44
Savings deposits	120	78	198
Time deposits	(89)	26	(63)
Short-term borrowings	48	373	421
Long-term borrowings and capital trust securities	(166)	77	(89)
Total interest paid on interest bearing liabilities	(85)	596	511
Net interest income	\$1,807	\$(1,236)	\$571

Noninterest Income

Total noninterest income decreased to \$5.9 million for the first six months of 2016, compared to \$6.0 million for the same period of 2015. Further detail regarding noninterest income is reflected in the following table.

Table III - Noninterest Income

Dollars in thousands	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Insurance commissions	\$1,090	\$1,080	\$2,014	\$2,208
Service fees related to deposit accounts	1,059	1,072	2,038	2,048
Realized securities gains	383	170	775	650
Bank owned life insurance income	258	261	514	522
Other	255	277	511	571
Total	\$3,045	\$2,860	\$5,852	\$5,999

Noninterest Expense

Total noninterest expense increased 4.5% for the six months ended June 30, 2016, as compared to the same period in 2015, with increased gains on sales of foreclosed properties and lower write-downs of foreclosed properties having the largest positive impacts and higher salaries, commissions, and employee benefits having the largest negative impact. Table IV below shows the breakdown of the changes.

Table of Contents

48

Table IV - Noninterest Expense

Dollars in thousands	For the Quarter Ended June 30,				For the Six Months Ended June 30,			
	2016	Change		2015	2016	Change		2015
	\$	%		\$	\$	%		\$
Salaries, commissions, and employee benefits	\$4,764	\$322	7.2	% \$4,442	\$9,446	\$817	9.5	% \$8,629
Net occupancy expense	512	23	4.7	% 489	1,051	63	6.4	% 988
Equipment expense	686	126	22.5	% 560	1,342	247	22.6	% 1,095
Professional fees	429	57	15.3	% 372	901	194	27.4	% 707
Amortization of intangibles	50	—	—	% 50	100	—	—	% 100
FDIC premiums	300	(20)	(6.3)	% 320	600	(50)	(7.7)	% 650
Merger expense	153	153	n/a	—	265	265	n/a	—
Foreclosed properties expense	93	(65)	(41.1)	% 158	217	(149)	(40.7)	% 366
(Gain) loss on sales of foreclosed properties	(276)	(379)	(368.0)	% 103	(282)	(535)	(211.5)	% 253
Write-downs of foreclosed properties	259	99	61.9	% 160	369	(363)	(49.6)	% 732
Other	1,467	60	4.3	% 1,407	2,982	236	8.6	% 2,746
Total	\$8,437	\$376	4.7	% \$8,061	\$16,991	\$725	4.5	% \$16,266

Salaries, commissions, and employee benefits: These expenses are 9.5% higher in first six months of 2016 compared to first six months of 2015 due to an increase in number of employees, general merit raises, and increased incentive accruals based upon performance. In accordance with our policies, substantially all salary and wage merit raises are awarded at the beginning of the second quarter of each year.

Foreclosed properties expense: Management expects foreclosed properties expense to trend lower than in recent years due to lower levels of foreclosed properties.

Write-downs of foreclosed properties: Management anticipates write-downs of foreclosed properties to their fair values to trend lower in 2016 than in recent years.

Credit Experience

As a result of a historically slow economic recovery, our foreclosed properties portfolio remains elevated relative to our peers. Prior elevated levels of nonperforming loans have returned to acceptable levels. Management expects net reductions in foreclosed properties to continue, although not as rapid as over the past two years.

For purposes of this discussion, we define nonperforming assets to include foreclosed properties, other repossessed assets, and nonperforming loans, which is comprised of loans 90 days or more past due and still accruing interest and nonaccrual loans. Performing TDRs are excluded from nonperforming loans.

The provision for loan losses represents charges to earnings necessary to maintain an adequate allowance for probable credit losses inherent in the loan portfolio. Our determination of the appropriate level of the allowance is based on an ongoing analysis of credit quality and loss potential in the loan portfolio, change in the composition and risk characteristics of the loan portfolio, and the anticipated influence of national and local economic conditions. The adequacy of the allowance for loan losses is reviewed quarterly and adjustments are made as considered necessary.

We recorded \$500,000 and \$750,000 provisions for loan losses for the first six months of 2016 and 2015, respectively. These smaller provisions are a result of lower average loan losses experienced over the past twelve quarters. Lower losses cause our historical charge-off factor of the quantitative reserve calculation to decline, thus requiring fewer quantitative reserves.

Table of Contents

49

As illustrated in Table V below, our non-performing assets have decreased since year end 2015.

Table V - Summary of Non-Performing Assets

Dollars in thousands	June 30,		December 31,	
	2016	2015	2015	
Accruing loans past due 90 days or more	\$—	\$8	\$9	
Nonaccrual loans				
Commercial	399	1,065	853	
Commercial real estate	5,773	2,421	5,955	
Commercial construction and development	—	—	—	
Residential construction and development	5,400	5,627	5,623	
Residential real estate	3,531	4,433	3,245	
Consumer	91	37	83	
Total nonaccrual loans	15,194	13,583	15,759	
Foreclosed properties				
Commercial	—	—	—	
Commercial real estate	976	3,279	1,300	
Commercial construction and development	8,708	10,179	8,717	
Residential construction and development	12,989	15,839	14,069	
Residential real estate	752	2,203	1,481	
Total foreclosed properties	23,425	31,500	25,567	
Reposessed assets	38	55	5	
Total nonperforming assets	\$38,657	\$45,146	\$41,340	
Total nonperforming loans as a percentage of total loans	1.29	% 1.26	% 1.45	%
Total nonperforming assets as a percentage of total assets	2.47	% 3.05	% 2.77	%
Allowance for loan losses as a percentage of nonperforming loans	74.88	% 82.99	% 72.75	%
Allowance for loan losses as a percentage of period end loans	0.97	% 1.05	% 1.05	%

The following table details the activity regarding our foreclosed properties for the three and six months ended June 30, 2016 and 2015.

Table VI - Foreclosed Property Activity

Dollars in thousands	For the Three Months Ended		For the Six Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
Beginning balance	\$24,684	\$34,367	\$25,567	\$37,529
Acquisitions	134	—	134	713
Improvements	134	7	463	23
Disposals	(1,267)	(2,714)	(2,370)	(6,033)
Writedowns to fair value	(260)	(160)	(369)	(732)
Balance March 31	\$23,425	\$31,500	\$23,425	\$31,500

Refer to Note 6 of the accompanying consolidated financial statements for information regarding our past due loans, impaired loans, nonaccrual loans, and troubled debt restructurings and to Note 7 for a summary of the methodology we employ on a quarterly basis to evaluate the overall adequacy of our allowance for loan losses.

Relationship between Allowance for Loan Losses, Net Charge-offs and Nonperforming Loans

In analyzing the relationship between the allowance for loan losses, net loan charge-offs and nonperforming loans, it is helpful to understand the process of how loans are treated as they deteriorate over time. Reserves for loans are established at origination through the quantitative and qualitative reserve process discussed in the accompanying Note 7 to the financial statements.

Charge-offs, if necessary, are typically recognized in a period after the reserves were established. If the previously established reserves exceed that needed to satisfactorily resolve the problem credit, a reduction in the overall level of the reserve could be

Table of Contents

50

recognized. In summary, if loan quality deteriorates, the typical credit sequence is periods of reserve building, followed by periods of higher net charge-offs.

Consumer loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), whichever is earlier. Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Commercial-related loans (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination includes many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity.

Substantially all of our nonperforming loans are secured by real estate. The majority of these loans were underwritten in accordance with our loan-to-value policy guidelines which range from 70-85% at the time of origination. The fair values of the underlying collateral value or the discounted cash flows remain in excess of the recorded investment in many of our nonperforming loans, and therefore, no specific reserve allocation is required.

At June 30, 2016, December 31, 2015, and June 30, 2015, our allowance for loan losses totaled \$11.4 million, or 0.97% of total loans, \$11.5 million, or 1.05% of total loans and \$11.3 million, or 1.05% of total loans, respectively, and is considered adequate to cover our estimate of probable credit losses inherent in our loan portfolio.

At June 30, 2016, December 31, 2015, and June 30, 2015, we had approximately \$23.4 million, \$25.6 million and \$31.5 million, respectively, in other real estate owned which was obtained as the result of foreclosure proceedings. Although foreclosed property is recorded at fair value less estimated costs to sell, the prices ultimately realized upon their sale may or may not result in us recognizing loss.

FINANCIAL CONDITION

Our total assets were \$1.57 billion at June 30, 2016, compared to \$1.49 billion at December 31, 2015, representing a 4.9% increase. Table VIII below serves to illustrate significant changes in our financial position between December 31, 2015 and June 30, 2016.

Table VIII - Summary of Significant Changes in Financial Position

	Balance December 31, 2015	Increase (Decrease) Amount		Percentage	Balance June 30, 2016
Dollars in thousands					
Assets					
Securities available for sale	\$280,792	(19,159)	(6.8)	%	\$261,633
Loans, net	1,079,331	87,392	8.1	%	1,166,723
Liabilities					
Deposits	\$1,066,709	29,836	2.8	%	\$1,096,545
Short-term borrowings	171,394	34,159	19.9	%	205,553
Long-term borrowings	75,581	(956)	(1.3)	%	74,625

Loans grew 8.1% during the first six months of 2016 principally as a result of us entering into a participation arrangement with a regional bank to fund residential mortgage warehouse lines of medium- and large-sized mortgage originators located throughout the United States. The outstanding balance of these lines totaled \$80.3 million at June

30, 2016. Our loan growth was funded primarily with deposits, short-term borrowings and a reduction of our securities portfolio.

Deposits increased approximately \$29.8 million during the first six months of 2016; checking deposits and time deposits decreased approximately \$8.8 million and \$1.3 million, respectively, while savings deposits increased \$40.0 million.

Refer to Notes 5, 6, 9, and 10 of the notes to the accompanying consolidated financial statements for additional information with regard to changes in the composition of our securities, loans, deposits and borrowings between June 30, 2016 and December 31, 2015.

Table of Contents

51

LIQUIDITY AND CAPITAL RESOURCES

Liquidity reflects our ability to ensure the availability of adequate funds to meet loan commitments and deposit withdrawals, as well as provide for other transactional requirements. Liquidity is provided primarily by funds invested in cash and due from banks (net of float and reserves), Federal funds sold, non-pledged securities, and available lines of credit with the Federal Home Loan Bank of Pittsburgh (“FHLB”) and Federal Reserve Bank of Richmond, which totaled approximately \$574 million or 36.66% of total consolidated assets at June 30, 2016.

Our liquidity strategy is to fund loan growth with deposits and other borrowed funds while maintaining an adequate level of short- and medium-term investments to meet normal daily loan and deposit activity. As a member of the FHLB, we have access to approximately \$562 million. As of June 30, 2016 and December 31, 2015, these advances totaled approximately \$203 million and \$169 million, respectively. At June 30, 2016, we had additional borrowing capacity of \$359 million through FHLB programs. We have established a line with the Federal Reserve Bank to be used as a contingency liquidity vehicle. The amount available on this line at June 30, 2016 was approximately \$91 million, which is secured by a pledge of our consumer and commercial and industrial loan portfolios. We have a \$6 million unsecured line of credit with a correspondent bank. Also, we classify all of our securities as available for sale to enable us to liquidate them if the need arises.

Liquidity risk represents the risk of loss due to the possibility that funds may not be available to satisfy current or future commitments based on external market issues, customer or creditor perception of financial strength, and events unrelated to Summit such as war, terrorism, or financial institution market specific issues. The Asset/Liability Management Committee (“ALCO”), comprised of members of senior management and certain members of the Board of Directors, oversees our liquidity risk management process. The ALCO develops and recommends policies and limits governing our liquidity to the Board of Directors for approval with the objective of ensuring that we can obtain cost-effective funding to meet current and future obligations, as well as maintain sufficient levels of on-hand liquidity, under both normal and “stressed” circumstances.

We continuously monitor our liquidity position to ensure that day-to-day as well as anticipated funding needs are met. We are not aware of any trends, commitments, events or uncertainties that have resulted in or are reasonably likely to result in a material change to our liquidity.

One of our continuous goals is maintenance of a strong capital position. Through management of our capital resources, we seek to provide an attractive financial return to our shareholders while retaining sufficient capital to support future growth. Shareholders’ equity at June 30, 2016 totaled \$150.7 million compared to \$143.7 million at December 31, 2015.

Refer to Note 13 of the notes to the accompanying consolidated financial statements for additional information regarding regulatory restrictions on our capital as well as our subsidiaries’ capital.

CONTRACTUAL CASH OBLIGATIONS

During our normal course of business, we incur contractual cash obligations. The following table summarizes our contractual cash obligations at June 30, 2016.

Table IX - Contractual Cash Obligations

Dollars in thousands	Long Term	Capital Trust	Operating Leases
----------------------	-----------	---------------	------------------

	Debt	Securities	
2016	\$27,955	\$ —	\$ 152
2017	918	—	250
2018	45,017	—	162
2019	18	—	136
2020	19	—	23
Thereafter	698	19,589	—
Total	\$74,625	\$ 19,589	\$ 723

Table of Contents

52

OFF-BALANCE SHEET ARRANGEMENTS

We are involved with some off-balance sheet arrangements that have or are reasonably likely to have an effect on our financial condition, liquidity, or capital. These arrangements at June 30, 2016 are presented in the following table.

Table X - Off-Balance Sheet Arrangements	June 30, 2016
Dollars in thousands	
Commitments to extend credit:	
Revolving home equity and credit card lines	\$61,678
Construction loans	29,199
Other loans	82,399
Standby letters of credit	2,737
Total	\$176,013

Table of Contents

53

MARKET RISK MANAGEMENT

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. Interest rate risk is our primary market risk and results from timing differences in the repricing of assets, liabilities and off-balance sheet instruments, changes in relationships between rate indices and the potential exercise of imbedded options. The principal objective of asset/liability management is to minimize interest rate risk and our actions in this regard are taken under the guidance of our Asset/Liability Management Committee (“ALCO”), which is comprised of members of senior management and members of the Board of Directors. The ALCO actively formulates the economic assumptions that we use in our financial planning and budgeting process and establishes policies which control and monitor our sources, uses and prices of funds.

Some amount of interest rate risk is inherent and appropriate to the banking business. Our net income is affected by changes in the absolute level of interest rates. Our interest rate risk position at present is slightly liability sensitive. The nature of our lending and funding activities tends to drive our interest rate risk position to being liability sensitive. That is, absent any changes in the volumes of our interest earning assets or interest bearing liabilities, liabilities are likely to reprice faster than assets, resulting in a decrease in net income in a rising rate environment. Net income would increase in a falling interest rate environment. Net income is also subject to changes in the shape of the yield curve. In general, a flattening yield curve would result in a decline in our earnings due to the compression of earning asset yields and funding rates, while a steepening would result in increased earnings as margins widen.

Several techniques are available to monitor and control the level of interest rate risk. We primarily use earnings simulations modeling to monitor interest rate risk. The earnings simulation model forecasts the effects on net interest income under a variety of interest rate scenarios that incorporate changes in the absolute level of interest rates and changes in the shape of the yield curve. Each increase or decrease in interest rates is assumed to gradually take place over the next 12 months, and then remain stable, except for the up 400 scenario, which assumes a gradual increase in rates over 24 months. Assumptions used to project yields and rates for new loans and deposits are derived from historical analysis. Securities portfolio maturities and prepayments are reinvested in like instruments. Mortgage loan prepayment assumptions are developed from industry estimates of prepayment speeds. Noncontractual deposit repricings are modeled on historical patterns.

The following table presents the estimated sensitivity of our net interest income to changes in interest rates, as measured by our earnings simulation model as of June 30, 2016. The sensitivity is measured as a percentage change in net interest income given the stated changes in interest rates (gradual change over 12 months, stable thereafter for the down 100 and the up 200 scenarios, and gradual change over 24 months for the up 400 scenario) compared to net interest income with rates unchanged in the same period. The estimated changes set forth below are dependent on the assumptions discussed above and are well within our ALCO policy limits shown below relative to reductions in net interest income over the ensuing twelve month period.

Change in Interest Rates	Policy	Estimated % Change in Net Interest Income over:			
		0 - 12 Months Actual		13 - 24 Months Actual	
Down 100 basis points (1)	-7 %	0.27 %	1.37 %		
Up 200 basis points (1)	-10 %	-1.85 %	-0.79 %		
Up 400 basis points (2)	N/A	-0.97 %	-2.20 %		

- (1) assumes a parallel shift in the yield curve over 12 months
- (2) assumes a parallel shift in the yield curve over 24 months

Table of Contents

54

CONTROLS AND PROCEDURES

Our management, including the Chief Executive Officer and Chief Financial Officer, has conducted as of June 30, 2016, an evaluation of the effectiveness of disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures as of June 30, 2016 were effective. There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

55

Part II. Other Information

Item 1. Legal Proceedings

Refer to Note 12 of the Notes to the Consolidated Financial Statements in Part I, Item 1 for information regarding legal proceedings not reportable under this Item.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015.

Item 6. Exhibits

Exhibit 3.i Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.

Exhibit 3.ii Articles of Amendment 2009

Exhibit 3.iii Articles of Amendment 2011

Exhibit 3.iv Amended and Restated By-Laws of Summit Financial Group, Inc.

Exhibit 11 Statement re: Computation of Earnings per Share – Information contained in Note 4 to the Consolidated Financial Statements on page 15 of this Quarterly Report is incorporated herein by reference.

Exhibit 31.1 Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer

Exhibit 31.2 Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer

Exhibit 32.1 Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer

Exhibit 32.2 Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer

Exhibit 101 Interactive Data File (XBRL)

Table of Contents

56

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.

SUMMIT FINANCIAL GROUP, INC.
(registrant)

By: /s/ H. Charles Maddy, III
H. Charles Maddy, III,
President and Chief Executive Officer

By: /s/ Robert S. Tissue
Robert S. Tissue,
Senior Vice President and Chief Financial Officer

By: /s/ Julie R. Markwood
Julie R. Markwood,
Vice President and Chief Accounting Officer

Date: August 4, 2016

Table of Contents

57

EXHIBIT INDEX

Exhibit No.	Description	Page Number
(3)	Articles of Incorporation and By-laws:	
	(i) Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.	(a)
	(ii) Articles of Amendment 2009	(b)
	(iii) Articles of Amendment 2011	(c)
	(iv) Amended and Restated By-laws of Summit Financial Group, Inc.	(d)
11	Statement re: Computation of Earnings per Share	15
31.1	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer	
31.2	Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer	
32.1*	Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer	
32.2*	Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer	
101**	Interactive data file (XBRL)	

*Furnished, not filed.

** As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

- (a) Incorporated by reference to Exhibit 3.i of Summit Financial Group, Inc.'s filing on Form 10-Q dated March 31, 2006.
- (b) Incorporated by reference to Exhibit 3.1 of Summit Financial Group, Inc.'s filing on Form 8-K dated September 30, 2009.
- (c) Incorporated by reference to Exhibit 3.1 of Summit Financial Group, Inc.'s filing on Form 8-K dated November 3, 2011.
- (d) Incorporated by reference to Exhibit 3.2 of Summit Financial Group, Inc.'s filing on Form 10-Q dated June 30, 2006.

Table of Contents

58