

PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
August 01, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(mark one)

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

For the quarterly period ended June 30, 2014

or

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

For the transition period from ____ to ____

Commission File Number: 000-31225

, Inc.

(Exact name of registrant as specified in its charter)

Tennessee

(State or other jurisdiction of incorporation or organization) 62-1812853 (I.R.S. Employer Identification No.)

150 Third Avenue South, Suite 900, Nashville, Tennessee

(Address of principal executive offices) 37201 (Zip Code)

(615) 744-3700

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files).

Yes No

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

Large Accelerated Filer Accelerated Filer

Non-accelerated Filer Smaller reporting company

(do not check if you are a smaller reporting company)

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

Yes No

As of July 31, 2014 there were 35,610,952 shares of common stock, \$1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
June 30, 2014

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FORWARD-LOOKING STATEMENTS

Certain of the statements in this quarterly report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words "expect," "anticipate," "goal," "objective," "intend," "plan," "believe," "should," "seek," "estimate" and similar expressions are intended to identify such forward-looking statements, but other statements not based on historical information may also be considered forward-looking. All forward-looking statements are subject to risks, uncertainties and other factors that may cause the actual results, performance or achievements of Pinnacle Financial to differ materially from any results expressed or implied by such forward-looking statements. Such risks include, without limitation, (i) deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses; (ii) continuation of the historically low short-term interest rate environment; (iii) the inability of Pinnacle Financial to grow its loan portfolio; (iv) changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments; (v) effectiveness of Pinnacle Financial's asset management activities in improving, resolving or liquidating lower-quality assets; (vi) increased competition with other financial institutions; (vii) greater than anticipated adverse conditions in the national or local economies including the Nashville-Davidson-Murfreesboro-Franklin MSA and the Knoxville MSA, particularly in commercial and residential real estate markets; (viii) rapid fluctuations or unanticipated changes in interest rates on loans or deposits; (ix) the results of regulatory examinations; (x) the ability to retain large, uninsured deposits; (xi) the development of any new market other than Nashville or Knoxville; (xii) a merger or acquisition; (xiii) any matter that would cause Pinnacle Financial to conclude that there was impairment of any asset, including intangible assets; (xiv) reduced ability to attract additional financial advisors (or failure of such advisors to cause their clients to switch to Pinnacle Financial) or otherwise to attract customers from other financial institutions; (xv) further deterioration in the valuation of other real estate owned and increased expenses associated therewith; (xvi) inability to comply with regulatory capital requirements, including those resulting from changes to capital calculation methodologies and required capital maintenance levels; (xvii) risks associated with litigation, including the applicability of insurance coverage; (xviii) approval of the declaration of any dividend by Pinnacle Financial's board of directors; (xix) the vulnerability of our network and online banking portals to unauthorized access, computer viruses, phishing schemes, spam attacks, human error, natural disasters, power loss and other security breaches; (xx) the possibility of increased compliance costs as a result of increased regulatory oversight and the development of additional banking products for our corporate and consumer clients; and (xxi) changes in state and federal legislation, regulations or policies applicable to banks and other financial service providers, including regulatory or legislative developments arising out of current unsettled conditions in the economy, including implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. A more detailed description of these and other risks is contained in Pinnacle Financial's most recent annual report on Form 10-K filed with the Securities and Exchange Commission on February 25, 2014 and Pinnacle Financial's most recent quarterly report on Form 10-Q filed with the Securities and Exchange Commission on May 2, 2014. Many of such factors are beyond Pinnacle Financial's ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Pinnacle Financial disclaims any obligation to update or revise any forward-looking statements contained in this report, whether as a result of new information, future events or otherwise.

Item 1. Part I. Financial Information

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2014	December 31, 2013
ASSETS		
Cash and noninterest-bearing due from banks	\$91,575,519	\$79,785,004
Interest-bearing due from banks	114,865,408	124,509,486
Federal funds sold and other	4,667,086	4,644,247
Cash and cash equivalents	211,108,013	208,938,737
Securities available-for-sale, at fair value	743,528,294	693,456,314
Securities held-to-maturity (fair value of \$38,290,464 and \$38,817,467 at June 30, 2014 and December 31, 2013, respectively)	38,537,545	39,795,649
Mortgage loans held-for-sale	24,591,553	12,850,339
Loans	4,315,561,552	4,144,493,486
Less allowance for loan losses	(66,888,250)	(67,969,693)
Loans, net	4,248,673,302	4,076,523,793
Premises and equipment, net	72,534,086	72,649,574
Other investments	33,496,695	33,226,195
Accrued interest receivable	15,921,099	15,406,389
Goodwill	243,550,227	243,651,006
Core deposits and other intangible assets	3,365,399	3,840,750
Other real estate owned	12,946,465	15,226,136
Other assets	140,538,915	148,210,975
Total assets	\$5,788,791,593	\$5,563,775,857
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	\$1,324,358,420	\$1,167,414,487
Interest-bearing	900,576,170	884,294,802
Savings and money market accounts	1,950,235,361	1,962,714,398
Time	476,343,393	519,049,037
Total deposits	4,651,513,344	4,533,472,724
Securities sold under agreements to repurchase	62,272,670	70,465,326
Federal Home Loan Bank advances	170,556,327	90,637,328
Subordinated debt and other borrowings	97,408,292	98,658,292
Accrued interest payable	661,273	792,703
Other liabilities	41,997,702	46,041,823
Total liabilities	5,024,409,608	4,840,068,196
Stockholders' equity:		
Preferred stock, no par value, 10,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, par value \$1.00; 90,000,000 shares authorized; 35,601,495 and 35,221,941 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	35,601,495	35,221,941
Additional paid-in capital	555,428,349	550,212,135

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Retained earnings	170,155,642	142,298,199
Accumulated other comprehensive loss, net of taxes	3,196,499	(4,024,614)
Total stockholders' equity	764,381,985	723,707,661
Total liabilities and stockholders' equity	\$5,788,791,593	\$5,563,775,857

See accompanying notes to consolidated financial statements (unaudited).

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Interest income:				
Loans, including fees	\$45,089,706	\$42,149,149	\$88,785,364	\$83,663,362
Securities:				
Taxable	3,628,264	3,650,766	7,348,543	7,321,700
Tax-exempt	1,563,612	1,483,965	3,161,409	3,140,373
Federal funds sold and other	282,822	260,440	559,880	575,212
Total interest income	50,564,404	47,544,320	99,855,196	94,700,647
Interest expense:				
Deposits	2,481,762	2,955,985	5,077,002	6,368,381
Securities sold under agreements to repurchase	31,329	70,823	61,844	148,639
Federal Home Loan Bank advances and other borrowings	824,912	918,762	1,582,134	1,826,403
Total interest expense	3,338,003	3,945,570	6,720,980	8,343,423
Net interest income	47,226,401	43,598,750	93,134,216	86,357,224
Provision for loan losses	254,348	2,774,048	741,986	4,946,452
Net interest income after provision for loan losses	46,972,053	40,824,702	92,392,230	81,410,772
Noninterest income:				
Service charges on deposit accounts	2,965,644	2,540,866	5,756,612	5,021,110
Investment services	2,164,410	1,895,398	4,292,244	3,688,038
Insurance sales commissions	1,144,871	1,107,696	2,529,792	2,501,000
Gain on mortgage loans sold, net	1,668,604	1,948,531	2,903,475	3,803,942
Loss on sale of investment securities	-	(25,241)	-	(25,241)
Trust fees	1,071,848	880,204	2,217,599	1,824,536
Other noninterest income	3,582,067	2,978,266	7,630,084	6,414,691
Total noninterest income	12,597,444	11,325,720	25,329,806	23,228,076
Noninterest expense:				
Salaries and employee benefits	21,772,469	20,570,753	43,522,429	40,143,109
Equipment and occupancy	5,822,662	5,204,159	11,531,692	10,317,209
Other real estate expense	226,006	1,390,606	877,158	2,111,568
Marketing and other business development	1,064,990	987,171	1,973,891	1,777,842
Postage and supplies	544,194	517,667	1,104,808	1,109,155
Amortization of intangibles	237,676	248,186	475,351	769,173
Other noninterest expense	4,233,931	1,943,190	8,062,459	7,073,683
Total noninterest expense	33,901,928	30,861,732	67,547,788	63,301,739
Income before income taxes	25,667,569	21,288,690	50,174,248	41,337,109
Income tax expense	8,497,589	6,978,160	16,637,146	13,578,452
Net income	17,169,980	14,310,530	33,537,102	27,758,657
Per share information:				
Basic net income per common share	\$0.49	\$0.42	\$0.97	\$0.81
Diluted net income per common share	\$0.49	\$0.42	\$0.96	\$0.81
Weighted average shares outstanding:				

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Basic	34,697,888	34,172,274	34,650,377	34,080,281
Diluted	35,081,702	34,431,054	35,024,859	34,319,796

See accompanying notes to consolidated financial statements (unaudited).

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Net income	\$ 17,169,980	\$ 14,310,530	\$ 33,537,102	\$ 27,758,657
Other comprehensive income (loss), net of tax:				
Change in fair value on available-for-sale securities, net of tax	5,104,719	(13,933,693)	10,050,631	(16,204,604)
Change in fair value of cash flow hedges, net of tax	(1,535,212)	3,347,367	(2,829,518)	3,347,367
Net loss on sale of investment securities reclassified from other comprehensive income into net income, net of tax	-	15,339	-	15,339
Total comprehensive income	\$ 20,739,487	\$ 3,739,543	\$ 40,758,215	\$ 14,916,759

See accompanying notes to consolidated financial statements (unaudited).

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comp. Income (Loss), net	Total Stockholders' Equity
	Shares	Amount				
Balances, December 31, 2012	34,696,597	\$34,696,597	\$543,760,439	\$87,386,689	\$13,227,634	\$679,071,359
Exercise of employee common stock options and related tax benefits	123,239	123,239	1,282,323	-	-	1,405,562
Issuance of restricted common shares, net of forfeitures	293,441	293,441	(293,441)	-	-	-
Restricted shares withheld for taxes	(39,514)	(39,514)	(781,156)	-	-	(820,670)
Compensation expense for restricted shares	-	-	1,983,339	-	-	1,983,339
Compensation expense for stock options	-	-	12,470	-	-	12,470
Net income	-	-	-	27,758,657	-	27,758,657
Other comprehensive loss	-	-	-	-	(12,841,898)	(12,841,898)
Balances, June 30, 2013	35,073,763	\$35,073,763	\$545,963,974	\$115,145,346	\$385,736	\$696,568,819
Balances, December 31, 2013	35,221,941	\$35,221,941	\$550,212,135	\$142,298,199	\$(4,024,614)	\$723,707,661
Exercise of employee common stock options and related tax benefits	175,442	175,442	4,664,969	-	-	4,840,411
Common stock dividends paid	-	-	-	(5,679,659)	-	(5,679,659)
Issuance of restricted common shares, net of forfeitures	259,197	259,197	(259,197)	-	-	-
Restricted shares withheld for taxes	(55,085)	(55,085)	(1,771,041)	-	-	(1,826,126)
Compensation expense for restricted shares	-	-	2,581,483	-	-	2,581,483
Net income	-	-	-	33,537,102	-	33,537,102
Other comprehensive income	-	-	-	-	7,221,113	7,221,113
Balances, June 30, 2014	35,601,495	\$35,601,495	\$555,428,349	\$170,155,642	\$3,196,499	\$764,381,985

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2014	2013
Operating activities:		
Net income	\$33,537,102	\$27,758,657
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization/accretion of premium/discount on securities	2,154,065	2,373,927
Depreciation and amortization	4,598,989	4,622,942
Provision for loan losses	741,986	4,946,452
Gain on mortgage loans sold, net	(2,903,475)	(3,803,942)
Loss on sale of investment securities	-	25,241
Stock-based compensation expense	2,581,483	1,995,809
Deferred tax benefit (expense)	(136,855)	67,794
Losses on dispositions of other real estate and other investments	141,913	1,877,964
Excess tax benefit from stock compensation	(1,166,463)	(140,181)
Mortgage loans held for sale:		
Loans originated	(153,548,739)	(226,714,093)
Loans sold	144,711,000	243,750,000
(Decrease) increase in other assets	(1,504,523)	10,576,616
Decrease in other liabilities	(4,207,922)	(12,608,365)
Net cash provided by operating activities	24,998,561	54,728,821
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(96,556,556)	(128,922,089)
Sales	1,273,528	1,213,584
Maturities, prepayments and calls	59,975,601	77,932,668
Activities in securities held-to-maturity:		
Purchases	-	(2,045,030)
Maturities, prepayments and calls	864,028	2,325,000
Increase in loans, net	(171,994,156)	(221,126,597)
Purchases of software, premises and equipment	(3,265,513)	(3,388,292)
Purchase of bank owned life insurance	-	(30,000,000)
Increase in other investments	(178,118)	(3,325,587)
Net cash used in investing activities	(209,881,186)	(307,336,343)
Financing activities:		
Net increase in deposits	118,040,619	81,390,021
Net (decrease) increase in securities sold under agreements to repurchase	(8,192,656)	2,678,252
Advances from Federal Home Loan Bank:		
Issuances	410,000,000	324,038,282
Payments/maturities	(330,047,151)	(74,091,731)
Decrease in other borrowings	(1,250,000)	(6,250,000)
Exercise of common stock options and stock appreciation rights, net of repurchase of restricted shares	3,014,285	584,892
Excess tax benefit from stock compensation	1,166,463	140,181
Common stock dividends paid	(5,679,659)	-

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Net cash provided by financing activities	187,051,901	328,489,897
Net decrease in cash and cash equivalents	2,169,276	75,882,375
Cash and cash equivalents, beginning of period	208,938,737	165,288,669
Cash and cash equivalents, end of period	\$211,108,013	\$241,171,044

See accompanying notes to consolidated financial statements (unaudited).

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Nature of Business — Pinnacle Financial Partners, Inc. (Pinnacle Financial) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, Pinnacle Bank. Pinnacle Bank is a commercial bank headquartered in Nashville, Tennessee. Pinnacle Bank provides a full range of banking services in its primary market areas of the Nashville-Davidson-Murfreesboro-Franklin, Tennessee and Knoxville, Tennessee Metropolitan Statistical Areas.

Basis of Presentation — The accompanying unaudited consolidated financial statements have been prepared in accordance with instructions to Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial position, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles (U.S. GAAP). All adjustments consisting of normally recurring accruals that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods covered by the report have been included. The accompanying unaudited consolidated financial statements should be read in conjunction with the Pinnacle Financial consolidated financial statements and related notes appearing in the 2013 Annual Report previously filed on Form 10-K.

These consolidated financial statements include the accounts of Pinnacle Financial and its wholly-owned subsidiaries. PNFP Statutory Trust I, PNFP Statutory Trust II, PNFP Statutory Trust III and PNFP Statutory Trust IV are affiliates of Pinnacle Financial and are included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

Use of Estimates — The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, any potential impairment of intangible assets, including goodwill and the valuation of deferred tax assets, other real estate owned, and our investment portfolio, including other-than-temporary impairment. These financial statements should be read in conjunction with Pinnacle Financial's Annual Report on Form 10-K for the year ended December 31, 2013. There have been no significant changes to Pinnacle Financial's significant accounting policies as disclosed in Pinnacle Financial's Annual Report on Form 10-K for the year ended December 31, 2013.

Recently Adopted Accounting Pronouncements — In February 2013, the FASB issued Accounting Standards Update 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" which provides disclosure guidance on amounts reclassified out of AOCI by component. The adoption did not have any impact on our financial position or results of operations but has impacted our financial statement disclosure. As shown on the statement of comprehensive income for the three and six months ended June 30, 2014, Pinnacle Financial did not reclassify any net losses out of other comprehensive income into loss on the sale of investment securities, net of tax, compared to reclassifications of net losses for the three and six months ended June 30, 2013, of approximately \$15,000, net of tax.

Cash Flow Information — Supplemental cash flow information addressing certain cash and noncash transactions for each of the six months ended June 30, 2014 and 2013 was as follows:

	For the six months ended	
	June 30, 2014	2013
Cash Transactions:		
Interest paid	\$6,886,261	\$8,701,479
Income taxes paid, net	14,100,000	15,600,009
Noncash Transactions:		
Loans charged-off to the allowance for loan losses	3,268,626	11,377,491
Loans foreclosed upon and transferred to other real estate owned	1,672,459	1,780,131
Available-for-sale securities transferred to held-to-maturity portfolio	-	39,959,647

Income Per Common Share — Basic net income per common share (EPS) is computed by dividing net income by the weighted average common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding is attributable to common stock options, common stock appreciation rights, restricted share awards, and restricted share unit awards. The dilutive effect of outstanding options, common stock appreciation rights, restricted share awards, and restricted share unit awards is reflected in diluted EPS by application of the treasury stock method.

The following is a summary of the basic and diluted net income per share calculations for the three and six months ended June 30, 2014 and 2013:

	For the three months ended		For the six months ended	
	June 30, 2014	2013	June 30, 2014	2013
Basic net income per share calculation:				
Numerator - Net income	\$17,169,980	\$14,310,530	\$33,537,102	\$27,758,657
Denominator - Average common shares outstanding	34,697,888	34,172,274	34,650,377	34,080,281
Basic net income per share	\$0.49	\$0.42	\$0.97	\$0.81
Diluted net income per share calculation:				
Numerator - Net income	\$17,169,980	\$14,310,530	\$33,537,102	\$27,758,657
Denominator - Average common shares outstanding	34,697,888	34,172,274	34,650,377	34,080,281
Dilutive shares contingently issuable	383,814	258,780	374,482	239,515
Average diluted common shares outstanding	35,081,702	34,431,054	35,024,859	34,319,796
Diluted net income per share	\$0.49	\$0.42	\$0.96	\$0.81

Note 2. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at June 30, 2014 and December 31, 2013 are summarized as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2014:				
Securities available-for-sale:				
U.S. Treasury securities	\$-	\$ -	\$ -	\$-
U.S. government agency securities	117,053	19	6,148	110,924
Mortgage-backed agency securities	452,580	11,608	4,250	459,938
State and municipal securities	138,382	8,066	328	146,120
Asset-backed securities	15,380	-	150	15,230
Corporate notes and other	10,207	1,109	-	11,316
	\$733,602	\$ 20,802	\$ 10,876	\$743,528
Securities held-to-maturity:				
State and municipal securities	\$38,538	\$ 120	\$ 368	\$38,290
	\$38,538	\$ 120	\$ 368	\$38,290
December 31, 2013:				
Securities available-for-sale:				
U.S. Treasury securities	\$-	\$ -	\$ -	\$-
U.S. government agency securities	117,282	13	13,422	103,873
Mortgage-backed agency securities	411,967	9,771	8,802	412,936
State and municipal securities	143,763	5,504	856	148,411
Asset-backed securities	17,262	-	255	17,007
Corporate notes and other	10,218	1,018	7	11,229
	\$700,492	\$ 16,306	23,342	\$693,456
Securities held-to-maturity:				
State and municipal securities	\$39,796	\$ 72	\$ 1,051	\$38,817
	\$39,796	\$ 72	\$ 1,051	\$38,817

At June 30, 2014, approximately \$619.1 million of securities within Pinnacle Financial's investment portfolio were either pledged to secure public funds and other deposits or securities sold under agreements to repurchase.

The amortized cost and fair value of debt securities as of June 30, 2014 by contractual maturity are shown below. Actual maturities may differ from contractual maturities of mortgage- and asset-backed securities since the mortgages and assets underlying the securities may be called or prepaid with or without penalty. Therefore, these securities are not included in the maturity categories in the following summary (in thousands):

	Available-for-sale		Held-to-maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
June 30, 2014:				
Due in one year or less	\$4,124	\$4,161	\$658	\$660
Due in one year to five years	33,208	34,896	8,184	8,107
Due in five years to ten years	125,395	128,613	12,578	12,632
Due after ten years	102,915	100,690	17,118	16,891
Mortgage-backed agency securities	452,580	459,938	-	-
Asset-backed securities	15,380	15,230	-	-
	\$733,602	\$743,528	\$38,538	\$38,290

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At June 30, 2014 and December 31, 2013, the following investments had unrealized losses. The table below classifies these investments according to the term of the unrealized losses of less than twelve months or twelve months or longer (in thousands):

	Investments with an Unrealized Loss of less than 12 months		Investments with an Unrealized Loss of 12 months or longer		Total Investments with an Unrealized Loss	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At June 30, 2014:						
U.S. Treasury securities	\$-	\$ -	\$-	\$ -	\$-	\$ -
U.S. government agency securities	903	2	101,152	6,146	102,055	6,148
Mortgage-backed agency securities	69,147	515	109,845	3,735	178,992	4,250
State and municipal securities	3,098	13	31,228	683	34,326	696
Asset-backed securities	-	-	15,230	150	15,230	150
Corporate notes	500	-	157	-	657	-
Total temporarily-impaired securities	\$73,648	\$ 530	\$257,612	\$ 10,714	\$331,260	\$ 11,244

At December 31, 2013:

U.S. Treasury securities	\$-	\$ -	\$-	\$ -	\$-	\$ -
U.S. government agency securities	8,742	22	92,869	13,400	101,611	13,422
Mortgage-backed agency securities	157,262	3,913	42,903	4,889	200,165	8,802
State and municipal securities	46,282	1,351	3,798	555	50,080	1,906
Asset-backed securities	-	-	17,006	255	17,006	255
Corporate notes	946	6	159	2	1,105	8
Total temporarily-impaired securities	\$213,232	\$ 5,292	\$156,735	\$ 19,101	\$369,967	\$ 24,393

The applicable dates for determining when securities are in an unrealized loss position are June 30, 2014 and December 31, 2013. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month periods ended June 30, 2014 and December 31, 2013, but is in the "Investments with an Unrealized Loss of less than 12 months" category above.

As shown in the tables above, at June 30, 2014, Pinnacle Financial had approximately \$11.2 million in unrealized losses on \$331.3 million of securities. The unrealized losses associated with these investment securities are driven by changes in interest rates and the unrealized loss is recorded as a component of equity. These securities will continue to be monitored as a part of our ongoing impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond issuers. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If a shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a charge to earnings and a new cost basis for the security will be established.

Because Pinnacle Financial currently does not intend to sell those securities that have an unrealized loss at June 30, 2014, and it is not more-likely-than-not that Pinnacle Financial will be required to sell the securities before recovery of their amortized cost bases, which may be maturity, Pinnacle Financial does not consider these securities to be other-than-temporarily impaired at June 30, 2014.

Periodically, available-for-sale securities may be sold or the composition of the portfolio realigned to improve yields, quality or marketability, or to implement changes in investment or asset/liability strategy, including maintaining collateral requirements and raising funds for liquidity purposes. Additionally, if an available-for-sale security loses its investment grade or tax-exempt status, the underlying credit support is terminated or collection otherwise becomes uncertain based on factors known to management, Pinnacle Financial will consider selling the security, but will review each security on a case-by-case basis as these factors become known.

The carrying values of Pinnacle Financial's investment securities could decline in the future if the financial condition of issuers deteriorates and management determines it is probable that Pinnacle Financial will not recover the entire amortized cost bases of the securities. As a result, there is a risk that other-than-temporary impairment charges may occur in the future. There is also a risk that other-than-temporary impairment charges may occur in the future if management's intention to hold these securities to maturity and/or recovery changes.

Note 3. Loans and Allowance for Loan Losses

For financial reporting purposes, Pinnacle Financial classifies its loan portfolio based on the underlying collateral utilized to secure each loan. This classification is consistent with those utilized in the Quarterly Report of Condition and Income filed with the Federal Deposit Insurance Corporation (FDIC).

Commercial loans receive risk ratings by the assigned financial advisor subject to validation by Pinnacle Financial's independent loan review department. Risk ratings are categorized as pass, special mention, substandard, substandard-nonaccrual or doubtful-nonaccrual. Pinnacle Financial believes that its categories follow those used by Pinnacle Bank's primary regulators. At June 30, 2014, approximately 75% of our loan portfolio was analyzed as a commercial loan type with a specifically assigned risk rating in the allowance for loan loss assessment. Consumer loans and small business loans are generally not assigned an individual risk rating but are evaluated as either accrual or nonaccrual based on the performance of the individual loans. However, certain consumer real estate-mortgage loans and certain consumer and other loans receive a specific risk rating due to the loan proceeds being used for commercial purposes even though the collateral may be of a consumer loan nature.

Risk ratings are subject to continual review by the loan officer. At least annually, our credit procedures require that every risk rated loan of \$500,000 or more be subject to a formal credit risk review process. Each loan's risk rating is also subject to review by our independent loan review department, which reviews a substantial portion of our risk rated portfolio annually. Included in the coverage are independent loan reviews of loans in targeted higher-risk portfolio segments.

The following table presents our loan balances by primary loan classification and the amount within each risk rating category. Pass rated loans include all credits other than those included in special mention, substandard, substandard-nonaccrual and doubtful-nonaccrual which are defined as follows:

Special mention loans have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in Pinnacle Financial's credit position at some future date.

Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize collection of the debt. Substandard loans are characterized by the distinct possibility that Pinnacle Financial will sustain some loss if the deficiencies are not corrected.

Substandard-nonaccrual loans are substandard loans that have been placed on nonaccrual status.

Doubtful-nonaccrual loans have all the characteristics of substandard-nonaccrual loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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The following table outlines the amount of each loan classification categorized into each risk rating category as of June 30, 2014 and December 31, 2013 (in thousands):

	Commercial real estate mortgage	Consumer real estate mortgage	Construction and land development	Commercial and industrial	Consumer and other	Total
June 30, 2014						
Accruing loans						
Pass	\$ 1,417,022	\$ 672,747	\$ 253,501	\$ 1,634,704	\$ 168,287	\$ 4,146,261
Special Mention	16,291	2,667	26,739	23,163	146	69,006
Substandard ⁽¹⁾	17,268	12,932	11,550	35,162	154	77,066
Total	1,450,581	688,346	291,790	1,693,029	168,587	4,292,333
Impaired loans						
Nonaccrual loans						
Substandard-nonaccrual	6,754	6,239	978	1,387	320	15,678
Doubtful-nonaccrual	-	-	-	-	-	-
Total nonaccrual loans	6,754	6,239	978	1,387	320	15,678
Troubled debt restructurings ⁽²⁾						
Pass	-	66	107	263	83	519
Special Mention	-	820	-	-	200	1,020
Substandard	-	3,057	-	2,955	-	6,012
Total troubled debt restructurings	-	3,943	107	3,218	283	7,551
Total impaired loans	6,754	10,182	1,085	4,605	603	23,229
Total loans	\$ 1,457,335	\$ 698,528	\$ 292,875	\$ 1,697,634	\$ 169,190	\$ 4,315,562

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by Pinnacle Bank's primary regulators for loans classified as substandard, excluding the impact of nonaccrual loans and troubled debt restructurings. Potential problem loans, which are not included in nonaccrual loans, amounted to approximately \$77.1 million at June 30, 2014, compared to \$65.0 million at December 31, 2013.

(1)

(2) Troubled debt restructurings are presented as an impaired loan; however, they continue to accrue interest at contractual rates.

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	Commercial real estate - mortgage	Consumer real estate mortgage	Construction and land development	Commercial and industrial	Consumer and other	Total
December 31, 2013						
Accruing loans						
Pass	\$ 1,332,387	\$ 670,412	\$ 275,876	\$ 1,557,923	\$ 143,032	\$ 3,979,630
Special Mention	8,282	1,824	31,835	20,065	-	62,006
Substandard ⁽¹⁾	20,296	14,107	7,297	23,174	154	65,028
Total	1,360,965	686,343	315,008	1,601,162	143,186	4,106,664
Impaired loans						
Nonaccrual loans						
Substandard-nonaccrual	9,017	5,289	1,070	2,565	242	18,183
Doubtful-nonaccrual	-	-	-	-	-	-
Total nonaccrual loans	9,017	5,289	1,070	2,565	242	18,183
Troubled debt restructurings ⁽²⁾						
Pass	2,564	1,666	113	320	276	4,939
Special Mention	-	-	-	-	-	-
Substandard	10,889	2,318	-	1,500	-	14,707
Total troubled debt restructurings	13,453	3,984	113	1,820	276	19,646
Total impaired loans	22,470	9,273	1,183	4,385	518	37,829
Total loans	\$ 1,383,435	\$ 695,616	\$ 316,191	\$ 1,605,547	\$ 143,704	\$ 4,144,493

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by (1) Pinnacle Bank's primary regulators for loans classified as substandard, excluding the impact of nonaccrual loans and troubled debt restructurings. Potential problem loans, which are not included in nonaccrual loans, amounted to approximately \$77.1 million at June 30, 2014, compared to \$65.0 million at December 31, 2013.

(2) Troubled debt restructurings are presented as an impaired loan; however, they continue to accrue interest at contractual rates.

At June 30, 2014 and December 31, 2013, all loans classified as nonaccrual were deemed to be impaired. The principal balances of these nonaccrual loans amounted to \$15.7 million and \$18.2 million at June 30, 2014 and December 31, 2013, respectively, and are included in the tables above. For the six months ended June 30, 2014, the average balance of nonaccrual loans was \$16.1 million as compared to \$21.5 million for the twelve months ended December 31, 2013. At the date such loans were placed on nonaccrual status, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Had these nonaccrual loans been on accruing status, interest income would have been higher by \$416,000 for the six months ended June 30, 2014 and by \$573,000 for the six months ended June 30, 2013.

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The following table details the recorded investment, unpaid principal balance and related allowance and average recorded investment of our nonaccrual loans at June 30, 2014 and December 31, 2013 by loan classification and the amount of interest income recognized on a cash basis throughout the fiscal year-to-date period then ended, respectively, on these loans that remain on the balance sheets (in thousands):

	At June 30, 2014			For the six months ended June 30, 2014	
	Recorded investment	Unpaid principal balance	Related allowance ⁽¹⁾	Average recorded investment	Interest income recognized
Collateral dependent nonaccrual loans:					
Commercial real estate – mortgage	\$4,814	\$5,407	\$ -	\$4,913	\$ -
Consumer real estate – mortgage	2,336	2,416	-	2,366	-
Construction and land development	545	545	-	545	-
Commercial and industrial	1,018	1,161	-	1,053	-
Consumer and other	-	-	-	-	-
Total	\$8,713	\$9,529	\$ -	\$8,877	\$ -
Cash flow dependent nonaccrual loans:					
Commercial real estate – mortgage	\$1,940	\$2,145	\$ 190	\$1,967	\$ -
Consumer real estate – mortgage	3,903	4,185	1,089	4,045	-
Construction and land development	433	512	16	443	-
Commercial and industrial	369	375	145	469	-
Consumer and other	320	338	126	333	-
Total	\$6,965	\$7,555	\$ 1,566	\$7,257	\$ -
Total nonaccrual loans	\$15,678	\$17,084	\$ 1,566	\$16,134	\$ -

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	At December 31, 2013:			For the year ended December 31, 2013	
	Recorded investment balance	Unpaid principal balance	Related allowance ⁽¹⁾	Average recorded investment	Interest income recognized
Collateral dependent nonaccrual loans:					
Commercial real estate – mortgage	\$7,035	\$7,481	\$ -	\$6,522	\$ -
Consumer real estate – mortgage	2,162	2,209	-	2,234	-
Construction and land development	545	545	-	938	-
Commercial and industrial	1,828	1,901	-	3,911	-
Consumer and other	-	-	-	-	-
Total	\$11,570	\$12,136	\$ -	\$13,605	\$ -
Cash flow dependent nonaccrual loans:					
Commercial real estate – mortgage	\$1,982	\$2,166	\$ 142	\$2,448	\$ -
Consumer real estate – mortgage	3,127	3,334	722	3,405	-
Construction and land development	525	609	33	568	-
Commercial and industrial	737	1,029	218	1,216	-
Consumer and other	242	252	72	242	-
Total	\$6,613	\$7,390	\$ 1,187	\$7,879	\$ -
Total nonaccrual loans	\$18,183	\$19,526	\$ 1,187	\$21,484	\$ -

- (1) Collateral dependent loans are typically charged-off to their net realizable value pursuant to requirements of our primary regulators and no specific allowance is carried related to those loans.

Pinnacle Financial's policy is that once a loan is placed on nonaccrual status each subsequent payment is reviewed on a case-by-case basis to determine if the payment should be applied to interest or principal pursuant to regulatory guidelines. Pinnacle Financial recognized no interest income from cash payments received on nonaccrual loans during the three and six months ended June 30, 2014 or during the year ended December 31, 2013.

Impaired loans also include loans that Pinnacle Bank has elected to formally restructure due to the weakening credit status of a borrower. The restructuring may facilitate a repayment plan that seeks to minimize the potential losses that Pinnacle Bank may otherwise incur. If on nonaccrual status as of the date of restructuring, the loans are included in nonaccrual loans. Loans that have been restructured that were performing as of the restructure date and continue to perform in accordance with the restructured terms are reported separately as troubled debt restructurings.

At June 30, 2014 and December 31, 2013, there were \$7.6 million and \$19.6 million, respectively, of troubled debt restructurings that were performing as of their restructure date and which were accruing interest. These troubled debt restructurings are considered impaired loans pursuant to U.S. GAAP. Troubled commercial loans are restructured by specialists within our Special Assets Group, and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are charged with reducing Pinnacle Financial's overall risk and exposure to loss in the event of a restructuring by obtaining some or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral release terms, additional collateral or other similar strategies.

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The following table outlines the amount of each troubled debt restructuring categorized by loan classification made during the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

	Three months ended June 30, 2014			Six months ended June 30, 2014		
	Pre Modification Outstanding Investment, net of related allowance	Post Modification Recorded	Post Modification Outstanding Investment, net of related allowance	Pre Modification Outstanding Investment, net of related allowance	Post Modification Recorded	Post Modification Outstanding Investment, net of related allowance
Commercial real estate – mortgage	-	\$ -	\$ -	-	\$ -	\$ -
Consumer real estate – mortgage	-	-	-	-	-	-
Construction and land development	-	-	-	-	-	-
Commercial and industrial	1	75	59	7	2,955	2,099
Consumer and other	-	-	-	-	-	-
	1	\$ 75	\$ 59	7	\$ 2,955	\$ 2,099
	Three months ended June 30, 2013			Six months ended June 30, 2013		
	Pre Modification Outstanding Investment, net of related allowance	Post Modification Recorded	Post Modification Outstanding Investment, net of related allowance	Pre Modification Outstanding Investment, net of related allowance	Post Modification Recorded	Post Modification Outstanding Investment, net of related allowance
Commercial real estate – mortgage	-	\$ -	\$ -	-	\$ -	\$ -
Consumer real estate – mortgage	-	-	-	1	428	355
Construction and land development	1	51	44	1	51	44
Commercial and industrial	1	1,500	1,290	1	1,500	1,290
Consumer and other	-	-	-	1	193	164
	2	\$ 1,551	\$ 1,334	4	\$ 2,172	\$ 1,853

During the three months ended June 30, 2014 and 2013, Pinnacle Financial did not have any troubled debt restructurings that subsequently defaulted within twelve months of the restructuring. During the six months ended June 30, 2014, Pinnacle Financial did not have any troubled debt restructurings that subsequently defaulted within twelve months of the restructuring. During the six months ended June 30, 2013, two consumer real estate loans totaling \$1.0 million which were previously classified as a troubled debt restructuring subsequently defaulted due to their lack of performance, within twelve months of the restructuring. A default of a troubled debt restructuring is defined as an occurrence which violates the terms of the receivable's restructured contract.

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Pinnacle Financial analyzes its commercial loan portfolio to determine if a concentration of credit risk exists to any industry. Pinnacle Financial utilizes broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Pinnacle Financial has a credit exposure (loans outstanding plus unfunded lines of credit) exceeding 25% of Pinnacle Bank's total risk-based capital to borrowers in the following industries at June 30, 2014 with the comparative exposures for December 31, 2013 (in thousands):

At June 30, 2014:

	Outstanding Principal Balances	Unfunded Commitments	Total exposure	Total Exposure at December 31, 2013
Lessors of nonresidential buildings	\$477,902	\$ 73,210	\$551,112	\$515,240
Lessors of residential buildings	245,782	33,609	279,391	270,773

The table below presents past due balances at June 30, 2014 and December 31, 2013, by loan classification and segment allocated between accruing and nonaccrual status (in thousands):

	30-89 days past due and accruing	90 days or more past due and accruing	Total past due and accruing	Nonaccrual ⁽¹⁾	Current and accruing	Total Loans
June 30, 2014						
Commercial real estate:						
Owner-occupied	\$914	\$ 280	\$1,194	\$ 6,754	\$694,903	\$702,851
All other	21	-	21	-	754,463	754,484
Consumer real estate – mortgage	5,402	-	5,402	6,239	686,887	698,528
Construction and land development	5,083	-	5,083	978	286,814	292,875
Commercial and industrial	3,581	51	3,632	1,387	1,692,615	1,697,634
Consumer and other	3,561	318	3,879	320	164,991	169,190
	\$18,562	\$ 649	\$19,211	\$ 15,678	\$4,280,673	\$4,315,562
December 31, 2013						
Commercial real estate:						
Owner-occupied	\$2,534	\$-	\$2,534	\$7,750	\$669,014	\$679,298
All other	27	2,232	2,259	1,267	700,611	704,137
Consumer real estate – mortgage	2,215	-	2,215	5,289	688,112	695,616
Construction and land development	4,839	-	4,839	1,070	310,282	316,191
Commercial and industrial	1,847	825	2,672	2,565	1,600,310	1,605,547
Consumer and other	1,488	289	1,777	242	141,685	143,704
	\$12,950	\$3,346	\$16,296	\$18,183	\$4,110,014	\$4,144,493

(1) Approximately \$10.7 million and \$10.9 million of nonaccrual loans as of June 30, 2014 and December 31, 2013, respectively, were performing pursuant to their contractual terms at those dates.

The following table shows the allowance allocation by loan classification and accrual status at June 30, 2014 and December 31, 2013 (in thousands):

	Accruing Loans		Impaired Loans		Troubled Debt Restructurings ⁽¹⁾		Total Allowance for Loan Losses	
			Nonaccrual Loans		June		June	
	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Commercial real estate –mortgage	\$19,149	\$19,298	\$190	\$142	\$-	\$1,932	\$19,339	\$21,372
Consumer real estate – mortgage	6,292	7,090	1,089	722	827	543	8,208	8,355
Construction and land development	6,376	7,186	16	33	22	16	6,414	7,235
Commercial and industrial	26,663	24,660	145	218	675	256	27,483	25,134
Consumer and other	1,751	1,521	126	72	59	39	1,936	1,632
Unallocated	-	-	-	-	-	-	3,508	4,242
	\$60,231	\$59,755	\$1,566	\$1,187	\$1,583	\$2,786	\$66,888	\$67,970

- Troubled debt restructurings of \$7.6 million and \$19.6 million as of June 30, 2014 and December 31, 2013, respectively, are classified as impaired loans pursuant to U.S. GAAP; however, these loans continue to accrue interest at contractual rates.

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The following table details the changes in the allowance for loan losses from December 31, 2012 to December 31, 2013 to June 30, 2014 by loan classification and the allocation of the allowance for loan losses (in thousands):

	Commercial real estate – mortgage	Consumer real estate – mortgagedevelopment	Construction and land development	Commercial and industrial	Commercial Consumer and other	Unallocated	Total
Allowance for Loan Losses:							
Balance at December 31, 2012	\$19,634	\$8,762	\$9,164	\$24,738	\$1,094	\$6,025	\$69,417
Charged-off loans	(4,123)	(2,250)	(1,351)	(8,159)	(1,369)	-	(17,252)
Recovery of previously charged-off loans	500	1,209	1,464	4,531	244	-	7,948
Provision for loan losses	5,361	634	(2,042)	4,024	1,663	(1,783)	7,857
Balance at December 31, 2013	\$21,372	\$8,355	\$7,235	\$25,134	\$1,632	\$4,242	\$67,970
Collectively evaluated for impairment	\$19,298	\$7,090	\$7,186	\$24,660	\$1,521		\$59,755
Individually evaluated for impairment	2,074	1,265	49	474	111		3,973
Loans acquired with deteriorated credit quality	-	-	-	-	-		-
Balance at December 31, 2013	\$21,372	\$8,355	\$7,235	\$25,134	\$1,632		\$67,970
Loans:							
Collectively evaluated for impairment	\$1,360,965	\$686,343	\$315,008	\$1,601,162	\$143,186		\$4,106,664
Individually evaluated for impairment	22,470	9,273	1,183	4,385	518		37,829
Loans acquired with deteriorated credit quality	-	-	-	-	-		-
Balance at December 31, 2013	\$1,383,435	\$695,616	\$316,191	\$1,605,547	\$143,704		\$4,144,493

	Consumer						
	Commercial real estate - mortgage	Commercial real estate - mortgage	Construction and land development	Commercial and industrial	Commercial and other	Unallocated	Total
Allowance for Loan Losses:							
Balance at December 31, 2013	\$21,372	\$8,355	\$7,235	\$25,134	\$1,632	\$4,242	\$67,970
Charged-off loans	(393)	(418)	(7)	(1,777)	(674)	-	(3,269)
Recovery of previously charged-off loans	216	126	240	624	239	-	1,445
Provision for loan losses	(1,856)	145	(1,054)	3,502	739	(734)	742
Balance at June 30, 2014	\$19,339	\$8,208	\$6,414	\$27,483	\$1,936	\$3,508	\$66,888
Collectively evaluated for impairment	\$19,149	\$6,292	\$6,376	\$26,663	\$1,751		\$63,739
Individually evaluated for impairment	190	\$1,916	38	820	185		3,149
Loans acquired with deteriorated credit quality	-	\$-	-	-	-		-
Balance at June 30, 2014	\$19,339	\$8,208	\$6,414	\$27,483	\$1,936		\$66,888
Loans:							
Collectively evaluated for impairment	\$1,450,581	\$688,346	\$291,790	\$1,693,029	\$168,587		\$4,292,333
Individually evaluated for impairment	\$6,754	\$10,182	\$1,085	\$4,605	\$603		\$23,229
Loans acquired with deteriorated credit quality	\$-	\$-	\$-	\$-	\$-		\$-
Balance at June 30, 2014	\$1,457,335	\$698,528	\$292,875	\$1,697,634	\$169,190		\$4,315,562

The adequacy of the allowance for loan losses is assessed at the end of each calendar quarter. The level of the allowance is based upon evaluation of the loan portfolio, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, historical loss experience, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations.

At June 30, 2014, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$8.7 million to current directors, executive officers, and their related entities, of which \$6.2 million had been drawn upon. At December 31, 2013, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$11.2 million to directors, executive officers, and their related entities, of which approximately \$8.9 million had been drawn upon. These loans and extensions of credit were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to persons not related to Pinnacle Bank and did not involve more than the normal risk of collectability or present other unfavorable features. None of these loans to directors, executive officers, and their related entities were impaired at June 30, 2014 or December 31, 2013.

Residential Lending

At June 30, 2014, Pinnacle Financial had approximately \$24.6 million of mortgage loans held-for-sale compared to approximately \$12.9 million at December 31, 2013. During the first quarter of 2014, Pinnacle Financial began delivering loans on a mandatory basis to its approved investors. Mandatory delivery requires that Pinnacle Financial deliver an individual loan contract to the investor or compensate the investor in the event the loan does not ultimately close. Mandatory delivery exposes Pinnacle Financial to interest rate risk between the initial rate-lock and the ultimate sale of the loan to its approved investors. Pinnacle Financial enters into a short-term economic hedging relationship on a loan-by-loan basis to mitigate this interest rate exposure. Pinnacle Financial has not entered into any forward commitments with investors for future bulk loan sales. All of these loan sales transfer servicing rights to the buyer. During the six months ended June 30, 2014, Pinnacle Financial recognized \$2.9 million in gains on the sale of these loans, net of commissions paid, compared to \$3.8 million during the six months ended June 30, 2013.

These mortgage loans held-for-sale are originated internally and are primarily to borrowers in Pinnacle Bank's geographic markets. These sales are typically on a mandatory basis to investors that follow conventional government sponsored entities (GSE) and the Department of Housing and Urban Development/U.S. Department of Veterans Affairs (HUD/VA) guidelines.

Each purchaser has specific guidelines and criteria for sellers of loans, and the risk of credit loss with regard to the principal amount of the loans sold is generally transferred to the purchasers upon sale. While the loans are sold without recourse, the purchase agreements require Pinnacle Bank to make certain representations and warranties regarding the existence and sufficiency of file documentation and the absence of fraud by borrowers or other third parties such as appraisers in connection with obtaining the loan. If it is determined that the loans sold were in breach of these representations or warranties, Pinnacle Bank has obligations to either repurchase the loan for the unpaid principal balance and related investor fees or make the purchaser whole for the economic benefits of the loan. To date, repurchase activity pursuant to the terms of these representations and warranties has been insignificant to Pinnacle Bank.

Note 4. Income Taxes

Accounting Standards Codification (ASC) 740, Income Taxes, defines the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority. As of June 30, 2014, Pinnacle Financial had no unrecognized tax benefits related to Federal or State income tax matters and

does not currently anticipate any material increase or decrease in unrecognized tax benefits relative to any tax positions taken prior to June 30, 2014. As of June 30, 2014, Pinnacle Financial has accrued no interest and no penalties related to uncertain tax positions.

Pinnacle Financial's effective tax rate for the three and six months ended June 30, 2014 was 33.1% and 33.2% compared to 32.8% for the three and six months ended June 30, 2013. The effective tax rate differs from the Federal income tax statutory rate of 35% and state income tax rate of 6.50% primarily due to our investments in bank qualified municipal securities, bank-owned life insurance, and tax savings from our captive insurance subsidiary, PNF Insurance Inc., offset in part by meals and entertainment and executive compensation expense, portions of which are non-deductible.

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Note 5. Commitments and Contingent Liabilities

In the normal course of business, Pinnacle Financial has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions, and thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At June 30, 2014, these commitments amounted to \$1.2 billion.

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from Pinnacle Financial under certain prescribed circumstances. Subsequently, Pinnacle Financial would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit. At June 30, 2014, these commitments amounted to \$65.7 million.

Pinnacle Financial follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each customer's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment and personal property.

The contractual amounts of these commitments are not reflected in the consolidated financial statements and only amounts drawn upon would be reflected in the future. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should our customers default on their resulting obligation to us, Pinnacle Financial's maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those commitments. At June 30, 2014, and December 31, 2013, Pinnacle Financial had accrued \$1.4 million for the inherent risks associated with these off-balance sheet commitments.

During the fourth quarter of 2011, a customer of Pinnacle Bank filed a putative class action lawsuit (styled John Higgins, et al, v. Pinnacle Financial Partners, Inc., d/b/a Pinnacle National Bank) in Davidson County, Tennessee Circuit Court against Pinnacle Bank and Pinnacle Financial, on his own behalf, as well as on behalf of a purported class of Pinnacle Bank's customers within the State of Tennessee alleging that Pinnacle Bank's method of ordering debit card transactions had caused customers of Pinnacle Bank to incur higher overdraft charges than had a different method been used. In April 2014, an order was entered giving final approval to the settlement, and providing a release of claims against Pinnacle Bank and Pinnacle Financial. The order is now final and non-appealable. The settlement of this matter did not have a material adverse effect on Pinnacle Financial's consolidated financial condition, operating results, or cash flows.

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of these claims outstanding at June 30, 2014 will not have a material impact on Pinnacle Financial's consolidated financial condition, operating results or cash flows.

Note 6. Stock Options, Stock Appreciation Rights and Restricted Shares

At Pinnacle Financial's annual shareholders' meeting on April 15, 2014, the shareholders of Pinnacle Financial voted in favor of a proposal that adopted Pinnacle Financial's 2014 Equity Incentive Plan (the "2014 Plan"). The issuance of Pinnacle Financial's 2014 Plan proposal addressed the following matters:

- Consolidation of the two existing equity incentive plans, the Pinnacle Financial Partners, Inc. 2004 Amended and Restated Equity Incentive Plan (the "2004 Plan") and the Mid-America Bancshares, Inc. 2006 Omnibus Equity Incentive Plan (the "Mid-America Plan") including approximately 396,000 shares in the aggregate that remained available for issuance under those two plans at that date; and
- (i) Increased the maximum number of shares of common stock that may be issued to associates and directors by an additional 930,000 shares.
- (ii)

The 2014 Plan also permits Pinnacle Financial to reissue awards currently outstanding under the 2004 Plan and the Mid-America Plan that are subsequently forfeited, settled in cash or expired unexercised and returned to the 2014 Plan. Total shares available for issuance under the 2014 Plan were approximately 1.4 million shares as of June 30, 2014, inclusive of shares returned to the plan during the six months ended June 30, 2014.

Common Stock Options and Stock Appreciation Rights

As of June 30, 2014, there were 821,651 stock options and 4,159 stock appreciation rights outstanding to purchase common shares. A summary of the stock option and stock appreciation rights activity within the equity incentive plans during the six months ended June 30, 2014 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters is as follows:

	Number	Weighted- Average Exercise Price	Weighted- Average Contractual Term (in years)	Aggregate Intrinsic Value (000's)	
Outstanding at December 31, 2013	1,002,500	\$ 25.77	2.48	\$ 7,097	(1)
Granted	-				
Exercised	(174,920)				
Stock appreciation rights exercised ⁽³⁾	(1,370)				
Forfeited	(400)				
Outstanding at June 30, 2014	825,810	\$ 26.68	2.20	\$ 10,495	(2)
Options exercisable at June 30, 2014	825,810	\$ 26.68	2.20	\$ 10,495	(2)

- (1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of \$32.53 per common share at December 31, 2013 for the approximately 931,425 options and stock appreciation rights that were in-the-money at December 31, 2013.

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of \$39.48 per common share at June 30, 2014 for the approximately 825,810 options and stock appreciation rights that were in-the-money at June 30, 2014.

(3) During the six months ended June 30, 2014, 1,370 SARS were converted into 522 common shares upon exercise.

During the six months ended June 30, 2014, Pinnacle Financial recorded no stock option compensation expense compared to \$13,000 during the six months ended June 30, 2013. Compensation costs related to unvested stock options granted under Pinnacle Financial's equity incentive plan had been fully recognized and all outstanding option

awards are fully vested.

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Restricted Share Awards

Additionally, the recently adopted 2014 Plan provides for the granting of restricted share awards and other performance or market-based awards. There were no market-based awards outstanding as of June 30, 2014 under this plan.

A summary of activity for unvested restricted share awards for the six months ended June 30, 2014 is as follows:

	Number	Grant Date Weighted-Average Cost
Unvested at December 31, 2013	821,695	\$ 19.18
Shares awarded	97,018	32.35
Conversion of restricted share units to restricted share awards	186,943	31.68
Restrictions lapsed and shares released to associates/directors	(199,403)	19.14
Shares forfeited ⁽¹⁾	(24,764)	20.71
Unvested at June 30, 2014	881,489	\$ 23.25

- (1) Represents shares forfeited due to employee termination and/or retirement. No shares were forfeited due to failure to meet performance targets.

Pinnacle Financial grants restricted share awards to associates, executive management and outside directors with a combination of time and, in the case of executive management, performance vesting criteria. The following table outlines restricted stock grants that were made, grouped by similar vesting criteria, during the six months ended June 30, 2014:

Grant Year	Group ⁽¹⁾	Vesting Period in years	Shares awarded	Restrictions Lapsed and shares released to participants	Shares Forfeited by participants ⁽⁵⁾	Shares Unvested
Time Based Awards ⁽²⁾						
2014	Associates	5	84,819	-	1,527	83,292
Performance Based Awards ⁽³⁾						
2014	Leadership team	5	186,943	-	3,096	183,847
Outside Director Awards ⁽⁴⁾						
2014	Outside directors	1	12,199	-	-	12,199

- (1) Groups include employees (referred to as associates above), the leadership team which includes our named executive officers and other key senior leadership members, and outside directors. When the restricted shares are awarded, a participant receives voting rights and forfeitable dividend rights with respect to the shares, but is not able to transfer the shares until the restrictions have lapsed. Once the restrictions lapse, the participant is taxed on the value of the award and may elect to sell some shares to pay the applicable income taxes associated with the award. For time-based restricted share awards, dividends paid on shares for which the forfeiture restrictions do not lapse will be recouped by the Company at the time of termination. For performance-based awards, dividends are placed into escrow until the forfeiture restrictions on such shares lapse.

- (2) The forfeiture restrictions on these restricted share awards lapse in equal annual installments on the anniversary date of the grant.
- (3) The forfeiture restrictions on these restricted share awards lapse in separate equal installments should Pinnacle Financial achieve certain earnings and soundness targets over each year of the subsequent vesting period. Restricted share awards are issued to the outside members of the board of directors in accordance with their board compensation plan. Restrictions lapse on the one year anniversary date of the award based on each individual
- (4) board member meeting their attendance goals for the various board and board committee meetings to which each member was scheduled to attend. These shares represent forfeitures resulting from recipients for whom employment terminated during the
- (5) year-to-date period ended June 30, 2014. Any dividends paid on shares for which the forfeiture restrictions do not lapse will be recouped by the Company at the time of termination.

Compensation expense associated with the time-based restricted share awards is recognized over the time period that the restrictions associated with the awards lapse on a straight-line basis based on the total grant date fair value. Compensation expense associated with performance-based restricted share awards is recognized over the time period that the restrictions associated with the awards are anticipated to lapse based on a schedule consistent with the nature of the award. For the three and six months ended June 30, 2014, Pinnacle Financial recognized approximately \$1.2 million and \$2.4 million in compensation costs attributable to restricted share awards, compared to \$1.0 million and \$2.0 million for the three and six months ended June 30, 2013.

Restricted Share Units

Pinnacle Financial granted restricted share units to the senior executive officers and other members of the leadership team in the first quarter of 2014. The senior executive officers' restricted share unit award included a range from 58,404 units at the target compensation level to 102,209 units at the maximum compensation level. These restricted share units will convert to a number of restricted share awards based on the achievement of certain performance metrics. The Leadership Team restricted share unit award of 29,087 units was granted at a target level of performance. For both senior executive officers and the Leadership Team, approximately one-third of these awards are eligible for conversion to restricted share awards based on the achievement of certain predetermined goals for each of the fiscal years ended December 31, 2014, 2015 and 2016, respectively. Once converted to restricted share awards, the restrictions on these shares will lapse in 2018 and 2019 in 50% increments based on the attainment of certain soundness targets in fiscal 2017 and 2018, respectively. The performance metrics and soundness criteria for each of the impacted fiscal years were established concurrently with the restricted share unit grants in January 2014 by the Human Resources and Compensation Committee of Pinnacle Financial's board of directors (HRCC). These restricted share units are being expensed based on the requisite service period of the underlying tranche of the award. Each period, the number of shares that is expected to lapse to the recipient is reevaluated and the associated compensation expense is adjusted accordingly. For the three and six months ended June 30, 2014, Pinnacle Financial recognized expense associated with the first tranche of this award totaling \$83,000 and \$155,000, respectively. The expense is being accrued at the maximum compensation level for the senior executive officers and the target compensation level for the Leadership Team.

Note 7. Regulatory Matters

Pursuant to Tennessee banking law, Pinnacle Bank may not, without the prior consent of the Commissioner of the TDFI, pay any dividends to Pinnacle Financial in a calendar year in excess of the total of Pinnacle Bank's retained net income for that year plus the retained net income for the preceding two years. During the six months ended June 30, 2014, Pinnacle Bank paid \$8.97 million in dividends to Pinnacle Financial. As of June 30, 2014, Pinnacle Bank could not pay in excess of \$90.7 million of additional dividends to Pinnacle Financial in 2014 without prior approval of the Commissioner of the TDFI. Pinnacle Financial initiated payment of a quarterly dividend of \$0.08 per share of common stock in the fourth quarter of 2013 and has since declared three subsequent dividend payments. The amount and timing of all future dividend payments, if any, is subject to Board discretion and will depend on Pinnacle Financial's earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to us.

Pinnacle Financial and Pinnacle Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions, by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Pinnacle Financial and Pinnacle Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require Pinnacle Financial and Pinnacle Bank to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and for Pinnacle Bank of Tier I capital to average assets. Management believes, as of June 30, 2014, that Pinnacle Financial and Pinnacle Bank met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized under applicable banking regulations, Pinnacle Financial and Pinnacle Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table and not be subject to a written agreement, order or directive to maintain a higher capital level. Pinnacle Financial's and Pinnacle Bank's actual capital amounts and ratios are presented in the following table (in thousands):

	Actual Amount	Ratio	Minimum Capital Requirement Amount	Ratio	Minimum To Be Well-Capitalized Amount	Ratio
At June 30, 2014						
Total capital to risk weighted assets:						
Pinnacle Financial	\$657,333	13.4 %	\$393,991	8.0 %	\$493,150	10.0 %
Pinnacle Bank	\$627,449	12.8 %	\$196,447	8.0 %	\$295,077	10.0 %
Tier I capital to risk weighted assets:						
Pinnacle Financial	\$595,690	12.1 %	\$196,995	4.0 %	\$295,890	6.0 %
Pinnacle Bank	\$565,975	11.5 %	\$196,447	4.0 %	\$295,077	6.0 %
Tier I capital to average assets (*):						
Pinnacle Financial	\$595,690	11.0 %	\$217,121	4.0 %	\$N/	A N/ A
Pinnacle Bank	\$565,975	10.5 %	\$216,416	4.0 %	\$270,520	5.0 %

(*): Average assets for the above calculations were based on the most recent quarter.

In July 2013, the Federal Reserve Board and the FDIC approved final rules that substantially amend the regulatory risk-based capital rules applicable to Pinnacle Bank and Pinnacle Financial. The final rules implement the regulatory capital reforms of the Basel Committee on Banking Supervision reflected in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III) and changes required by the Dodd-Frank Act.

Under these rules, the leverage and risk-based capital ratios of bank holding companies may not be lower than the leverage and risk-based capital ratios for insured depository institutions. The final rules implementing the Basel III regulatory capital reforms will become effective as to Pinnacle Financial and Pinnacle Bank on January 1, 2015, and include new minimum risk-based capital and leverage ratios. Moreover, these rules refine the definition of what constitutes "capital" for purposes of calculating those ratios, including the definitions of Tier 1 capital and Tier 2 capital.

The new minimum capital level requirements applicable to bank holding companies and banks subject to the rules are:

- (i) a new common equity Tier 1 capital ratio of 4.5%;
- (ii) a Tier 1 risk-based capital ratio of 6% (increased from 4%);
- (iii) a total risk-based capital ratio of 8% (unchanged from current rules);
- (iv) a Tier 1 leverage ratio of 4% for all institutions.

The rules also establish a "capital conservation buffer" of 2.5% (to be phased in over three years) above the new regulatory minimum risk-based capital ratios, and result in the following minimum ratios once the capital conservation buffer is fully phased in:

- (i) a common equity Tier 1 risk-based capital ratio of 7.0%,
- (ii) a Tier 1 risk-based capital ratio of 8.5%, and
- (iii) a total risk-based capital ratio of 10.5%.

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The capital conservation buffer requirement is to be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if capital levels fall below minimum levels plus the buffer amounts. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

Under these new rules, Tier 1 capital will generally consist of common stock (plus related surplus) and retained earnings, limited amounts of minority interest in the form of additional Tier 1 capital instruments, and non-cumulative preferred stock and related surplus, subject to certain eligibility standards, less goodwill and other specified intangible assets and other regulatory deductions. Cumulative preferred stock and trust preferred securities issued after May 19, 2010, will no longer qualify as Tier 1 capital, but such securities issued prior to May 19, 2010, including in the case of bank holding companies with less than \$15.0 billion in total assets, trust preferred securities issued prior to that date, will continue to count as Tier 1 capital subject to certain limitations. The definition of Tier 2 capital is generally unchanged for most banking organizations, subject to certain new eligibility criteria.

Common equity Tier 1 capital will generally consist of common stock (plus related surplus) and retained earnings plus limited amounts of minority interest in the form of common stock, less goodwill and other specified intangible assets and other regulatory deductions.

The final rules allow banks and their holding companies with less than \$250 billion in assets a one-time opportunity to opt-out of a requirement to include unrealized gains and losses in accumulated other comprehensive income in their capital calculation. Pinnacle Financial expects that it will opt-out of this requirement.

Note 8. Derivative Instruments

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings.

Non-hedge derivatives

Pinnacle Financial enters into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, Pinnacle Financial enters into offsetting positions with a large U.S. financial institution in order to minimize the risk to Pinnacle Financial. These swaps are derivatives, but are not designated as hedging instruments.

Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counter party or customer owes Pinnacle Financial, and results in credit risk to Pinnacle Financial. When the fair value of a derivative instrument contract is negative, Pinnacle Financial owes the customer or counterparty and therefore, has no credit risk.

A summary of Pinnacle Financial's interest rate swaps related to customers as of June 30, 2014 and December 31, 2013 is included in the following table (in thousands):

	June 30, 2014		December 31, 2013	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate swap agreements:				
Pay fixed / receive variable swaps	\$257,823	\$13,490	\$294,486	\$13,296

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Pay variable / receive fixed swaps	257,823	(13,878)	294,486	(13,670)
Total	\$515,646	\$(388)	\$588,972	\$(374)

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Hedge derivatives

During the second quarter of 2013, Pinnacle Financial entered into a forward cash flow hedge relationship to manage future interest rate exposure. The hedging strategy converts the LIBOR based variable interest rate on forecasted borrowings to a fixed interest rate and protects Pinnacle Financial from floating interest rate variability. The terms of the individual contracts within the relationship are as follows (in thousands):

	Forecasted				June 30, 2014		December 31, 2013	
	Notional Amount	Receive Rate	Pay Rate	Term ⁽¹⁾	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income
Interest Rate Swap	\$ 33,000	3 month LIBOR	1.428%	April 2015-April 2018	\$ 101	\$ 61	\$ 463	\$ 281
Interest Rate Swap	33,000	3 month LIBOR	1.857%	Oct. 2015-April 2019	236	\$ 143	837	509
Interest Rate Swap	33,000	3 month LIBOR	1.996%	Oct. 2015-Oct. 2019	256	\$ 156	1,007	612
Interest Rate Swap	33,000	3 month LIBOR	2.265%	April 2016-April 2020	304	\$ 185	1,172	712
Interest Rate Swap	34,000	3 month LIBOR	2.646%	April 2016-April 2022	353	\$ 215	1,818	1,105
Interest Rate Swap	34,000	3 month LIBOR	2.523%	Oct. 2016-Oct. 2020	316	\$ 192	1,307	795
	\$ 200,000				\$ 1,566	\$ 952	\$ 6,604	\$ 4,014

(1) No cash will be exchanged prior to the term.

During the second quarter of 2014, Pinnacle Financial entered into four additional interest rate swap agreements as part of the management of interest rate risk. Pinnacle Financial designated the interest rate swaps as cash flow hedges intended to protect against the variability of cash flows using the first payments received method on a rolling portfolio of selected LIBOR based loans to customers. The swaps hedge the interest rate risk, wherein Pinnacle Financial receives a fixed rate of interest from a counterparty and pays a variable rate, based on one month LIBOR. The terms of the respective swaps range from seven to ten years and start on July 1, 2014. The swaps were entered into with a counterparty that met Pinnacle Financial's credit standards and the agreements contain collateral provisions protecting the at-risk party. Pinnacle Financial believes that the credit risk inherent in the contract is not significant. The terms of the individual contracts within the relationship are as follows (in thousands):

	Forecasted				June 30, 2014		December 31, 2013	
	Notional Amount	Pay Rate	Receive Rate	Term ⁽¹⁾	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income
Interest Rate Swap	\$ 27,500	1 month LIBOR	2.09%	July 2014 - July 2021	\$ 151	\$ 92	\$ 0	\$ 0
Interest Rate Swap	25,000	1 month LIBOR	2.27%	July 2014 - July 2022	86	52	0	0

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Interest Rate Swap	30,000	1 month LIBOR	2.42	July 2014 - July %2023	114	69	0	0
Interest Rate Swap	27,500	1 month LIBOR	2.50	July 2014 - July %2024	31	19	0	0
	\$ 110,000				\$382	\$ 232	\$ 0	\$ 0

(1) No cash will be exchanged prior to the term.

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All of the cash flow hedges were determined to be effective during the period presented, and therefore, no amount of ineffectiveness has been included in net income. The aggregate fair value of the swaps is recorded in other assets with changes in fair value recorded in accumulated other comprehensive (loss) income, net of tax. If a hedge was deemed to be ineffective, the amount included in accumulated other comprehensive (loss) income would be reclassified into a line item within the consolidated statement of income that impacts operating results. The hedge would no longer be considered effective if a portion of the hedge becomes ineffective, the item hedged is no longer in existence or Pinnacle Financial discontinues hedge accounting. Pinnacle Financial expects the hedges to remain fully effective during the remaining terms of the swaps.

Note 9. Fair Value of Financial Instruments

FASB ASC 820, Fair Value Measurements and Disclosures, which defines fair value, establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability.

Valuation Hierarchy

FASB ASC 820 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Following is a description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Assets

Securities available-for-sale – Where quoted prices are available for identical securities in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other financial products. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics and are classified within Level 2 of the valuation hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation and more complex pricing models or discounted cash flows are used, securities are classified within Level 3 of the valuation hierarchy.

Other equity investments – Included in other investments are other equity investments in certain nonpublic private equity funds. The valuation of nonpublic private equity investments requires management judgment due to the absence of observable quoted market prices, inherent lack of liquidity and the long-term nature of such assets. These investments are valued initially based upon transaction price. The carrying values of other investments are adjusted either upwards or downwards from the transaction price to reflect expected exit values as evidenced by financing and sale transactions with third parties, or when determination of a valuation adjustment is confirmed through ongoing reviews by senior investment managers. A variety of factors are reviewed and monitored to assess positive and negative changes in valuation including, but not limited to, current operating performance and future expectations of the particular investment, industry valuations of comparable public companies and changes in market outlook and the third-party financing environment over time. In determining valuation adjustments resulting from the investment review process, emphasis is placed on current company performance and market conditions. These investments are included in Level 3 of the valuation hierarchy as these funds are not widely traded and the underlying investments of such funds are often privately-held and/or start-up companies for which market values are not readily available.

Other assets – Included in other assets are certain assets carried at fair value, including interest rate swap agreements, the cash flow hedge and interest rate locks associated with the mortgage loan pipeline. The carrying amount of interest rate swap agreements is based on Pinnacle Financial's pricing models that utilize observable market inputs. The fair value of the cash flow hedge is determined by calculating the difference between the discounted fixed rate cash flows and the discounted variable rate cash flows. The fair value of the mortgage loan pipeline is based upon the projected sales price of the underlying loans, taking into account market interest rates and other market factors at the measurement date, net of the projected fallout rate. Pinnacle Financial reflects these assets within Level 2 of the valuation hierarchy as these assets are valued using similar transactions that occur in the market.

Nonaccrual loans – A loan is classified as nonaccrual when it is probable Pinnacle Financial will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Nonaccrual loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. If the recorded investment in the nonaccrual loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses or the difference may be recognized as a charge-off. Nonaccrual loans are classified within Level 3 of the hierarchy due to the unobservable inputs used in determining their fair value such as collateral values and the borrower's underlying financial condition.

Other real estate owned – Other real estate owned (OREO) represents real estate foreclosed upon by Pinnacle Bank through loan defaults by customers or acquired by deed in lieu of foreclosure. Substantially all of these amounts relate to lots, homes and development projects that are either completed or are in various stages of construction for which Pinnacle Financial believes it has adequate collateral. Upon foreclosure, the property is recorded at the lower of cost or fair value, based on appraised value, less selling costs estimated as of the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation downward adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs. Any gains or losses realized at the time of disposal are also reflected in noninterest expense, as applicable. OREO is included in Level 3 of the valuation hierarchy due to the lack of observable market inputs into the determination of fair value. Appraisal values are property-specific and sensitive to the changes in the overall economic environment.

Liabilities

Other liabilities – Pinnacle Financial has certain liabilities carried at fair value including certain interest rate swap agreements to facilitate customer transactions. The fair value of these liabilities is based on Pinnacle Financial's pricing models that utilize observable market inputs and is reflected within Level 2 of the valuation hierarchy.

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The following tables present financial instruments measured at fair value on a recurring basis as of June 30, 2014 and December 31, 2013, by caption on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above) (in thousands):

	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)
June 30, 2014				
Investment securities available-for-sale:				
U.S. Treasury securities	\$ -	\$ -	\$ -	\$ -
U.S. government agency securities	110,924	-	110,924	-
Mortgage-backed securities	459,938	-	459,938	-
State and municipal securities	146,120	-	146,120	-
Agency-backed securities	15,230	-	15,230	-
Corporate notes and other	11,316	-	11,316	-
Total investment securities available-for-sale	\$ 743,528	\$ -	\$ 743,528	\$ -
Other equity investments	7,186	-	-	7,186
Other assets	16,073	-	16,073	-
Total assets at fair value	\$ 766,787	\$ -	\$ 759,601	\$ 7,186
Other liabilities	\$ 13,878	\$ -	\$ 13,878	\$ -
Total liabilities at fair value	\$ 13,878	\$ -	\$ 13,878	\$ -
December 31, 2013				
Investment securities available-for-sale:				
U.S. government agency securities	\$ 103,873	\$ -	\$ 103,873	\$ -
Mortgage-backed securities	412,936	-	412,936	-
State and municipal securities	148,411	-	148,411	-
Agency-backed securities	17,007	-	17,007	-
Corporate notes and other	11,229	-	11,229	-
Total investment securities available-for-sale	693,456	-	693,456	-
Other equity investments	6,701	-	-	6,701
Other assets	19,900	-	19,900	-
Total assets at fair value	\$ 720,057	\$ -	\$ 713,356	\$ 6,701
Other liabilities	\$ 13,670	\$ -	\$ 13,670	\$ -
Total liabilities at fair value	\$ 13,670	\$ -	\$ 13,670	\$ -

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The following table presents assets measured at fair value on a nonrecurring basis as of June 30, 2014 and December 31, 2013 (in thousands):

	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)	Total net losses for the year-to-date period then ended
June 30, 2014					
Other real estate owned	\$ 12,946	\$ -	\$ -	\$ 12,946	\$ 566
Nonaccrual loans, net ⁽¹⁾	14,112	-	-	14,112	102
Total	\$ 27,058	\$ -	\$ -	\$ 27,058	\$ 668
December 31, 2013					
Other real estate owned	\$ 15,226	\$ -	\$ -	\$ 15,226	\$ 2,258
Nonaccrual loans, net ⁽¹⁾	16,996	-	-	16,996	2,921
Total	\$ 32,222	\$ -	\$ -	\$ 32,222	\$ 5,179

(1) Amount is net of a valuation allowance of \$1.6 million at June 30, 2014 and \$1.2 million at December 31, 2013 as required by ASC 310-10, "Receivables."

In the case of the investment securities portfolio, Pinnacle Financial monitors the portfolio to ascertain when transfers between levels have been affected. The nature of the remaining assets and liabilities is such that transfers in and out of any level are expected to be rare. For the six months ended June 30, 2014, there were no transfers between Levels 1, 2 or 3.

The table below includes a rollforward of the balance sheet amounts for the three and six months ended June 30, 2014 (including the change in fair value) for financial instruments classified by Pinnacle Financial within Level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, since Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources), the gains and losses in the table below include changes in fair value due in part to observable factors that are part of the valuation methodology (in thousands):

	For the six months ended June 30,			
	2014	2013		
	Other assets	Other liabilities	Other assets	Other liabilities
Fair value, January 1	\$6,701	\$ -	\$4,681	\$ -
Total realized gains (losses) included in income	92	-	(320)	-
Change in unrealized gains/losses included in other comprehensive income for assets and liabilities still held at June 30	-	-	-	-
Purchases	393	-	1,365	-
Issuances	-	-	-	-
Settlements	-	-	-	-
Transfers out of Level 3	-	-	-	-
Fair value, June 30	7,186	-	5,726	-

Total realized gains (losses) included in income related to financial assets and liabilities still on the consolidated balance sheet at June 30	\$92	\$	-	\$(320)	\$	-
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The following methods and assumptions were used by Pinnacle Financial in estimating its fair value disclosures for financial instruments that are not measured at fair value. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flow models. Those models are significantly affected by the assumptions used, including the discount rates, estimates of future cash flows and borrower creditworthiness. The fair value estimates presented herein are based on pertinent information available to management as of June 30, 2014 and December 31, 2013. Such amounts have not been revalued for purposes of these consolidated financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Securities held-to-maturity - Estimated fair values for investment securities are based on quoted market prices where available. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics.

Loans, net - The fair value of our loan portfolio includes a credit risk factor in the determination of the fair value of our loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. Our loan portfolio is initially fair valued using a segmented approach. We divide our loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk.

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral. For other loans, fair values are estimated using discounted cash flow models, using current market interest rates offered for loans with similar terms to borrowers of similar credit quality. The values derived from the discounted cash flow approach for each of the above portfolios are then further discounted to incorporate credit risk to determine the exit price.

Mortgage loans held-for-sale - Mortgage loans held-for-sale are carried at the lower of cost or fair value. The estimate of fair value is based on pricing models and other information.

Deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, subordinated debt and other borrowings - The carrying amounts of demand deposits, savings deposits, securities sold under agreements to repurchase, floating rate advances from the FHLB, floating rate subordinated debt and other borrowings, and floating rate loans approximate their fair values due to having no stated maturity. Fair values for certificates of deposit, fixed rate advances from the FHLB and fixed rate subordinated debt are estimated using discounted cash flow models, using current market interest rates offered on certificates, advances and other borrowings with similar remaining maturities. For fixed rate subordinated debt, the maturity is assumed to be as of the earliest date that the indebtedness will be repriced.

Off-balance sheet instruments - The fair values of Pinnacle Financial's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to Pinnacle Financial until such commitments are funded.

The following table presents the carrying amounts, estimated fair value and placement in the fair value hierarchy of Pinnacle Financial's financial instruments at June 30, 2014 and December 31, 2013. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as non-interest bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity (in thousands).

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(dollars in thousands) June 30, 2014	Carrying/ Notional Amount	Estimated Fair Value ⁽¹⁾	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)
Financial assets:					
Securities held-to-maturity	\$38,538	\$38,290	\$ -	\$ 38,290	\$ -
Loans, net	4,248,673	4,178,982	-	-	4,178,982
Mortgage loans held-for-sale	24,592	25,049	-	25,049	-
Financial liabilities:					
Deposits and securities sold under agreements to repurchase	4,713,786	4,435,305	-	-	4,435,305
Federal Home Loan Bank advances	170,556	170,407	-	-	170,407
Subordinated debt and other borrowings	97,408	76,620	-	&#	