HERITAGE FINANCIAL CORP /WA/
Form 10-Q
May 01, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1857900 (I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA (Address of principal executive offices)	98501 (Zip Code)

(360) 943-1500
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý 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 ý 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 definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
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 ý

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the last practicable date:

As of April 22, 2014 there were 16,210,833 shares of the registrant's common stock, no par value per share, outstanding.

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FORWARD LOOKING STATEMENTS:

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q ("Form 10-Q") contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and the proposed Washington Banking Company transactions described in this Form 10-Q, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Board of Governors of the Federal Reserve System ("Federal Reserve") and of our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), the Washington State Department of Financial Institutions, Division of Banks ("Division") or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, or change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our Condensed Consolidated Statement of Financial Condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board ("FASB"), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission "SEC" including our Annual Report on Form 10-K for the year ended December 31, 2013.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for future periods to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company’s operating and stock price performance.

As used throughout this report, the terms “we”, “our”, “us”, or the “Company” refer to Heritage Financial Corporation and its consolidated subsidiary, unless the context otherwise requires.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
March 31, 2014 and December 31, 2013
(Dollars in thousands)
(Unaudited)

	March 31, 2014	December 31, 2013
ASSETS		
Cash on hand and in banks	$40,042	$40,162
Interest earning deposits	114,353	90,238
Cash and cash equivalents	154,395	130,400
Other interest earning deposits	15,150	15,662
Investment securities available for sale, at fair value	138,794	163,134
Investment securities held to maturity (fair value of $39,713 and $36,340, respectively)	39,208	36,154
Originated loans receivable, net	993,911	977,285
Less: Allowance for loan losses	(17,534)	(17,153)
Originated loans receivable, net of allowance for loan losses	976,377	960,132
Purchased covered loans receivable, net of allowance for loan losses ($6,567 and $6,167, respectively)	54,907	57,587
Purchased non-covered loans receivable, net of allowance for loan losses ($5,286 and $5,504, respectively)	176,366	185,377
Total loans receivable, net	1,207,650	1,203,096
Federal Deposit Insurance Corporation indemnification asset	3,969	4,382
Other real estate owned ($182 and $182 covered by FDIC shared-loss agreements, respectively)	4,284	4,559
Premises and equipment, net	33,907	34,348
Federal Home Loan Bank stock, at cost	5,666	5,741
Accrued interest receivable	5,180	5,462
Prepaid expenses and other assets	23,446	25,120
Other intangible assets, net	1,459	1,615
Goodwill	29,365	29,365
Total assets	$1,662,473	$1,659,038
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$1,404,214	$1,399,189
Securities sold under agreement to repurchase	28,790	29,420
Accrued expenses and other liabilities	13,052	14,667
Total liabilities	1,446,056	1,443,276
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at March 31, 2014 and December 31, 2013	—	—
Common stock, no par value, 50,000,000 shares authorized; 16,211,537 and 16,210,747 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	138,874	138,659

Retained earnings	78,214	78,265
Accumulated other comprehensive loss, net	(671)	(1,162)
Total stockholders’ equity	216,417	215,762
Total liabilities and stockholders’ equity	$1,662,473	$1,659,038

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three Months Ended March 31, 2014 and 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,	
	2014	2013
INTEREST INCOME:		
Interest and fees on loans	$16,451	$16,756
Taxable interest on investment securities	639	373
Nontaxable interest on investment securities	436	335
Interest and dividends on other interest earning assets	87	57
Total interest income	17,613	17,521
INTEREST EXPENSE:		
Deposits	854	937
Other borrowings	18	9
Total interest expense	872	946
Net interest income	16,741	16,575
Provision for loan losses on originated loans	200	495
Provision for loan losses on purchased loans	258	363
Total provision for loan losses	458	858
Net interest income after provision for loan losses	16,283	15,717
NONINTEREST INCOME:		
Bargain purchase gain on bank acquisition	—	399
Service charges and other fees	1,398	1,353
Merchant Visa income, net	245	172
Change in FDIC indemnification asset	(37)	(267)
Gain on sale of investment securities, net	180	—
Other income	521	588
Total noninterest income	2,307	2,245
NONINTEREST EXPENSE:		
Impairment loss on investment securities	8	2
Compensation and employee benefits	8,011	7,589
Occupancy and equipment	2,617	1,920
Data processing	996	1,136
Marketing	505	326
Professional services	830	1,030
State and local taxes	249	279
Federal deposit insurance premium	252	233
Other real estate owned, net	52	(104)
Amortization of intangible assets	156	115
Other expense	1,103	1,193
Total noninterest expense	14,779	13,719
Income before income taxes	3,811	4,243
Income tax expense	1,268	1,358
Net income	$2,543	$2,885
Basic earnings per common share	$0.16	$0.19

Diluted earnings per common share	$0.16	$0.19
Dividends declared per common share	$0.16	$0.08

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three Months Ended March 31, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Three Months Ended March 31,	
	2014	2013
Net income	$2,543	$2,885
Change in fair value of securities available for sale, net of tax of $319 and $(184), respectively	593	(342)
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $(63) and $0, respectively	(117)	—
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $8 and $7, respectively	15	14
Other comprehensive income (loss)	$491	$(328)
Comprehensive income	$3,034	$2,557

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Three Months Ended March 31, 2014 and 2013
(In thousands, except per share amounts)
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock-holders' equity
Balance at December 31, 2012	15,118	$121,832	$75,362	$1,744	$198,938
Restricted and unrestricted stock awards issued, net of forfeitures	36	—	—	—	—
Stock option compensation expense	—	22	—	—	22
Exercise of stock options (including excess tax benefits from nonqualified stock options)	2	20	—	—	20
Restricted stock compensation expense	—	251	—	—	251
Excess tax benefits from restricted stock	—	47	—	—	47
Common stock repurchased and retired	(8)	(118)	—	—	(118)
Net income	—	—	2,885	—	2,885
Other comprehensive loss, net of tax	—	—	—	(328)	(328)
Cash dividends declared on common stock ($0.08 per share)	—	—	(1,209)	—	(1,209)
Balance at March 31, 2013	15,148	$122,054	$77,038	$1,416	$200,508
Balance at December 31, 2013	16,211	$138,659	$78,265	$(1,162)	$215,762
Restricted and unrestricted stock awards issued, net of forfeitures	5	—	—	—	—
Stock option compensation expense	—	15	—	—	15
Exercise of stock options (including excess tax benefits from nonqualified stock options)	4	57	—	—	57
Restricted stock compensation expense	—	276	—	—	276
Excess tax benefits from restricted stock	—	32	—	—	32
Common stock repurchased and retired	(9)	(165)	—	—	(165)
Net income	—	—	2,543	—	2,543
Other comprehensive income, net of tax	—	—	—	491	491
Cash dividends declared on common stock ($0.16 per share)	—	—	(2,594)	—	(2,594)
Balance at March 31, 2014	16,211	$138,874	$78,214	$(671)	$216,417

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Three Months Ended March 31, 2014	2013
Cash flows from operating activities:		
Net income	$2,543	$2,885
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,666	1,292
Changes in net deferred loan fees, net of amortization	(48)	148
Provision for loan losses	458	858
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(776)	(1,483)
Restricted and unrestricted stock compensation expense	276	251
Stock option compensation expense	15	22
Excess tax benefits from stock options and restricted and unrestricted stock	(32)	(47)
Amortization of intangible assets	156	115
Bargain purchase gain on bank acquisition	—	(399)
Gain on sale of investment securities, net	(180)	—
Impairment loss on investment of securities	8	2
Origination of loans held for sale	—	(4,143)
Gain on sale of loans	—	(81)
Proceeds from sale of loans	—	5,171
Valuation adjustment on other real estate owned	—	(107)
Gain on other real estate owned, net	(27)	(172)
Write-off of furniture, equipment and leasehold improvements	421	—
Net cash provided by operating activities	5,480	4,312
Cash flows from investing activities:		
Loans originated, net of principal payments	(5,180)	(6,393)
Maturities of other interest earning deposits	497	—
Maturities of investment securities available for sale	7,343	16,109
Maturities of investment securities held to maturity	241	338
Purchase of investment securities available for sale	(24,443)	(17,490)
Purchase of investment securities held to maturity	(3,294)	(1,157)
Purchase of premises and equipment	(584)	(1,527)
Proceeds from sales of other real estate owned	520	2,711
Proceeds from sales of investment securities available for sale	40,318	—
Proceeds from redemption of FHLB stock	75	50
Net cash received from acquisitions	—	748
Net cash provided by (used in) investing activities	15,493	(6,611)
Cash flows from financing activities:		
Net increase in deposits	5,025	46,699
Common stock cash dividends paid	(1,297)	(1,209)
Net decrease in securities sold under agreement to repurchase	(630)	(3,992)
Proceeds from exercise of stock options	57	20
Excess tax benefits from stock options and restricted and unrestricted stock	32	47

Repurchase of common stock	(165)	(118)
Net cash provided by financing activities	3,022	41,447
Net increase in cash and cash equivalents	23,995	39,148

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	Three Months Ended March 31,	
	2014	2013
Cash and cash equivalents at beginning of period	130,400	107,086
Cash and cash equivalents at end of period	$154,395	$146,234
Supplemental disclosures of cash flow information:		
Cash paid for interest	$887	$952
Cash paid for income taxes	7	2,612
Transfers of loans receivable to other real estate owned	218	—
Seller-financed sale of other real estate owned	—	250
Assets acquired (liabilities assumed) in acquisitions:		
Investment securities available for sale	—	2,753
Purchased non-covered loans receivable	—	51,509
Other real estate owned	—	2,279
Premises and equipment	—	214
FHLB stock	—	88
Accrued interest receivable	—	232
Prepaid expenses and other assets	—	4,048
Core deposit intangible	—	156
Deposits	—	(60,442)
Accrued expenses and other liabilities	—	(1,186)

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the Three Months Ended March 31, 2014 and 2013
(Unaudited)

(1) Description of Business, Basis of Presentation and Significant Accounting Policies

(a) Description of Business

Heritage Financial Corporation (the “Company”) is a bank holding company that was incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly-owned subsidiary Heritage Bank (the “Bank”). The Bank is a Washington-chartered commercial bank and its deposits are insured by the FDIC under the Deposit Insurance Fund. The Bank is headquartered in Olympia, Washington and conducts business from its thirty-six branch offices located throughout Washington state and the greater Portland, Oregon area. The Bank’s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Bank also makes real estate construction and land development loans and consumer loans and originates first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

The Company has expanded its footprint through acquisitions beginning with the FDIC-assisted acquisition of Cowlitz Bank ("Cowlitz"), a Washington chartered commercial bank headquartered in Longview, Washington effective on July 30, 2010. Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank (the “Cowlitz Acquisition”). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. It also included the Trust Services Division of Cowlitz Bank.

Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank ("Pierce"), a Washington chartered commercial bank headquartered in Tacoma, Washington (the “Pierce Commercial Acquisition”). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010.

On September 14, 2012, the Company and the Bank entered into a definitive agreement to acquire Northwest Commercial Bank (“NCB”), a Washington chartered commercial bank headquartered in Lakewood, Washington (the “NCB Acquisition”). The NCB Acquisition was completed on January 9, 2013, with the merger of NCB into Heritage Bank. The NCB Acquisition included two branches, and one of those branches was consolidated into an existing Heritage Bank location.

On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley" or "Valley Community Bancshares") and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the “Valley Acquisition”). The Valley Acquisition was completed on July 15, 2013 and included eight branches, four of which were initially maintained by Heritage Bank following the completion of the transaction. At the time of the acquisition, one of the four branches, an owned branch building, was considered held for sale. During the fourth quarter of 2013, the leases for the remaining three leases were terminated by Heritage Bank.

On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013 and on a consolidated basis had no accounting impact on the Company. Central Valley Bank now operates as a division of Heritage Bank.

On October 23, 2013, the Company, along with the Bank, and Washington Banking Company (“Washington Banking”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"), jointly announced the signing of a merger agreement pursuant to which Heritage and Washington Banking will enter into a strategic merger with Washington Banking merging into Heritage, and immediately thereafter, Whidbey will merge with and into the Bank (the

"Washington Banking Merger"). Washington Banking branches will adopt the Heritage Bank name in all markets, with the exception of six branches in the Whidbey Island markets that will continue to operate using the Whidbey Island Bank name. The corporate headquarters of the combined company will be in Olympia, Washington. The Washington Banking Merger is anticipated to be completed in the second quarter of 2014. See "Note 13 - Proposed Merger" for additional information.

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(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), for interim financial information, pursuant to the rules and regulations of the SEC. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These Condensed Consolidated Financial Statements and accompanying Notes should be read with our December 31, 2013 audited Consolidated Financial Statements and the accompanying Notes included in our Annual Report on Form 10-K ("2013 Annual Form 10-K"). In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. In preparing the Condensed Consolidated Financial Statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Estimates related to the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes are particularly subject to change.

Certain prior period amounts have been reclassified to conform to the current period's presentation. Reclassifications had no effect on prior periods' net income or stockholders' equity.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our Condensed Consolidated Financial Statements are disclosed in our 2013 Annual Form 10-K. There have not been any material changes in our significant accounting policies from those contained in our 2013 Annual Form 10-K.

(d) Recently Issued Accounting Pronouncements

FASB ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, A Similar Tax Loss, or a Tax Credit Carryforward Exists, was issued in July 2013. This Update provides that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013. The adoption of this amendment did not have a material impact on the Condensed Consolidated Financial Statements.

FASB ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure, was issued in January 2014. This Update intends to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendment states that the real estate property should be recognized upon either the creditor obtaining legal title or the borrower convening all interest through a deed in lieu of foreclosure or similar legal agreement. These amendments are effective for interim and annual reporting periods beginning after December 15, 2014. Early adoption is permitted. The Company adopted the amendments in first quarter of 2014. The adoption did not have an impact on the Condensed Consolidated Financial Statements.

(2) Cash and Cash Equivalents

Since the fourth quarter of 2013, the Company has been required to maintain an average reserve balance with the Federal Reserve or maintain such reserve balance in the form of cash. The average required reserve balance for the three months ended March 31, 2014 was approximately $46.1 million and was met by holding cash and maintaining an average balance with the Federal Reserve. The Company did not have a cash reserve requirement for the three months ended March 31, 2013.

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(3) Investment Securities

The Company's investment policy is designed primarily to provide and maintain liquidity, generate a favorable return on assets without incurring undue interest rate and credit risk, and complement the Bank's lending activities. Securities are classified as either available for sale or held to maturity when acquired.

(a) Securities by Type and Maturity

The amortized cost, gross unrealized gains, gross unrealized losses and fair values of investment securities available for sale at the dates indicated were as follows:

	Securities Available for Sale March 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$6,582	$4	$(36)	$6,550
Municipal securities	51,559	942	(1,098)	51,403
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	81,338	307	(804)	80,841
Total	$139,479	$1,253	$(1,938)	$138,794

	Securities Available for Sale December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$6,098	$3	$(62)	$6,039
Municipal securities	49,989	806	(1,735)	49,060
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government agencies	108,466	898	(1,329)	108,035
Total	$164,553	$1,707	$(3,126)	$163,134

The amortized cost, gross unrealized gains, gross unrealized losses and fair values of investment securities held to maturity at the dates indicated were as follows:

	Securities Held to Maturity March 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,679	$155	$—	$1,834
Municipal securities	24,974	319	(77)	25,216
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	11,527	157	(226)	11,458

Private residential collateralized mortgage obligations	1,028	205	(28)	1,205
Total	$39,208	$836	$(331)	$39,713

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	Securities Held to Maturity December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,687	$153	$—	$1,840
Municipal securities	24,290	200	(184)	24,306
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	9,129	144	(284)	8,989
Private residential collateralized mortgage obligations	1,048	185	(28)	1,205
Total	$36,154	$682	$(496)	$36,340

There were no securities classified as trading at March 31, 2014 or December 31, 2013.

The amortized cost and fair value of securities at March 31, 2014, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Due in one year or less	$1,145	$1,148	$1,757	$1,768
Due after one year through three years	3,855	3,928	5,587	5,654
Due after three years through five years	9,848	10,047	5,007	5,079
Due after five years through ten years	38,375	38,276	18,391	18,588
Due after ten years	86,256	85,395	8,466	8,624
Total	$139,479	$138,794	$39,208	$39,713

(b) Unrealized Losses and Other-Than-Temporary Impairments

Available for sale investment securities with unrealized losses as of March 31, 2014 and December 31, 2013 were as follows:

	Securities Available for Sale March 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$1,551	$(36)	$—	$—	$1,551	$(36)
Municipal securities	16,593	(556)	7,981	(542)	24,574	(1,098)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	39,841	(702)	6,891	(102)	46,732	(804)
Total	$57,985	$(1,294)	$14,872	$(644)	$72,857	$(1,938)

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	Securities Available for Sale December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$3,031	$(62)	$—	$—	$3,031	$(62)
Municipal securities	21,471	(1,242)	4,644	(493)	26,115	(1,735)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	56,327	(1,184)	7,758	(145)	64,085	(1,329)
Total	$80,829	$(2,488)	$12,402	$(638)	$93,231	$(3,126)

Held to maturity investment securities with unrealized losses as of March 31, 2014 and December 31, 2013 were as follows:

	Securities Held to Maturity March 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Municipal securities	$4,553	$(77)	$—	$—	$4,553	$(77)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	7,501	(226)	—	—	7,501	(226)
Private residential collateralized mortgage obligations	161	(4)	121	(24)	282	(28)
Total	$12,215	$(307)	$121	$(24)	$12,336	$(331)

	Securities Held to Maturity December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Municipal securities	$10,967	$(184)	$—	$—	$10,967	$(184)
Mortgage backed securities and collateralized mortgage obligations-residential:						
	4,869	(284)	—	—	4,869	(284)

U.S. Government-sponsored agencies						
Private residential collateralized mortgage obligations	211	(5)	124	(23)	335	(28)
Total	$16,047	$(473)	$124	$(23)	$16,171	$(496)

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The Company has evaluated these securities and has determined that, other than certain private residential collateralized mortgage obligations discussed below, the decline in their value is temporary. The unrealized losses are primarily due to increases in market interest rates and larger spreads in the market for mortgage-related products. The fair value of these securities is expected to recover as the securities approach their maturity date and/or as the pricing spreads narrow on mortgage-related securities. The Company has the ability and intent to hold the investments until recovery of the market value which may be the maturity date of the securities.

To analyze the unrealized losses, the Company estimated expected future cash flows of the private residential collateralized mortgage obligations by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security are then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount. The average discount interest rate used in the valuations of the present value was 6.7% for both the three months ended March 31, 2014 and 2013, and the average prepayment rate for each period was 6.0%.

For the three months ended March 31, 2014, there were two private residential collateralized mortgage obligations determined to be other-than-temporarily impaired. All unrealized losses for the three months ended March 31, 2014 were deemed to be credit related, and the Company recorded the impairment in earnings. For the three months ended March 31, 2013, there was one private residential collateralized mortgage obligation determined to be other-than-temporarily impaired. The impairment for the three months ended March 31, 2013 was considered credit related and was recorded in earnings. No impairment for the three months ended March 31, 2014 and 2013 was recorded through other comprehensive income (loss). The following table summarizes activity for the three months ended March 31, 2014 and 2013 related to the amount of impairments on held to maturity securities:

	Life-to-Date Gross Other-Than-Temporary Impairments	Life-to-Date Other-Than-Temporary Impairments Included in Other Comprehensive Income (Loss)	Life-to-Date Net Other-Than-Temporary Impairments Included in Earnings
	(In thousands)		
December 31, 2012	$2,565	$1,152	$1,413
Subsequent impairments	2	—	2
March 31, 2013	$2,567	$1,152	$1,415
December 31, 2013	$2,603	$1,152	$1,451
Subsequent impairments	8	—	8
March 31, 2014	$2,611	$1,152	$1,459

(c) Redemption-in-Kind

In May 2008, the Board of Trustees of the AMF Ultra Short Mortgage Fund (“Fund”) activated the Fund’s redemption-in-kind provision because of the uncertainty in the mortgage backed securities market. Exiting participants in the Fund were allowed to redeem and receive up to $250,000 in cash per quarter or receive 100% of their investment in “like-kind” securities equal to their proportional ownership in the Fund. The Company elected to receive the like-kind securities.

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Details of private residential collateralized mortgage obligation securities received from the redemption-in-kind election as of March 31, 2014 were as follows:

Type of Security	Par Value	Amortized Cost	Fair Value (1)	Aggregate Unrealized Gain	Year-to-date Change in Unrealized Gain	Year-to-date Impairment Charge	Life-to-date Impairment Charge (2)	Current Ratings AAA	AA	A	BBB	Below Investment Grade
	(Dollars in thousands)											
Alt-A	$723	$ 245	$263	$ 18	$ 3	$ 8	$ 690	— %	— %	— %	— %	100 %
Prime	1,202	783	942	159	17	—	769	— %	— %	— %	7 %	93 %
Totals	$1,925	$ 1,028	$1,205	$ 177	$ 20	$ 8	$ 1,459	— %	— %	— %	6 %	94 %

(1)Level two valuation assumptions were used to determine the fair value of held to maturity securities in the Fund.
(2)Life-to-date impairment charge represents impairment charges recognized in earnings subsequent to redemption of the Fund.

(d) Pledged Securities

The following table summarizes the amortized cost and fair value of available for sale and held to maturity securities that are pledged as collateral for the following obligations at March 31, 2014 and December 31, 2013:

	March 31, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	$74,572	$74,706	$80,386	$80,881
Repurchase agreements	35,398	35,195	34,170	33,893
Total	$109,970	$109,901	$114,556	$114,774

(4) Loans Receivable

The Company originates loans in the ordinary course of business. These loans are identified as “originated” loans. Disclosures related to the Company’s recorded investment in originated loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs because they are insignificant. The Company has also acquired loans through FDIC-assisted and open bank transactions. Loans acquired in a business acquisition are designated as “purchased” loans. The Company refers to the purchased loans subject to the FDIC shared-loss agreements as “covered” loans, and those loans without shared-loss agreements are referred to as “non-covered” loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as “purchased impaired” loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs. These loans are identified as “purchased other” loans.

(a) Loan Origination/Risk Management

The Company originates loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential and consumer. Within these segments are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts internal loan reviews and validates the credit risk assessment on a periodic basis and presents the results of these reviews to management. The loan review process complements and reinforces the risk identification and assessment decisions made by loan officers and credit personnel, as well as the Company’s policies and procedures.

A discussion of the risk characteristics of each loan portfolio segment is as follows:
Commercial Business:
There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.
Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.
Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes of loans in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.
One-to-Four Family Residential:
The majority of the Company’s one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company’s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. Until the second quarter of 2013, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. After the second quarter of 2013, the Company only originated single-family loans for its loan portfolio.
Real Estate Construction and Land Development:
The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project’s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company’s estimates with regard to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company’s estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being dependent upon successful completion of the construction project, interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:
The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process for these loans ensures a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are significantly influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures

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are developed and modified, as needed. The majority of consumer loans are for relatively small amounts disbursed among many individual borrowers which reduces the credit risk for this type of loan. To further reduce the risk, trend reports are reviewed by management on a regular basis.

Originated loans receivable at March 31, 2014 and December 31, 2013 consisted of the following portfolio segments and classes:

	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$284,949	$283,075
Owner-occupied commercial real estate	209,286	211,287
Non-owner occupied commercial real estate	361,602	354,451
Total commercial business	855,837	848,813
One-to-four family residential	40,866	39,235
Real estate construction and land development:		
One-to-four family residential	19,302	18,593
Five or more family residential and commercial properties	49,929	45,184
Total real estate construction and land development	69,231	63,777
Consumer	30,599	28,130
Gross originated loans receivable	996,533	979,955
Net deferred loan fees	(2,622)	(2,670)
Originated loans receivable, net	993,911	977,285
Allowance for loan losses	(17,534)	(17,153)
Originated loans receivable, net of allowance for loan losses	$976,377	$960,132

The recorded investment of purchased covered loans receivable at March 31, 2014 and December 31, 2013 consisted of the following portfolio segments and classes:

	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$14,646	$14,690
Owner-occupied commercial real estate	24,107	24,366
Non-owner occupied commercial real estate	13,399	14,625
Total commercial business	52,152	53,681
One-to-four family residential	4,306	4,777
Real estate construction and land development:		
One-to-four family residential	1,554	1,556
Total real estate construction and land development	1,554	1,556
Consumer	3,462	3,740
Gross purchased covered loans receivable	61,474	63,754
Allowance for loan losses	(6,567)	(6,167)
Purchased covered loans receivable, net	$54,907	$57,587

The March 31, 2014 and December 31, 2013 gross recorded investment balance of purchased impaired covered loans accounted for under FASB ASC 310-30 was $37.3 million and $38.9 million, respectively. The gross recorded investment balance of purchased other covered loans was $24.2 million and $24.9 million at March 31, 2014 and December 31, 2013, respectively. At both March 31, 2014 and December 31, 2013, the recorded investment balance of purchased covered loans which are no longer covered under the FDIC shared-loss agreements was $2.6 million.

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Funds advanced on the purchased covered loans subsequent to acquisition, referred to as "subsequent advances," are included in the purchased covered loan balances as these subsequent advances are covered under the shared-loss agreements. These subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased covered loans was $5.6 million and $4.7 million as of March 31, 2014 and December 31, 2013, respectively.

The recorded investment of purchased non-covered loans receivable at March 31, 2014 and December 31, 2013 consisted of the following portfolio segments and classes:

	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$48,267	$53,465
Owner-occupied commercial real estate	68,366	70,022
Non-owner occupied commercial real estate	44,246	45,528
Total commercial business	160,879	169,015
One-to-four family residential	2,747	3,847
Real estate construction and land development:		
One-to-four family residential	1,134	1,131
Five or more family residential and commercial properties	4,398	3,471
Total real estate construction and land development	5,532	4,602
Consumer	12,494	13,417
Gross purchased non-covered loans receivable	181,652	190,881
Allowance for loan losses	(5,286)	(5,504)
Purchased non-covered loans receivable, net	$176,366	$185,377

The March 31, 2014 and December 31, 2013 gross recorded investment balance of purchased impaired non-covered loans accounted for under FASB ASC 310-30 was $32.8 million and $36.0 million, respectively. The recorded investment balance of purchased other non-covered loans was $148.9 million and $154.9 million at March 31, 2014 and December 31, 2013, respectively.

(b) Concentrations of Credit

Most of the Company's lending activity occurs within Washington State, and to a lesser extent Oregon State. The Company's primary market areas include Thurston, Pierce, King, Mason, Cowlitz, Yakima, Kittitas and Clark counties in Washington and Multnomah County in Oregon, as well as other contiguous markets. The majority of the Company's loan portfolio consists of (in order of balances at March 31, 2014) non-owner occupied commercial real estate, commercial and industrial and owner-occupied commercial real estate. As of March 31, 2014 and December 31, 2013, there were no concentrations of loans related to any single industry in excess of 10% of the Company's total loans.

(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 10. A description of the general characteristics of the risk grades is as follows:

- Grades 0 to 5: These grades are considered "pass grade" and include loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the "pass" category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.

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- Grade 6: This grade includes "Watch" loans and is considered a “pass grade”. The grade is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.
- Grade 7: This grade includes “Other Assets Especially Mentioned” (“OAEM”) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.
- Grade 8: This grade includes “Substandard” loans in accordance with regulatory guidelines, which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company’s accrual policy.
- Grade 9: This grade includes “Doubtful” loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.
- Grade 10: This grade includes “Loss” loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. “Loss” is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. One-to-four family residential loans and consumer loans (“non-commercial loans”) are not numerically graded at origination date as these loans are determined to be “pass graded” loans. These non-commercial loans may subsequently require numeric grade if the credit department has evaluated the credit and determined it necessary to classify the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some estimated inherent losses, but to a lesser extent than the other loan grades. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

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The following tables present the balance of the originated loans receivable by credit quality indicator as of March 31, 2014 and December 31, 2013.

	March 31, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$264,175	$6,570	$13,445	$759	$284,949
Owner-occupied commercial real estate	200,252	2,568	6,466	—	209,286
Non-owner occupied commercial real estate	343,354	11,989	6,259	—	361,602
Total commercial business	807,781	21,127	26,170	759	855,837
One-to-four family residential	39,974	268	624	—	40,866
Real estate construction and land development:					
One-to-four family residential	11,291	1,021	6,990	—	19,302
Five or more family residential and commercial properties	40,057	—	9,872	—	49,929
Total real estate construction and land development	51,348	1,021	16,862	—	69,231
Consumer	30,413	17	169	—	30,599
Gross originated loans	$929,516	$22,433	$43,825	$759	$996,533

	December 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$259,071	$8,367	$14,368	$1,269	$283,075
Owner-occupied commercial real estate	202,440	3,393	5,454	—	211,287
Non-owner occupied commercial real estate	340,732	7,927	5,792	—	354,451
Total commercial business	802,243	19,687	25,614	1,269	848,813
One-to-four family residential	38,330	269	636	—	39,235
Real estate construction and land development:					
One-to-four family residential	10,608	4,159	3,826	—	18,593
Five or more family residential and commercial properties	42,780	—	2,404	—	45,184
Total real estate construction and land development	53,388	4,159	6,230	—	63,777
Consumer	27,986	—	144	—	28,130
Gross originated loans	$921,947	$24,115	$32,624	$1,269	$979,955

The tables above include $29.3 million and $27.4 million of originated impaired loans as of March 31, 2014 and December 31, 2013, respectively, as detailed in the impaired loans section below. These impaired loans have been individually reviewed for probable incurred losses and have a specific valuation allowance, as necessary. The tables above also include potential problem loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem originated loans as of March 31, 2014 and December 31, 2013 were $41.6 million and $34.5 million, respectively. The balance of

potential problem originated loans guaranteed by a governmental agency, which reduces the Company's credit exposure, was $1.4 million and $1.8 million as of March 31, 2014 and December 31, 2013, respectively.
The following tables present the recorded invested balance of the purchased covered and non-covered loans receivable by credit quality indicator as of March 31, 2014 and December 31, 2013.

	March 31, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$50,841	$4,520	$6,683	$869	$62,913
Owner-occupied commercial real estate	88,100	897	3,223	253	92,473
Non-owner occupied commercial real estate	45,753	1,151	7,402	3,339	57,645
Total commercial business	184,694	6,568	17,308	4,461	213,031
One-to-four family residential	4,795	429	1,829	—	7,053
Real estate construction and land development:					
One-to-four family residential	754	—	1,934	—	2,688
Five or more family residential and commercial properties	3,449	—	949	—	4,398
Total real estate construction and land development	4,203	—	2,883	—	7,086
Consumer	13,015	343	2,038	560	15,956
Gross purchased covered and non-covered loans	$206,707	$7,340	$24,058	$5,021	$243,126

	December 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$55,404	$4,703	$7,183	$865	$68,155
Owner-occupied commercial real estate	87,774	2,739	3,619	256	94,388
Non-owner occupied commercial real estate	47,157	1,165	7,562	4,269	60,153
Total commercial business	190,335	8,607	18,364	5,390	222,696
One-to-four family residential	5,654	882	2,088	—	8,624
Real estate construction and land development:					
One-to-four family residential	1,672	—	1,015	—	2,687
Five or more family residential and commercial properties	2,552	—	919	—	3,471
Total real estate construction and land development	4,224	—	1,934	—	6,158
Consumer	14,562	354	2,241	—	17,157
Gross purchased covered and non-covered loans	$214,775	$9,843	$24,627	$5,390	$254,635

The tables above include $6.7 million of purchased other impaired loans as of both March 31, 2014 and December 31, 2013 as detailed in the impaired loans section below. These purchased other impaired loans have been individually reviewed for potential losses and have a specific valuation allowance, as necessary.

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(d) Nonaccrual loans

Originated nonaccrual loans, segregated by segments and classes of loans, were as follows as of March 31, 2014 and December 31, 2013:

	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$5,148	$4,497
Owner-occupied commercial real estate	1,006	1,024
Non-owner occupied commercial real estate	3	3
Total commercial business	6,157	5,524
One-to-four family residential	334	340
Real estate construction and land development:		
One-to-four family residential	4,074	1,045
Total real estate construction and land development	4,074	1,045
Consumer	62	38
Gross originated nonaccrual loans (1)	$10,627	$6,947

(1) $1.8 million and $1.7 million of nonaccrual originated loans were guaranteed by governmental agencies at March 31, 2014 and December 31, 2013, respectively.

The recorded investment balance of purchased other nonaccrual loans, segregated by segments and classes of loans, were as follows as of March 31, 2014 and December 31, 2013:

	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$276	$151
Owner-occupied commercial real estate	429	—
Total commercial business	705	151
Consumer	644	647
Gross purchased other nonaccrual loans (1)	$1,349	$798

(1) $7,000 of purchased other nonaccrual loans were covered by the FDIC shared-loss agreements at both March 31, 2014 and December 31, 2013.

(e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements.

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The balances of originated past due loans, segregated by segments and classes of loans, as of March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$2,279	$3,376	$5,655	$279,294	$284,949	$ —
Owner-occupied commercial real estate	168	578	746	208,540	209,286	—
Non-owner occupied commercial real estate	74	3	77	361,525	361,602	—
Total commercial business	2,521	3,957	6,478	849,359	855,837	—
One-to-four family residential	89	—	89	40,777	40,866	—
Real estate construction and land development:						
One-to-four family residential	315	1,045	1,360	17,942	19,302	—
Five or more family residential and commercial properties	—	—	—	49,929	49,929	—
Total real estate construction and land development	315	1,045	1,360	67,871	69,231	—
Consumer	31	—	31	30,568	30,599	—
Gross originated loans	$2,956	$5,002	$7,958	$988,575	$996,533	$ —

	December 31, 2013					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$2,253	$3,446	$5,699	$277,376	$283,075	$ —
Owner-occupied commercial real estate	325	849	1,174	210,113	211,287	—
Non-owner occupied commercial real estate	951	9	960	353,491	354,451	6
Total commercial business	3,529	4,304	7,833	840,980	848,813	6
One-to-four family residential	89	—	89	39,146	39,235	—
Real estate construction and land development:						
One-to-four family residential	821	1,045	1,866	16,727	18,593	—
Five or more family residential and commercial properties	—	—	—	45,184	45,184	—
Total real estate construction and land development	821	1,045	1,866	61,911	63,777	—
Consumer	211	—	211	27,919	28,130	—
Gross originated loans	$4,650	$5,349	$9,999	$969,956	$979,955	$ 6

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The balances of purchased covered and non-covered past due loans, segregated by segments and classes of loans, as of March 31, 2014 and December 31, 2013 are as follows:

	March 31, 2014					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$57	$2,888	$2,945	$59,968	$62,913	$ 106
Owner-occupied commercial real estate	1,110	147	1,257	91,216	92,473	—
Non-owner occupied commercial real estate	873	3,536	4,409	53,236	57,645	—
Total commercial business	2,040	6,571	8,611	204,420	213,031	106
One-to-four family residential	—	255	255	6,798	7,053	—
Real estate construction and land development:						
One-to-four family residential	532	861	1,393	1,295	2,688	—
Five or more family residential and commercial properties	—	870	870	3,528	4,398	381
Total real estate construction and land development	532	1,731	2,263	4,823	7,086	381
Consumer	199	638	837	15,119	15,956	—
Gross purchased covered and non-covered loans	$2,771	$9,195	$11,966	$231,160	$243,126	$ 487

	December 31, 2013					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$966	$2,089	$3,055	$65,100	$68,155	$ 23
Owner-occupied commercial real estate	511	147	658	93,730	94,388	—
Non-owner occupied commercial real estate	210	3,710	3,920	56,233	60,153	110
Total commercial business	1,687	5,946	7,633	215,063	222,696	133
One-to-four family residential	595	509	1,104	7,520	8,624	—
Real estate construction and land development:						
One-to-four family residential	213	644	857	1,830	2,687	—
Five or more family residential and commercial properties	384	453	837	2,634	3,471	—
Total real estate construction and land development	597	1,097	1,694	4,464	6,158	—
Consumer	66	91	157	17,000	17,157	—
	$2,945	$7,643	$10,588	$244,047	$254,635	$ 133

Gross purchased covered and
non-covered loans

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(f) Impaired loans

Originated impaired loans (including troubled debt restructured loans) as of March 31, 2014 and December 31, 2013 are set forth in the following tables.

	March 31, 2014				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$5,854	$4,325	$10,179	$11,926	$2,043
Owner-occupied commercial real estate	1,069	1,858	2,927	2,967	534
Non-owner occupied commercial real estate	2,757	4,095	6,852	6,852	336
Total commercial business	9,680	10,278	19,958	21,745	2,913
One-to-four family residential	585	—	585	615	—
Real estate construction and land development:					
One-to-four family residential	3,770	2,727	6,497	7,240	549
Five or more family residential and commercial properties	2,125	—	2,125	2,125	—
Total real estate construction and land development	5,895	2,727	8,622	9,365	549
Consumer	109	62	171	173	62
Gross originated loans	$16,269	$13,067	$29,336	$31,898	$3,524

	December 31, 2013				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$5,713	$3,980	$9,693	$13,889	$1,891
Owner-occupied commercial real estate	1,092	1,880	2,972	3,686	595
Non-owner occupied commercial real estate	2,780	4,123	6,903	6,757	364
Total commercial business	9,585	9,983	19,568	24,332	2,850
One-to-four family residential	592	—	592	849	—
Real estate construction and land development:					
One-to-four family residential	3,773	911	4,684	6,402	211
Five or more family residential and commercial properties	2,404	—	2,404	2,385	—
	6,177	911	7,088	8,787	211

Total real estate construction and land development					
Consumer	100	38	138	140	38
Gross originated loans	$16,454	$10,932	$27,386	$34,108	$3,099

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The Company had governmental guarantees of $3.0 million related to the originated impaired loan balances at both March 31, 2014 and December 31, 2013.

The average recorded investment of originated impaired loans (including TDRs) for the three months ended March 31, 2014 and 2013 are set forth in the following table.

	Three Months Ended March 31, 2014	2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$9,936	$11,858
Owner-occupied commercial real estate	2,949	2,251
Non-owner occupied commercial real estate	6,878	7,095
Total commercial business	19,763	21,204
One-to-four family residential	155	1,036
Real estate construction and land development:		
One-to-four family residential	5,591	3,213
Five or more family residential and commercial properties	2,265	3,310
Total real estate construction and land development	7,856	6,523
Consumer	155	102
Gross originated impaired loans	$27,929	$28,865

A purchased other loan generally becomes impaired when classified as nonaccrual or when its modification results in a TDR. Purchased other impaired loans (including TDRs) as of March 31, 2014 and December 31, 2013 are set forth in the following tables.

	March 31, 2014 Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$449	$4,491	$4,940	$5,101	$1,221
Owner-occupied commercial real estate	25	429	454	456	388
Non-owner occupied commercial real estate	516	—	516	516	—
Total commercial business	990	4,920	5,910	6,073	1,609
Consumer	821	—	821	823	—
Gross purchased other impaired loans	$1,811	$4,920	$6,731	$6,896	$1,609

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	December 31, 2013				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$437	$4,621	$5,058	$5,564	$1,454
Owner-occupied commercial real estate	26	—	26	153	—
Non-owner occupied commercial real estate	520	—	520	1,401	—
Total commercial business	983	4,621	5,604	7,118	1,454
One-to-four family residential	—	450	450	428	31
Consumer	7	640	647	648	115
Gross purchased other impaired loans	$990	$5,711	$6,701	$8,194	$1,600

The average recorded investment of purchased other impaired loans (including TDRs) for the three months ended March 31, 2014 and 2013 are set forth in the following table.

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$4,999	$437
Owner-occupied commercial real estate	240	138
Non-owner occupied commercial real estate	518	972
Total commercial business	5,757	1,547
One-to-four family residential	225	495
Consumer	734	101
Gross impaired purchased other loans	$6,716	$2,143

For the three months ended March 31, 2014 and 2013 no interest income was recognized subsequent to a loan's classification as nonaccrual. For the three months ended March 31, 2014 and 2013, the Bank recorded $309,000 and $217,000 of interest income related to restructured performing loans, respectively.

(g) Troubled Debt Restructured Loans

A troubled debt restructured loan is a restructuring in which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDRs are considered impaired and are separately measured for impairment under FASB ASC 310-10-35, whether on accrual or nonaccrual status.

The majority of the Bank's TDRs are a result of granting extensions to troubled credits which have already been adversely classified. We grant such extensions to reassess the borrower's financial status and to develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. Certain TDRs were additionally re-amortized over a longer period of time. The Bank additionally advanced funds to a troubled speculative home builder to complete established projects. These modifications would all be considered a concession for a borrower that could not obtain similar financing terms from another source other than from the Bank.

The financial effects of each modification will vary based on the specific restructure. For the majority of the Bank's TDRs, the loans were interest-only with a balloon payment at maturity. If the interest rate is not adjusted and the modified terms are consistent with other similar credits being offered, the Bank may not experience any loss associated with the restructure. If, however, the restructure involves forbearance agreements or interest rate

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modifications, the Bank may not collect all the principal and interest based on the original contractual terms. The Bank estimates the necessary allowance for loan losses on TDRs using the same guidance as used for other impaired loans.

The recorded investment balance and related allowance for loan losses of accruing and non-accruing TDRs as of March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014		December 31, 2013	
	Accruing TDRs	Non-accruing TDRs	Accruing TDRs	Non-accruing TDRs
	(In thousands)			
Originated TDRs	$18,710	$3,669	$20,439	$2,532
Allowance for loan losses on originated TDRs	2,007	434	2,187	133
Purchased other TDRs	5,382	232	5,903	110
Allowance for loan losses on purchased other TDRs	1,035	185	1,430	57

The unfunded commitment to borrowers related to originated TDRs was $842,000 and $1.5 million at March 31, 2014 and December 31, 2013, respectively. There were $74,000 and $17,000 of unfunded commitments to borrowers related to the purchased other TDRs as of March 31, 2014 and December 31, 2013, respectively.

Originated loans that were modified as TDRs during the three months ended March 31, 2014 and 2013 are set forth in the following table:

	Three Months Ended March 31,			
	2014		2013	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	7	$1,614	11	$4,224
Owner-occupied commercial real estate	1	351	—	—
Total commercial business	8	1,965	11	4,224
One-to-four family residential	—	—	1	257
Real estate construction and land development:				
One-to-four family residential	1	190	1	180
Total real estate construction and land development	1	190	1	180
Consumer	2	45	—	—
Total originated TDRs	11	$2,200	13	$4,661

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three months ended March 31, 2014 and 2013.

(2) Includes subsequent payments after modifications and reflects the balance as of period end. As the Bank did not forgive any principal or interest balance as part of the loan modification, the Bank’s recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification (post-modification), except when the modification was the initial advance on a one-to-four family residential real estate construction and land development loan under a master guidance line. There were no construction loans under a master guidance line that were modified as TDRs during the three months ended March 31, 2014 and 2013.

Of the 11 loans modified during the three months ended March 31, 2014, three loans with a total outstanding principal balance of $584,000 were previously reported as TDRs as of December 31, 2013. Of the 13 loans modified during the three months ended March 31, 2013, five loans with a total outstanding principal balance of $1.9 million were previously reported as TDRs as of December 31, 2012. The Bank typically grants shorter extension periods to continually monitor the troubled credits despite the fact that the extended date might not be the date the Bank expects the cash flow. The Company does not consider these modifications a subsequent default of a TDR as new loan terms, specifically maturity dates, were granted. The potential losses related to these loans would have been considered in the period the loan was first reported as a TDR and adjusted, as necessary, in the current periods based on more recent information. The related specific valuation allowance for TDRs that were modified during the three months ended March 31, 2014 was $744,000 at March 31, 2014. The related specific valuation allowance for those TDRs

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that were previously reported as TDRs as of December 31, 2013 was $484,000 and the allowance for loan losses for TDRs that were modified during the three months ended March 31, 2014 that were not previously reported as TDRs was $6,000 as of December 31, 2013.

Purchased other loans that were modified as TDRs during the three months ended March 31, 2014 and 2013 are set forth in the following table:

	Three Months Ended March 31,			
	2014		2013	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts	Outstanding Principal Balance
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	3	$4,224	—	$—
Total commercial business	3	4,224	—	—
Consumer	1	177	—	—
Total purchased other TDRs	4	$4,401	—	$—

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three months ended March 31, 2014 and 2013.

(2) Includes subsequent payments after modifications and reflects the balance as of period end. The Bank's initial recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification (post-modification) as the Bank did not forgive any principal or interest balance as part of the loan modification.

Of the four purchased other loans modified as TDRs during the three months ended March 31, 2014, the three commercial and industrial loans totaling $4.2 million were previously reported as TDRs at December 31, 2013. The Bank granted extensions of one year to two of the loans and required full payment of the third loan approximately two years before the original maturity date based on a revised loan agreement. The related specific valuation allowance for the purchased other loans modified as TDRs during the three months ended March 31, 2014 was $954,000 as of March 31, 2014.

The loans modified during the previous twelve months ended March 31, 2014 that subsequently defaulted during the three months ended March 31, 2014 are included in the following table:

	Three Months Ended March 31, 2014			
	Originated Loans		Purchased Other Loans	
	Number of Contracts	Outstanding Principal Balance	Number of Contracts	Outstanding Principal Balance
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	2	$674	1	$125
Non-owner occupied commercial real estate	1	3	—	—
Total commercial business	3	677	1	125
Total loans receivable	3	$677	1	$125

All of the loans included in the above table defaulted because they were past their modified maturity date. There were no originated or purchased other loans that had been modified during the previous twelve months ended March 31, 2013 that subsequently defaulted during the three months ended March 31, 2013.

(h) Purchased Impaired Loans

As indicated above, the Company purchased impaired loans from the Cowlitz, Pierce, NCB and Valley Acquisitions which are accounted for under FASB ASC 310-30.

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The following tables reflect the outstanding balance at March 31, 2014 and December 31, 2013 of the purchased impaired loans by acquisition:

	Cowlitz	
	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$10,562	$10,608
Owner-occupied commercial real estate	11,370	11,538
Non-owner occupied commercial real estate	9,460	10,611
Total commercial business	31,392	32,757
One-to-four family residential	3,934	3,966
Real estate construction and land development:		
One-to-four family residential	1,284	1,298
Total real estate construction and land development	1,284	1,298
Consumer	1,829	2,022
Gross purchased impaired covered loans	$38,439	$40,043

The total balance of subsequent advances on the purchased impaired covered loans was $3.3 million and $2.6 million as of March 31, 2014 and December 31, 2013, respectively. The Bank has the option to modify certain purchased covered loans which may terminate the FDIC shared-loss coverage on those modified loans. At both March 31, 2014 and December 31, 2013, the recorded investment balance of purchased impaired covered loans which are no longer covered under the FDIC shared-loss agreements was $1.7 million. The Bank continues to report these loans in the covered portfolio as they are in a pool and they continue to be accounted for under FASB ASC 310-30. The FDIC indemnification asset has been adjusted to reflect the change in the loan status.

	Pierce	
	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$13,756	$15,684
Owner-occupied commercial real estate	5,006	5,067
Non-owner occupied commercial real estate	4,860	4,893
Total commercial business	23,622	25,644
One-to-four family residential	2,819	4,055
Real estate construction and land development:		
One-to-four family residential	1,896	1,967
Five or more family residential and commercial properties	466	469
Total real estate construction and land development	2,362	2,436
Consumer	895	1,013
Gross purchased impaired non-covered loans	$29,698	$33,148

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	NCB	
	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$997	$1,014
Non-owner occupied commercial real estate	1,778	2,028
Total commercial business	2,775	3,042
Real estate construction and land development:		
Five or more family residential and commercial properties	604	608
Total real estate construction and land development	604	608
Consumer	78	79
Gross purchased impaired non-covered loans	$3,457	$3,729

	Valley	
	March 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$1,504	$1,495
Owner-occupied commercial real estate	437	443
Non-owner occupied commercial real estate	1,333	1,355
Total commercial business	3,274	3,293
Consumer	57	58
Gross purchased impaired non-covered loans	$3,331	$3,351

On the acquisition dates, the amount by which the undiscounted expected cash flows of the purchased impaired loans exceeded the estimate fair value of the loan is the “accretable yield”. The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the purchased impaired loan.

The following tables summarize the accretable yield on the purchased impaired loans resulting from the Cowlitz, Pierce, NCB and Valley Acquisitions for the three months ended March 31, 2014 and 2013. As the Valley Acquisition was not completed until third quarter of 2013, there are no balances for the three months ended March 31, 2013.

	Three Months Ended March 31, 2014				
	Cowlitz	Pierce	NCB	Valley	Total
	(In thousands)				
Balance at the beginning of the period	$9,535	$7,129	$433	$152	$17,249
Accretion	(685)	(762)	(66)	—	(1,513)
Disposal and other	(43)	(594)	(39)	—	(676)
Change in accretable yield	256	706	130	—	1,092
Balance at the end of the period	$9,063	$6,479	$458	$152	$16,152

	Three Months Ended March 31, 2013			
	Cowlitz	Pierce	NCB (1)	Total
	(In thousands)			
Balance at the beginning of the period	$14,286	$7,352	$—	$21,638
Accretion	(1,354)	(1,282)	(158)	(2,794)
Disposal and other	945	2,822		3,767
Change in accretable yield	231	28	745	1,004
Balance at the end of the period	$14,108	$8,920	$587	$23,615

(1) The accretable difference at acquisition date of January 9, 2013 was $745,000 and is included in the "change in accretable yield" caption.

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(5) Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and inherent risks in the loan portfolio. A summary of the changes in the originated loans' allowance for loan losses for the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Balance at the beginning of the period	$17,153	$19,125
Charge-offs	(63)	(1,827)
Recoveries of loans previously charged-off	244	119
Provision for loan losses	200	495
Balance at the end of the period	$17,534	$17,912

A summary of the changes in the purchased covered loans' allowance for loan losses for the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Balance at the beginning of the period	$6,167	$4,352
Charge-offs	(79)	—
Provision for loan losses	479	358
Balance at the end of the period	$6,567	$4,710

A summary of the changes in the purchased noncovered loans' allowance for loan losses for the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Balance at the beginning of the period	$5,504	$5,117
Charge-offs	—	(197)
Recoveries of loans previously charged-off	3	—
Provision for loan losses	(221)	5
Balance at the end of the period	$5,286	$4,925

The purchased loans acquired in the Cowlitz, Pierce, NCB and Valley Acquisitions are subject to the Company's internal credit review. If and when credit deterioration occurs subsequent to the acquisition dates, a provision for loan losses will be charged to earnings for the full amount without regard to the FDIC shared-loss agreements for the covered loan balances. The portion of the estimated loss reimbursable from the FDIC is recorded in noninterest income and increases the FDIC indemnification asset.

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The following table details activity in the allowance for loan losses disaggregated on the basis of the Company's impairment method as of and for the three months ended March 31, 2014:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Unallocated	Total
	(In thousands)								
Allowance for loan losses for the three months ended March 31, 2014:									
December 31, 2013	$13,478	$4,049	$5,326	$1,100	$1,720	$953	$1,597	$601	$28,824
Charge-offs	(79)	—	—	—	—	—	(63)	—	(142)
Recoveries	232	—	—	—	—	—	15	—	247
Provisions for / (Reallocation of) loan losses	(1,354)	414	(100)	21	259	1,030	141	47	458
March 31, 2014	$12,277	$4,463	$5,226	$1,121	$1,979	$1,983	$1,690	$648	$29,387
Allowance for loan losses as of March 31, 2014 allocated to:									
Originated loans individually evaluated for impairment	$2,043	$534	$336	$—	$549	$—	$62	$—	$3,524
Originated loans collectively evaluated for impairment	5,540	1,945	2,412	590	399	1,889	587	648	14,010
Purchased other covered	395	388	—	—	—	—	—	—	783

loans individually evaluated for impairment									
Purchased other covered loans collectively evaluated for impairment	27	14	14	14	—	—	41	—	110
Purchased other non-covered loans individually evaluated for impairment	826	—	—	—	—	—	—	—	826
Purchased other non-covered loans collectively evaluated for impairment	72	62	57	6	—	—	115	—	312
Purchased impaired covered loans collectively evaluated for impairment	1,128	1,180	2,057	299	752	—	258	—	5,674
Purchased impaired non-covered loans collectively evaluated for impairment	2,246	340	350	212	279	94	627	—	4,148
March 31, 2014	$ 12,277	$ 4,463	$ 5,226	$ 1,121	$ 1,979	$ 1,983	$ 1,690	$ 648	$ 29,387

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The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company's impairment method for the three months ended March 31, 2013 and as of December 31, 2013:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Unallocated	Total
	(In thousands)								
Allowance for loan losses for the three months ended March 31, 2013:									
December 31, 2012	$9,912	$4,021	$5,369	$1,221	$3,131	$2,309	$1,761	$870	$28,594
Charge-offs	(1,637)	—	—	(52)	—	(83)	(252)	—	$(2,024)
Recoveries	110	—	—	—	—	—	9	—	$119
Provision for / (Reallocation of) loan losses	2,459	(180)	(94)	37	(476)	(891)	(23)	26	$858
March 31, 2013	$10,844	$3,841	$5,275	$1,206	$2,655	$1,335	$1,495	$896	$27,547
Allowance for loan losses as of December 31, 2013 allocated to:									
Originated loans individually evaluated for impairment	$1,891	$595	$364	$—	$211	$—	$38	$—	$3,099
Originated loans collectively evaluated for impairment	6,614	2,039	2,459	564	429	855	493	601	14,054
Purchased other covered loans individually	629	—	—	31	—	—	—	—	660

evaluated for impairment									
Purchased other covered loans collectively evaluated for impairment	18	7	14	13	—	—	57	—	109
Purchased other non-covered loans individually evaluated for impairment	825	—	—	—	—	—	115	—	940
Purchased other non-covered loans collectively evaluated for impairment	113	62	57	6	—	—	82	—	320
Purchased impaired covered loans collectively evaluated for impairment	1,094	998	2,073	270	789	—	174	—	5,398
Purchased impaired non-covered loans collectively evaluated for impairment	2,294	348	359	216	291	98	638	—	4,244
December 31, 2013	$13,478	$4,049	$5,326	$1,100	$1,720	$953	$1,597	$601	$28,824

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The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company's impairment method as of March 31, 2014:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Total
	(In thousands)							
Originated loans individually evaluated for impairment	$10,179	$2,927	$6,852	$585	$6,497	$2,125	$171	$29,336
Originated loans collectively evaluated for impairment	274,770	206,359	354,750	40,281	12,805	47,804	30,428	967,197
Purchased other covered loans individually evaluated for impairment	3,650	429	—	—	—	—	7	4,086
Purchased other covered loans collectively evaluated for impairment	2,481	12,878	2,424	790	—	—	1,559	20,132
Purchased other non-covered loans individually evaluated for impairment	1,290	25	516	—	—	—	814	2,645
Purchased other non-covered loans collectively evaluated for impairment	32,293	63,271	37,456	79	1,084	3,011	9,058	146,252
Purchased impaired covered loans collectively evaluated for impairment	8,515	10,800	10,975	3,516	1,554	—	1,896	37,256
Purchased impaired	14,684	5,070	6,274	2,668	50	1,387	2,622	32,755

non-covered loans collectively evaluated for impairment								
Total gross loans receivable as of March 31, 2014	$347,862	$301,759	$419,247	$47,919	$21,990	$54,327	$46,555	$1,239,659

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company's impairment method for the year ended December 31, 2013:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Total
	(In thousands)							
Originated loans individually evaluated for impairment	$9,693	$2,972	$6,903	$592	$4,684	$2,404	$138	$27,386
Originated loans collectively evaluated for impairment	273,382	208,315	347,548	38,643	13,909	42,780	27,992	952,569
Purchased other covered loans individually evaluated for impairment	3,761	—	—	450	—	—	7	4,218
Purchased other covered loans collectively evaluated for impairment	2,249	13,443	2,438	797	—	—	1,733	20,660
Purchased other non-covered loans individually evaluated for impairment	1,297	26	520	—	—	—	640	2,483
Purchased other non-covered loans collectively evaluated for impairment	35,389	64,877	38,223	79	1,099	2,114	10,600	152,381
Purchased impaired covered loans	8,680	10,923	12,187	3,530	1,556	—	2,000	38,876

collectively evaluated for impairment								
Purchased impaired non-covered loans collectively evaluated for impairment	16,779	5,119	6,785	3,768	32	1,357	2,177	36,017
Total gross loans receivable as of December 31, 2013	$ 351,230	$ 305,675	$ 414,604	$ 47,859	$ 21,280	$ 48,655	$ 45,287	$ 1,234,590

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(6) FDIC Indemnification Asset

Changes in the FDIC indemnification asset during the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Balance at the beginning of the period	$4,382	$7,100
Cash payments received or receivable from the FDIC	(376)	(1,480)
FDIC share of additional estimated losses	336	88
Net amortization	(373)	(355)
Balance at the end of the period	$3,969	$5,353

(7) Other Real Estate Owned

Changes in other real estate owned during the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31,	
	2014	2013
	(In thousands)	
Balance at the beginning of the period	$4,559	$5,666
Additions	218	—
Additions from acquisitions	—	2,279
Proceeds from dispositions	(520)	(2,961)
Gain (loss) on sales, net	27	172
Valuation adjustment	—	107
Balance at the end of the period	$4,284	$5,263

(8) Goodwill and Other Intangible Assets

(a) Goodwill

The Company’s goodwill represents the excess of the purchase price over the fair value of net assets acquired in the purchases of Valley on July 15, 2013, Western Washington Bancorp in 2006 and North Pacific Bank in 1998. The Company’s goodwill is assigned to the Bank and is evaluated for impairment at the Bank level (reporting unit).

There were no goodwill additions recorded during the three months ended March 31, 2014 and 2013.

At March 31, 2014, the Company’s step-one analysis concluded that the reporting unit’s fair value was greater than its carrying value and therefore no goodwill impairment charges were required for the three months ended March 31, 2014. The Company did not record goodwill impairment charges for the three months ended March 31, 2013. Even though there was no goodwill impairment at March 31, 2014, adverse events may impact the recoverability of goodwill and could result in a future impairment charge which could have a material impact on the Company’s Condensed Consolidated Financial Statements.

b) Other Intangible Assets

The other intangible assets represents the core deposit intangible ("CDI") acquired in business combinations. The useful life of the CDI related to Valley, NCB, Pierce, Cowlitz, and Western Washington Bancorp acquisitions is ten, five, four, nine, and eight years, respectively.

There were no intangible asset additions recorded during the three months ended March 31, 2014. During the three months ended March 31, 2013, the Company recorded additions of intangible assets of $156,000 due to the NCB Acquisition.

Amortization expense related to the core deposit intangibles was $156,000 and $115,000 for the three months ended March 31, 2014 and 2013, respectively.

(9) Stock-Based Compensation

Stock options generally vest ratably over three years and expire five years after they become exercisable or vest ratably over four years and expire ten years from date of grant. Restricted stock awards issued generally have a five-year cliff vesting or four year ratable vesting schedule. The Company issues new shares to satisfy share option exercises and restricted stock awards. As of March 31, 2014, 110,745 shares remain available for future issuances under stock-based compensation plans.

(a) Stock Option Awards

For the three months ended March 31, 2014 and 2013, the Company recognized compensation expense related to stock options of $15,000 and $22,000, respectively, with no related tax benefit for either period. As of March 31, 2014, the total unrecognized compensation expense related to non-vested stock options was $10,000 and the related weighted average period over which it is expected to be recognized is approximately 0.15 years. The intrinsic value and cash proceeds from options exercised during the three months ended March 31, 2014 totaled $22,000 and $57,000, respectively. The intrinsic value and cash proceeds from options exercised during the three months ended March 31, 2013 totaled $6,000 and $20,000, respectively.

The following tables summarize the stock option activity for the three months ended March 31, 2014 and 2013:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2012	300,658	$17.48		
Granted	—	—		
Exercised	(1,800)	11.35		
Forfeited or expired	(35,735)	20.42		
Outstanding at March 31, 2013	263,123	17.12		
Outstanding at December 31, 2013	194,482	$15.82		
Granted	—	—		
Exercised	(4,492)	12.70		
Forfeited or expired	(6,055)	19.76		
Outstanding at March 31, 2014	183,935	$15.77	3.22	$503
Vested and expected to vest at March 31, 2014	183,924	$15.77	3.21	$503
Exercisable at March 31, 2014	166,425	$15.88	2.92	$466

(b) Restricted and Unrestricted Stock Awards

For the three months ended March 31, 2014 and 2013, the Company recognized compensation expense related to restricted and unrestricted stock awards of $276,000 and $251,000, respectively, and a related tax benefit of $97,000 and $88,000, respectively. As of March 31, 2014, the total unrecognized compensation expense related to non-vested restricted and unrestricted stock awards was $1.7 million and the related weighted average period over which it is expected to be recognized is approximately 2.05 years. The vesting date fair value of restricted stock awards that vested during the three months ended March 31, 2014 and 2013 was $536,000 and $615,000, respectively.

The following tables summarize the restricted and unrestricted stock award activity for the three months ended March 31, 2014 and 2013:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2012	189,670	$14.86
Granted	37,197	14.31
Vested	(43,491)	16.87
Forfeited	(890)	15.64
Nonvested at March 31, 2013	182,486	$14.27
Nonvested at December 31, 2013	202,939	$14.29
Granted	6,407	17.17
Vested	(30,176)	14.55
Forfeited	(811)	14.67
Nonvested at March 31, 2014	178,359	$14.35

(10) Stockholders' Equity

(a) Earnings Per Common Share

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,	
	2014	2013
	(Dollars in thousands)	
Net income:		
Net income	$2,543	$2,885
Less: Dividends and undistributed earnings allocated to participating securities	(28)	(34)
Net income allocated to common shareholders	$2,515	$2,851
Basic:		
Weighted average common shares outstanding	16,214,735	15,128,944
Less: Restricted stock awards	(197,697)	(186,751)
Total basic weighted average common shares outstanding	16,017,038	14,942,193
Diluted:		
Basic weighted average common shares outstanding	16,017,038	14,942,193
Incremental shares from stock options	9,764	15,996
Total diluted weighted average common shares outstanding	16,026,802	14,958,189

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2014 and 2013, anti-dilutive shares outstanding related to options to acquire common stock totaled 131,459 and 207,468, respectively, as the assumed proceeds from exercise price, tax benefits and future compensation was in excess of the market value.

(b) Dividends

The timing and amount of cash dividends paid on the Company's common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant sources of income. The following table summarizes the dividend activity for the three months ended March 31, 2014 and 2013.

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Declared	Cash Dividend per Share	Record Date	Paid/Payable Date
February 1, 2012	$0.06	February 10, 2012	February 24, 2012
April 26, 2012	$0.08	May 10, 2012	May 24, 2012
June 26, 2012	$0.20	July 10, 2012	July 24, 2012
July 25, 2012	$0.08	August 14, 2012	August 24, 2012
October 30, 2012	$0.08	November 9, 2012	November 21, 2012
November 30, 2012	$0.30	November 26, 2012	December 6, 2012
January 30, 2013	$0.08	February 8, 2013	February 22, 2013
April 24, 2013	$0.08	May 10, 2013	May 24, 2013
July 23, 2013	$0.18	August 6, 2013	August 15, 2013
October 23, 2013	$0.08	November 5, 2013	November 15, 2013
January 29, 2014	$0.08	February 10, 2014	February 24, 2014
March 27, 2014	$0.08	April 8, 2014	April 23, 2014

The FDIC and the Washington DFI have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank to the Company. Additionally, current guidance from the Federal Reserve Board provides, among other things, that dividends per share on the Company's common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. Current regulations allow the Company and the Bank to pay dividends on their common stock if the Company's or the Bank's regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve Board and the FDIC.

(c) Stock Repurchase Program

The Company has had various stock repurchase programs since March 1999. On August 30, 2012, the Board of Directors approved the Company's tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 757,000 shares.

During the three months ended March 31, 2014 and 2013, the Company did not repurchase shares under the plan. In total, the Company has repurchased 596,900 shares at an average price of $15.70 per share under the tenth stock repurchase plan as of March 31, 2014.

During the three months ended March 31, 2014 and 2013, the Company repurchased 9,298 and 7,780 shares at an average price of $17.77 and $14.21 to pay withholding taxes on restricted stock that vested during the three months ended March 31, 2014 and 2013, respectively.

(11) Accumulated Other Comprehensive Income (Loss)

The changes in accumulated other comprehensive income (loss) ("AOCI") by component, during the three months ended March 31, 2014 and 2013 are as follows:

	Three Months Ended March 31, 2014			
	Changes in Fair Value of Available for Sale Securities (1)	Reclassification Adjustment of Net gain from Sale of Available for Sale Securities Included in Income (1)	Accretion of Other-than-temporary Impairment on Held to Maturity Securities (1)	Total
	(In thousands)			
Balance of AOCI at the beginning of the period	$(923)	$—	$(239)	$(1,162)
Other comprehensive income (loss) before reclassification	593	(117)	15	491

Amounts reclassified from AOCI	—	—	—	—
Net current period other comprehensive income (loss)	593	(117)	15	491
Balance of AOCI at the end of the period	$(330)	$(117)	$(224)	$(671)

(1) All amounts are net of tax.

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	Three Months Ended March 31, 2013		
	Changes in Fair Value of Available for Sale Securities (1)	Accretion of Other-than-temporary Impairment on Held to Maturity Securities (1)	Total
	(In thousands)		
Balance of AOCI at the beginning of the period	$2,042	$(298)	$1,744
Other comprehensive (loss) income before reclassification	(342)	14	(328)
Amounts reclassified from AOCI	—	—	—
Net current period other comprehensive (loss) income	(342)	14	(328)
Balance of AOCI at the end of the period	$1,700	$(284)	$1,416

(1) All amounts are net of tax.

(12) Fair Value Measurements

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (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. There are three levels of inputs that may be used to measure fair values:

Level 1: Valuations for assets and liabilities traded in active exchange markets, or interest in open-end mutual funds that allow the Company to sell its ownership interest back to the fund at net asset value on a daily basis. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds.

Level 2: Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or valuations using methodologies with observable inputs.

Level 3: Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques using unobservable inputs, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

(a) Recurring and Nonrecurring Basis

The Company used the following methods and significant assumptions to estimate fair value of certain assets on a recurring and nonrecurring basis:

Investment Securities Available for Sale and Held to Maturity:

The fair values of all investment securities are based upon the assumptions market participants would use in pricing the security. If available, investment securities are determined by quoted market prices (Level 1). For investment securities where quoted market prices are not available, fair values are calculated based on market prices on similar securities (Level 2). Level 2 includes U.S. Treasury, U.S. government and agency debt securities, municipal securities, corporate securities and mortgage-backed securities and collateralized mortgage obligations-residential. For investment securities where quoted prices or market prices of similar securities are not available, fair values are calculated by using observable and unobservable inputs such as discounted cash flows or other market indicators (Level 3). Security valuations are obtained from third party pricing services for comparable assets or liabilities.

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Impaired Loans:

At the time a loan is considered impaired, its impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, a loan's observable market prices, or fair market value of the collateral if the loan is collateral-dependent. Impaired loans for which impairment is measured using the discounted cash flow approach are not considered to be measured at fair value because the loan's effective interest rate is not a fair value input, and for the purposes of fair value disclosures, the fair value of these loans are measured commensurate with non-impaired loans. Generally, the Company utilizes the fair market value of the collateral, which is commonly based on recent real estate appraisals, to measure impairment. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business (Level 3). Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Other Real Estate Owned:

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers for commercial properties or certified residential appraisers for residential properties whose qualifications and licenses have been reviewed and verified by the Company. Once received, the Company reviews the assumptions and approaches utilized in the appraisal as well as the resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Company compares the actual selling price of collateral that has been liquidated to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

The following table summarizes the balances of assets measured at fair value on a recurring basis as of March 31, 2014 and December 31, 2013.

	March 31, 2014			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	$6,550	$—	$6,550	$—
Municipal securities	51,403	—	51,403	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	80,841	—	80,841	—
Total	$138,794	$—	$138,794	$—

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	December 31, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	$6,039	$—	$6,039	$—
Municipal securities	49,060	—	49,060	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	108,035	—	108,035	—
Total	$163,134	$—	$163,134	$—

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2014 and 2013.

The Company may be required to measure certain financial assets and liabilities at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets.

The tables below represent assets measured at fair value on a nonrecurring basis at March 31, 2014 and December 31, 2013 and the net losses (gains) recorded in earnings during the three months ended March 31, 2014 and 2013.

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	Basis (1)	Fair Value at March 31, 2014				Net Losses (Gains) Recorded in Earnings During the Three Months Ended March 31, 2014
		Total	Level 1	Level 2	Level 3	
	(In thousands)					
Impaired originated loans:						
Commercial business:						
Commercial and industrial	$3,646	$1,884	$—	$—	$1,884	$369
Owner-occupied commercial real estate	1,373	936	—	—	936	(62)
Non-owner occupied commercial real estate	4,093	3,759	—	—	3,759	(27)
Total commercial business	9,112	6,579	—	—	6,579	280
Real estate construction and land development:						
One-to-four family residential	2,522	2,086	—	—	2,086	338
Five or more family residential and commercial properties	—	—	—	—	—	
Total real estate construction and land development	2,522	2,086	—	—	2,086	338
Consumer	62	—	—	—	—	24
Total impaired originated loans	11,696	8,665	—	—	8,665	642
Purchased other impaired loans:						
Commercial business:						
Commercial and industrial	4,383	3,287	—	—	3,287	(233)
Owner-occupied commercial real estate	429	41	—	—	41	388
Total commercial business	4,812	3,328	—	—	3,328	155
Consumer	637	637	—	—	637	(113)
Total purchased other impaired loans	5,449	3,965	—	—	3,965	42
Investment securities held to maturity:						
Mortgage back securities and collateralized mortgage obligations—residential:						
Private residential collateralized mortgage obligations (2)	—	—	—	—	—	8
Total	$17,145	$12,630	$—	$—	$12,630	$692

(1) Basis represents the unpaid principal balance of impaired originated and purchased other impaired loans, amortized cost of investment securities held to maturity, and carrying value at ownership date of other real estate owned.

(2) The two private residential collateralized mortgage obligation investments which were measured at fair value at March 31, 2014 have both a basis and a fair value that totaled less than $1,000 at March 31, 2014.

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	Fair Value at December 31, 2013					
	Basis (1)	Total	Level 1	Level 2	Level 3	Net Losses (Gains) Recorded in Earnings During the Three Months Ended March 31, 2013
	(In thousands)					
Impaired originated loans:						
Commercial business:						
Commercial and industrial	$4,835	$2,944	$—	$—	$2,944	$938
Owner-occupied commercial real estate	1,880	1,285	—	—	1,285	246
Non-owner occupied commercial real estate	4,123	3,759	—	—	3,759	63
Total commercial business	10,838	7,988	—	—	7,988	1,247
One-to-four family residential	340	340	—	—	340	53
Real estate construction and land development:						
One-to-four family residential	1,585	1,374	—	—	1,374	(4)
Five or more family residential and commercial properties	2,404	2,404	—	—	2,404	2
Total real estate construction and land development	3,989	3,778	—	—	3,778	(2)
Consumer	38	—	—	—	—	—
Total impaired originated loans	15,205	12,106	—	—	12,106	1,298
Purchased other impaired loans:						
Commercial business:						
Commercial and industrial	4,721	3,267	—	—	3,267	—
Non-owner occupied commercial real estate	520	520	—	—	520	—
Total commercial business	5,241	3,787	—	—	3,787	—
One-to-four family residential	450	419	—	—	419	—
Consumer	647	532	—	—	532	—
Total purchased other impaired loans	6,338	4,738	—	—	4,738	—
Investment securities held to maturity:						
Mortgage back securities and collateralized mortgage obligations – residential:						
Private residential collateralized mortgage obligations	19	19	—	19	—	2
Other real estate owned:						
Commercial properties	1,720	1,222	—	—	1,222	21
Total	$23,282	$18,085	$—	$19	$18,066	$1,321

(1) Basis represents the unpaid principal balance of impaired originated and purchased other impaired loans, amortized cost of investment securities held to maturity, and carrying value at ownership date of other real estate owned.

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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2014 and December 31, 2013.

	March 31, 2014			
	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
	(Dollars in thousands)			
Impaired originated loans	$8,665	Market approach	Adjustment for differences between the comparable sales	(33.0%) - 26.7%; (6.3%)
Purchased other impaired loans	$3,965	Market approach	Adjustment for differences between the comparable sales	(50.0%) - 3.0%; (20.4%)

	December 31, 2013			
	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
	(Dollars in thousands)			
Impaired originated loans	$12,106	Market approach	Adjustment for differences between the comparable sales	(27.8%) - 19.1%; (7.6%)
Purchased other impaired loans	$4,738	Market approach	Adjustment for differences between the comparable sales	(50.0%) - 15.0%; (26.2%)
Other real estate owned	$1,222	Market approach	Adjustment for differences between the comparable sales	(60.1)% - 13.6%; (35.2%)

(b) Fair Value of Financial Instruments

Because broadly traded markets do not exist for most of the Company’s financial instruments, the fair value calculations attempt to incorporate the effect of current market conditions at a specific time. These determinations are subjective in nature, involve uncertainties and matters of significant judgment and do not include tax ramifications; therefore, the results cannot be determined with precision, substantiated by comparison to independent markets and may not be realized in an actual sale or immediate settlement of the instruments. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Company.

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The tables below present the carrying value amount of the Company’s financial instruments and their corresponding estimated fair values at the dates indicated.

	March 31, 2014				
	Carrying Value	Fair Value	Fair Value Measurements Using:		
			Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash and cash equivalents	$154,395	$154,395	$154,395	$—	$—
Other interest earning deposits	15,150	15,227	—	15,227	