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.

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.

(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:

								Current Ratings				
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)	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	—						