S Y BANCORP INC
Form 10-K405
March 22, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K

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

For the Fiscal Year Ended December 31, 2001	Commission File Number 1-13661

S.Y. BANCORP, INC.

**1040 East Main Street
Louisville, Kentucky 40206
(502) 582-2571**

Incorporated in Kentucky	I.R.S.No. 61-1137529

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	Name of each exchange on which registered:
Common stock, no par value	American Stock Exchange
9.00% Cumulative trust preferred securities and the guarantee with respect thereto	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

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

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

The aggregate market value of registrant's voting stock (Common Stock, no par value) held by non-affiliates of the registrant as of February 28, 2002, was $208,173,297.

The number of shares of registrant's Common Stock, no par value, outstanding as of February 28, 2002, was 6,705,917.

Documents Incorporated by Reference

Portions of Registrant's definitive proxy statement related to Registrant's Annual Meeting of Stockholders to be held on April 24, 2002 (the "Proxy Statement"), are incorporated by reference into Part III of this Form 10-K.

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Part I

Item 1. Business

S. Y. Bancorp, Inc. ("Bancorp"), was incorporated in 1988 and is a Kentucky corporation headquartered in Louisville, Kentucky. Bancorp is a bank holding company registered with, and subject to supervision, regulation and examination by the Board of Governors of the Federal Reserve System. Bancorp has two subsidiaries, Stock Yards Bank & Trust Company ("the Bank") and S.Y. Bancorp Capital Trust I ("the Trust"). The Bank is wholly owned and is a state chartered bank. Bancorp conducts no active business operations; accordingly, the business of Bancorp is substantially the same as that of the Bank. The Trust is a Delaware statutory business trust that is a 100%-owned finance subsidiary of Bancorp.

Stock Yards Bank & Trust Company

Stock Yards Bank & Trust Company is the only banking subsidiary of Bancorp and was originally chartered in 1904. The Bank is headquartered in Louisville, Kentucky and provides commercial and retail banking services in Louisville and southern Indiana through 17 full service banking offices (See "ITEM 2. PROPERTIES"). The Bank is chartered under the laws of the Commonwealth of Kentucky. In addition to traditional commercial and personal banking activities, the Bank has an investment management and trust department offering a wide range of trust and investment services. The Bank also originates and sells single-family residential mortgages through its operating division, Stock Yards Mortgage Company, and offers securities brokerage services through an arrangement with Raymond James Financial Services, Inc.

At December 31, 2001, the Bank had 347 full-time equivalent employees. Employees are not subject to a collective bargaining agreement. Bancorp and the Bank consider their relationships with employees to be good.

See Note 20 to Bancorp's consolidated financial statements for the year ended December 31, 2001 for information relating to the Bank's business segments.

Supervision and Regulation

Bank holding companies and commercial banks are extensively regulated under both federal and state law. Any change in applicable law or regulation may have a material effect on the business and prospects of Bancorp and the Bank.

Bancorp, as a registered bank holding company, is subject to the supervision of and regulation by the Federal Reserve Board under the Bank Holding Company Act of 1956. In addition, Bancorp is subject to the provisions of Kentucky's banking laws regulating bank acquisitions and certain activities of controlling bank shareholders.

The Bank is subject to the supervision of and regular examination by the Federal Deposit Insurance Corporation and the Kentucky Department of Financial Institutions. The Federal Deposit Insurance Corporation insures the deposits of the Bank to the current maximum of $100,000 per depositor.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("the 1994 Act") removed state law barriers to interstate bank acquisitions and permits the consolidation of interstate banking operations. Under the 1994 Act, adequately capitalized and managed bank holding companies may acquire banks in any state, subject to Community Reinvestment Act compliance, compliance with federal and state antitrust laws and deposit concentration limits and subject to any state laws restricting the transaction. Kentucky banks are also permitted to acquire a branch in another state if permitted by law of the other state. Kentucky currently does not permit *de novo* branching by out-of-state banks into

Kentucky, and it does not permit an out-of-state bank to acquire a bank in Kentucky that has been in existence less than five years.

The Gramm-Leach-Bliley Act ("the 1999 Act") repealed the Depression-era barrier between commercial and investment banking established by the Glass-Steagall Act, as well as the prohibition on the mixing of banking and insurance established by the Bank Holding Company Act of 1956. The 1999 Act allows for affiliations among banks, securities firms and insurance companies by means of a financial holding company ("FHC"). In most cases, the creation of an FHC is a simple election and notice to the Federal Reserve Board. The 1999 Act requires that, at the time of establishment of an FHC, all depository institutions within that corporate group must be "well managed" and "well capitalized" and must have received a rating of "satisfactory" or better under its most recent Community Reinvestment Act examination. Further, non-banking financial firms (for example an insurance company or securities firm) may establish an FHC and acquire a depository institution. While the distinction between banks and non-banking financial firms has been blurring over recent years, the 1999 Act will make it less cumbersome for banks to offer services "financial in nature" but beyond traditional commercial banking activities. Likewise, non-banking financial firms may find it easier to offer services that have, heretofore, been provided primarily by depository institutions. Management of Bancorp has chosen not to become an FHC at this time, but may chose to do so in the future.

In its 2000 session, the Kentucky General Assembly enacted a law allowing banks with a Kentucky charter and a CAMEL rating of 1 or 2 at its most recent state or federal examination to engage in any banking activity in which it could engage if: (a) it were operating as a national bank in any state, (b) it were operating as a state bank, state thrift or state savings bank in any state, or (c) it meets the qualified thrift lender test as determined by the Office of Thrift Supervision, or was operating as a federally chartered thrift or federal savings bank in any state.

CAMEL ratings are used by examiners of financial institutions to rate these institutions in five categories. These categories are capital adequacy, asset quality, management effectiveness, quantity and quality of earnings and liquidity. Before a bank engages in any of the activities above, it must obtain a legal opinion specifying the statutory or regulatory provisions permitting the activity in which the bank intends to engage. The result of this legislation was to broaden the activities in which a Kentucky state chartered bank may engage.

Item 2. Properties

The principal offices of Bancorp and the Bank are located at 1040 East Main Street, Louisville, Kentucky. Adjacent to the main location is the Bank's operations center. In addition to the main office complex, the Bank owned eight branch properties at December 31, 2001 (one of which is located on leased land). The Bank also leased eight branch facilities. Of the seventeen banking locations, fourteen are located in Louisville and three are located in nearby southern Indiana. See Notes 5 and 16 to Bancorp's consolidated financial statements for the year ended December 31, 2001, for additional information relating to amounts invested in premises, equipment and lease commitments.

Item 3. Legal Proceedings

See Note 16 to Bancorp's consolidated financial statements for the year ended December 31, 2001, for information relating to legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

None

Executive Officers of the Registrant

The following table lists the names and ages (as of December 31, 2001) of all current executive officers of Bancorp. Each executive officer is appointed by Bancorp's Board of Directors to serve at the pleasure of the Board. There is no arrangement or understanding between any executive officer of Bancorp and any other person(s) pursuant to which he/she was or is to be selected as an officer.

Name and Age of Executive Officer	Position and Offices With Bancorp
David H. Brooks Age 59	Chairman and Chief Executive Officer and Director
David P. Heintzman Age 42	President and Director
Kathy C. Thompson Age 40	Executive Vice President and Director
Phillip S. Smith Age 44	Executive Vice President
Gregory A. Hoeck Age 51	Executive Vice President

Name and Age of Executive Officer	Position and Offices With Bancorp
Nancy B. Davis Age 46	Executive Vice President, Secretary, Treasurer and Chief Financial Officer

Mr. Brooks was appointed Chairman and Chief Executive Officer of Bancorp and the Bank in 1993. Prior thereto, he was President of Bancorp and the Bank.

Mr. Heintzman was appointed President of Bancorp and the Bank in 1993. Prior thereto, he served as Treasurer and Chief Financial Officer of Bancorp and Executive Vice President of the Bank.

Ms. Thompson was appointed Executive Vice President of Bancorp and the Bank in 1996. She joined the Bank in 1992 as Senior Vice President and is Manager of the Investment Management and Trust Department.

Mr. Smith was appointed Executive Vice President of the Bank in 1996. Prior thereto, he was Senior Vice President of the Bank. He is primarily responsible for the commercial lending area of the Bank.

Mr. Hoeck joined the Bank as Executive Vice President in 1998. He is primarily responsible for the retail and marketing areas of the Bank. Prior to joining the Bank, Mr. Hoeck was an Executive Vice President for PNC Bank and the Retail Market Manager for the Kentucky and Indiana markets.

Ms. Davis was appointed Executive Vice President of Bancorp and the Bank in 1999. Prior thereto, she was Senior Vice President of Bancorp and the Bank. She was appointed Chief Financial Officer of Bancorp in 1993.

Part II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

Bancorp's common stock is traded on the American Stock Exchange under the ticker symbol SYI. The table below sets forth the quarterly high and low market prices of Bancorp's common stock and dividends declared per share. The payment of dividends by the Bank to Bancorp is subject to the

restriction described in Note 15 to the consolidated financial statements. On December 31, 2001, Bancorp had 949 shareholders of record.

	2001			2000		
Quarter	High	Low	Cash Dividends Declared	High	Low	Cash Dividends Declared
First	$ 24.50	$ 20.25	$ 0.11	$ 22.50	$ 18.63	$ 0.09
Second	35.24	25.30	0.11	22.75	18.75	0.10
Third	34.45	29.15	0.11	22.00	19.00	0.10
Fourth	33.80	31.00	0.12	21.50	18.88	0.10

Item 6. Selected Financial Data

Selected Consolidated Financial Data

	Years Ended December 31				
	2001	2000	1999	1998	1997

	Years Ended December 31				
	(Dollars In Thousands Except Per Share Data)				
Net interest income	$ 34,945	$ 31,154	$ 27,470	$ 23,294	$ 19,723
Provision for loan losses	4,220	2,840	1,635	1,600	1,000
Net income	13,542	11,592	9,706	8,218	6,534
Per share data					
Net income, basic	$ 2.03	$ 1.75	$ 1.46	$ 1.25	$ 1.00
Net income, diluted	1.96	1.70	1.41	1.21	0.96
Cash dividends declared	0.45	0.39	0.33	0.28	0.24
Average balances					
Stockholders' equity	$ 66,433	$ 54,656	$ 48,052	$ 40,691	$ 34,174
Assets	884,483	747,816	637,276	540,696	437,037
Long-term debt	14,026	2,100	2,100	2,100	2,259
Ratios					
Return on average assets	1.53%	1.55%	1.52%	1.52%	1.50%
Return on average stockholders' equity	20.38%	21.21%	20.20%	20.20%	19.12%
Average stockholders' equity to average assets	7.51%	7.31%	7.54%	7.53%	7.82%

Per share information has been adjusted to reflect stock splits.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this discussion is to provide information as to the analysis of the consolidated financial condition and results of operations of S.Y. Bancorp, Inc. (Bancorp) and its wholly owned subsidiaries, Stock Yards Bank & Trust Company (the Bank) and S.Y. Bancorp Capital Trust I (the Trust). Bancorp, incorporated in 1988, has no active business operations. Thus, Bancorp's business is substantially the same as that of the Bank. The Bank has operated continuously since it opened in 1904. The Bank conducted business at one location for 85 years and then began branching. At December 31, 2001, the Bank had seventeen locations. The combined effect of added convenience with the Bank's focus on flexible, attentive customer service has been key to the Bank's growth and profitability. The wide range of services added by the wealth management group (investment management and trust, private banking and brokerage) and by the mortgage department help support the corporate philosophy of capitalizing on full service customer relationships.

Critical Accounting Policies

Bancorp has prepared all of the consolidated financial information in this report in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In preparing the consolidated financial statements in accordance with U.S. GAAP, Bancorp makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

We have identified the accounting policy related to the allowance for loan losses as critical to the understanding of Bancorp's results of operations, since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change. The impact and any associated risks related to these policies on our business operations are discussed in the "Allowance for Loan Losses" section below.

Forward-Looking Statements

This report contains forward-looking statements under the Private Securities Litigation Reform act that involve risks and uncertainties. Although Bancorp believes the assumptions underlying the forward-looking statements contained herein are reasonable, any of these

assumptions could be inaccurate. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions both generally and more specifically in the market in which Bancorp and its subsidiaries operate; competition for Bancorp's customers from other providers of financial services; government legislation and regulation which change from time to time and over which Bancorp has no control; changes in interest rates; material unforeseen changes in liquidity, results of operations or financial condition of Bancorp's customers; or other risks detailed in Bancorp's filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond the control of Bancorp.

The following discussion should be read in conjunction with Bancorp's consolidated financial statements and accompanying notes and other schedules presented elsewhere in this report.

Results of Operations

Net income was $13,542,000 or $1.96 per share on a diluted basis in 2001. This compares to $11,592,000 or $1.70 per share in 2000 and $9,706,000 or $1.41 per share in 1999. The increase in 2001 net income was attributable to growth in both net interest income and non-interest income that was partially offset by increased non-interest expenses. Earnings include a 12.5% increase in fully taxable equivalent net interest income and a 25.0% increase in non-interest income. All categories of non-interest income showed improvement when compared to the prior year. The strong results of our investment management and trust and mortgage departments for 2001 contributed significantly to this increase. Non-interest expenses increased 13.5%. Non-interest expenses increased in all categories reflective of continued expansion of the banking center network.

The following paragraphs provide a more detailed analysis of the significant factors affecting operating results.

Net Interest Income

Net interest income, the most significant component of Bancorp's earnings, is total interest income less total interest expense. Net interest spread is the difference between the taxable equivalent rate earned on average interest earning assets and the rate expensed on average interest bearing liabilities.

Net interest margin represents net interest income on a taxable equivalent basis as a percentage of average earning assets. Net interest margin is affected by both the interest rate spread and the level of non-interest bearing sources of funds, primarily consisting of demand deposits and stockholders' equity. The level of net interest income is determined by the mix and volume of interest earning assets, interest bearing deposits and interest bearing liabilities and by changes in interest rates. The discussion that follows is based on tax equivalent interest data.

Bancorp's net interest margin and net interest spread were affected negatively during the year by the unprecedented 475 basis point decrease in interest rates. Management believes that interest rates in 2002 will be less volatile and allow for improvement in the net interest margin and net interest spread during the year.

Comparative information regarding net interest income follows:

	2001	2000	1999	2001/2000 Change	2000/1999 Change
	(Dollars In Thousands)				
Net interest income, tax equivalent basis	$ 35,548	$ 31,601	$ 27,839	12.5%	13.5%
Net interest spread	3.61%	3.72%	4.03%	(11) bp	(31) bp
Net interest margin	4.27%	4.51%	4.72%	(24) bp	(21) bp
Average earning assets	$ 831,918	$ 700,579	$ 590,011	18.7%	18.7%
Prime rate at year end	4.75%	9.50%	8.50%	(475) bp	100 bp
Average prime rate	6.93%	9.24%	8.44%	(231) bp	80 bp

bp = basis point = 1/100th of a percent

Prime rate is included above to provide a general indication of the interest rate environment in which the Bank operates. The Bank's variable rate loans are indexed to the Bank's prime rate and reprice as the prime rate changes, unless they reach a contractual floor or ceiling. A significant amount of the Bank's variable rate loans reached their floor during the year.

Asset/Liability Management and Interest Rate Risk

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

Interest Rate Simulation Sensitivity Analysis

Bancorp uses an earnings simulation model to measure and evaluate the impact of changing interest rates on earnings. The simulation model is designed to reflect the dynamics of all interest earning assets, interest bearing liabilities and off-balance sheet financial instruments, combining factors affecting rate sensitivity into a one year forecast. By forecasting management's estimate of the most likely rate environment and adjusting those rates up and down the model can reveal approximate interest rate risk exposure. The December 31, 2001 simulation analysis indicates that an increase in

interest rates would have a positive effect on net interest income, and a decrease in interest rates would have a negative effect on net interest income. These estimates are summarized below.

	Net Interest Income Change	Net Income Change
Increase 200 bp	3.87%	6.80%
Increase 100 bp	2.84	4.73
Decrease 100 bp	(3.78)	(6.60)
Decrease 200 bp	(6.13)	(10.72)

To assist in achieving a desired level of interest rate sensitivity, management has in the past entered into derivative financial instruments that are designed to mitigate the effect of changes in interest rates. Derivative financial instruments can be a cost and capital efficient method of modifying interest rate risk sensitivity. The Bank had no derivative financial instruments at December 31, 2001.

The following table presents the increases in net interest income due to changes in rate and volume computed on a tax equivalent basis and indicates how net interest income in 2001 and 2000 was impacted by volume increases and the lower average interest rate environment. The tax equivalent adjustments are based on a 35% tax rate. The change in interest due to both rate and volume has been allocated to the change due to rate and change due to volume in proportion to the relationship of the absolute dollar amounts of the change in each.

Taxable Equivalent Rate/Volume Analysis

	2001/2000			2000/1999		
		Increase (Decrease) Due to			Increase (Decrease) Due to	
	Net Change	Rate	Volume	Net Change	Rate	Volume
	(In Thousands)					
Interest income						
Loans	$ 4,573	$ (4,698)	$ 9,271	$ 12,429	$ 1,570	$ 10,859
Federal funds sold	193	(214)	407	(340)	208	(548)
Mortgage loans held for sale	193	(30)	223	(184)	48	(232)
Securities						

	2001/2000			2000/1999		
Taxable	210	(13)	223	(234)	(252)	18
Tax-exempt	269	(238)	507	270	206	64
Total interest income	5,438	(5,193)	10,631	11,941	1,780	10,161
Interest expense						
Deposits						
Interest bearing demand deposits	(242)	(1,288)	1,046	906	376	530
Savings deposits	(303)	(349)	46	(47)	(39)	(8)
Money market deposits	(332)	(745)	413	549	282	267
Time deposits	2,283	(529)	2,812	5,839	2,322	3,517
Securities sold under agreements to repurchase and federal funds purchased	(868)	(997)	129	844	468	376
Other short-term borowings	(84)	(81)	(3)	69	40	29
Long-term debt	1,038	16	1,022	19	19	
Total interest expense	1,492	(3,973)	5,465	8,179	3,468	4,711
Net interest income	$ 3,946	$ (1,220)	$ 5,166	$ 3,762	$ (1,688)	$ 5,450

Provision for Loan Losses

In determining the provision for loan losses charged to expense, management considers many factors. Among these are the quality of the loan portfolio, previous loss experience, the size and composition of the loan portfolio and an assessment of the impact of current economic conditions on borrowers' ability to pay. The provision for loan losses is summarized below:

	2001	2000	1999
	(Dollars In Thousands)		
Provision for loan losses	$ 4,220	$ 2,840	$ 1,635
Allowance to loans at year end	1.41%	1.40%	1.34%
Allowance to average loans for year	1.52%	1.52%	1.49%

The provision for loan losses increased during the year due to significant loan growth and in consideration of loans charged off and the increase in non-performing loans during the year. See "Nonperforming Loans and Assets" for further discussion of non-performing loans. See "Summary of Loan Loss Experience" for further discussion of loans charged off during the year.

The Bank's loan portfolio is diversified with no significant concentrations of credit. Geographically, most loans are extended to borrowers in the Louisville, Kentucky metropolitan area. The adequacy of the allowance is monitored on an ongoing basis and it is the opinion of management that the balance of the allowance for loan losses at December 31, 2001 is adequate to absorb losses inherent in the loan portfolio as of the financial statement date. See "Financial Condition-Allowance for Loan Losses" for more information on the allowance for loan losses.

Non-Interest Income and Non-Interest Expenses

The following table provides a comparison of the components of non-interest income and expenses for 2001, 2000 and 1999. The table shows the dollar and percentage change from 2000 to 2001 and from 1999 to 2000. Below the table is a discussion of significant changes and trends.

	2001	2000	1999	2001/2000 Change	2001/2000 %	2000/1999 Change	2000/1999 %
	(Dollars In Thousands)						
Non-Interest income							
Investment management and trust services	$ 7,256	$ 6,327	$ 5,194	$ 929	14.7%	$ 1,133	21.8%
Service charges on deposit accounts	7,000	5,528	3,484	1,472	26.6%	2,044	58.7%
Gains on sales of mortgage loans held for sale	1,995	1,043	1,511	952	91.3%	(468)	(31.0)%
Gains on sales of securities available for sale			100			(100)	(100.0)%
Other	3,012	2,517	2,331	495	19.7%	186	8.0%
	$ 19,263	$ 15,415	$ 12,620	$ 3,848	25.0%	$ 2,795	22.1%
Non-interest expenses							
Salaries and employee benefits	17,644	15,559	13,750	2,085	13.4%	1,809	13.2%
Net occupancy expense	1,861	1,800	1,711	61	3.4%	89	5.2%
Furniture and equipment expense	2,523	2,309	2,282	214	9.3%	27	1.2%
Other	8,278	7,036	6,388	1,242	17.7%	648	10.1%
	$ 30,306	$ 26,704	$ 24,131	$ 3,602	13.5%	$ 2,573	10.7%

The largest component of non-interest income is the income from investment management and trust services. This area of the Bank continues to grow through attraction of new business and customer retention. At December 31, 2001 assets under management totaled $1.179 billion compared to

$1.056 billion at December 31, 2000 and $914 million as of December 31, 1999. Included in these totals are the assets of the Bank's investment portfolio. These amounts were $90 million at year end 2001, $77 million at year end 2000 and $76 million at year end 1999. Growth in the department's assets include both personal and employee benefit accounts.

Growth in service charges on deposit accounts is primarily due to increased account volumes and an overdraft service for retail customers. Opening new branch offices and promotion of retail accounts have presented opportunities for growth in deposit accounts and increased fee income. The Bank also introduced a new retail deposit account product line during 2001 that has been successful at attracting new accounts. Additionally, in March 2000 the Bank began offering an overdraft service to retail depositors. The service allows checking customers meeting specific criteria to incur overdrafts up to a predetermined limit, generally $500. For each check paid resulting in our increasing an overdraft, the customer pays the standard overdraft charge.

The Bank operates a mortgage banking company as a division of the Bank. This division originates residential mortgage loans and sells the loans in the secondary market. The division offers conventional, VA and FHA financing, as well as a program for low-income first time home buyers. Loans are made for both purchase and refinancing of homes. Virtually all loans originated by the mortgage banking company are sold in the secondary market with servicing rights released. The interest rates on the loans sold are locked with the buyer and Bancorp bears no interest rate risk related to these loans. Interest rates on conventional mortgage loans directly impact the volume of business transacted by the mortgage banking division. Favorable rates in early 1999 stimulated home buying and refinancing, however, beginning in the second quarter of 1999 and continuing through 2000, rising rates resulted in lower levels of activity, particularly refinancing. Mortgage rates again became favorable during the second half of 2001 and the fourth quarter of 2001 saw record volumes of activity.

Other non-interest income has increased for several reasons and primarily reflects the Bank's growth. Contributing factors to the increase for 2001 include the continued growth of income related to debit cards and internet banking. Also contributing were income items related to the increase in mortgage banking activity such as application fees and title fees.

Salaries and benefits are the largest component of non-interest expenses. Increases in personnel expense rose in part from regular salary increases. Officer increases are effective January 1 and non-officer increases are effective on each individual's anniversary date. Also, the Bank continues to add employees to support growth. At December 31, 2001, the Bank had 347 full-time equivalent employees compared to 327 at the same date in 2000 and 316 for 1999. There are no significant obligations for post-retirement or post-employment benefits.

Net occupancy expenses have increased as the Bank has added banking centers. During 2001 and 1999, the Bank opened two locations; during 2000 the Bank opened one. At December 31, 2001 the Bank had seventeen banking center locations including the main office. Furniture and equipment expenses also have increased with the addition of banking centers. Further, the Bank continues to update computer equipment and software as technology advances. Costs of capital asset additions flow through the statement of income, over the lives of the assets, in the form of depreciation expense.

Other non-interest expenses have increased from numerous factors and reflect the Bank's growth. Among the most significant costs that increased were marketing, advertising, mail and telephone. The increase in marketing and advertising reflects the introduction of a new product line of retail checking products during the year.

Income Taxes

A three year comparison of income tax expense and effective tax rate follows:

	2001	2000	1999
	(Dollars In Thousands)		
Income tax expense	$ 6,140	$ 5,433	$ 4,618
Effective tax rate	31.2%	31.9%	32.2%

Financial Condition

Earning Assets and Interest Bearing Liabilities

Summary information with regard to Bancorp's financial condition follows:

				2001/2000		2000/1999	
	2001	2000	1999	Change	%	Change	%
	(Dollars In Thousands)						
Average earning assets	$ 831,918	$ 700,579	$ 590,011	$ 131,339	18.7%	$ 110,568	18.7%
Average interest bearing liabilities	704,196	589,219	493,866	114,977	19.5%	95,353	19.3%
Average total assets	884,483	747,816	637,276	136,667	18.3%	110,540	17.3%
Total year end assets	937,293	852,260	689,815	85,033	10.0%	162,445	23.5%

The Bank has experienced significant growth in earning assets over the last several years. Growth of average earning assets occurred primarily in the area of loans. Loan demand continued to be strong during 2001. From year end 2000 to year end 2001, commercial and industrial loans increased 10.9%. Construction and development loans increased 8.7%. Real estate mortgage loans increased 21.3%. Consumer loans increased 7.6%. Securities also grew during 2001 in conjunction with the overall growth in the asset size of Bancorp.

The increase in average interest bearing liabilities from 2000 to 2001 occurred primarily in interest bearing demand deposits, time deposits and federal funds purchased. The increase in interest bearing demand deposits during the year was primarily a function of the poor performance of the stock market and lower interest rates. As the stock market continued to perform poorly during 2001, many investors moved their funds into deposit accounts. Because of lower interest rates, depositors tended to favor demand and money market deposits versus time deposits. The increase in federal funds purchased was due to the Bank's net funding position. Federal funds purchased are discussed further under the heading "Liquidity". Bancorp also issued $20 million of trust preferred securities during 2001. The net proceeds of $18.9 million were used to pay off

existing long-term debt and to fund the continued growth of Bancorp. See Note 9 and Note 10 to the consolidated financial statements for more details on long-term debt and trust preferred securities, respectively.

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Average Balances and Interest Rates Taxable Equivalent Basis

	Year 2001			Year 2000			Year 1999		
	Average Balances	Interest	Average Rate	Average Balances	Interest	Average Rate	Average Balances	Interest	Average Rate
	(Dollars In Thousands)								
Earning assets									
Federal funds sold	$ 14,384	$ 634	4.41%	$ 6,242	$ 441	7.07%	$ 14,795	$ 781	5.28%
Mortgage loans held for sale	5,375	376	7.00%	2,235	183	8.19%	5,141	368	7.16%
Securities									
Taxable	64,125	3,616	5.64%	57,434	3,406	5.93%	59,860	3,640	6.08%
Tax-exempt	26,458	1,729	6.53%	21,778	1,459	6.70%	18,114	1,197	6.61%
Loans, net of unearned income	721,576	59,918	8.30%	612,890	55,345	9.03%	492,101	42,907	8.72%
Total earning assets	831,918	66,273	7.97%	700,579	60,834	8.68%	590,011	48,893	8.29%
Less allowance for loan losses	10,356			8,613			7,172		
	821,562			691,966			582,839		
Non-earning assets									
Cash and due from banks	29,251			25,672			23,996		
Premises and equipment	18,428			16,729			16,454		
Accrued interest receivable and other assets	15,242			13,449			13,987		
Total assets	$ 884,483			$ 747,816			$ 637,276		
Interest bearing liabilities									
Deposits									
Interest bearing demand deposits	$ 164,589	$ 3,886	2.36%	$ 127,056	$ 4,128	3.25%	$ 110,049	$ 3,222	2.93%
Savings deposits	30,016	390	1.30%	28,053	693	2.47%	28,345	740	2.61%
Money market deposits	66,020	1,696	2.57%	53,423	2,027	3.79%	45,789	1,478	3.23%
Time deposits	377,630	21,815	5.78%	329,152	19,533	5.93%	266,544	13,694	5.14%
Securities sold under agreements to repurchase and federal funds purchased	49,610	1,668	3.36%	47,088	2,536	5.39%	39,231	1,692	4.31%
Other short-term borrowings	2,305	67	2.91%	2,347	151	6.43%	1,808	82	4.54%
Long-term debt	14,026	1,203	8.58%	2,100	165	7.86%	2,100	146	6.95%
Total interest bearing liabilities	704,196	30,725	4.36%	589,219	29,233	4.96%	493,866	21,054	4.26%
Non-interest bearing liabilities									
Non-interest bearing demand deposits	101,542			92,250			87,609		
Accrued interest payable and other liabilities	12,312			11,691			7,749		

	Year 2001			Year 2000			Year 1999		
Total liabilities	818,050			693,160			589,224		
Stockholders' equity	66,433			54,656			48,052		
Total liabilities and stockholders' equity	$ 884,483			$ 747,816			$ 637,276		
Net interest income		$ 35,548			$ 31,601			$ 27,839	
Net interest spread			3.61%			3.72%			4.03%
Net interest margin			4.27%			4.51%			4.72%

Notes

Yields on municipal securities have been computed on a fully tax equivalent basis using the federal income tax rate of 35%.

Average balances for loans include the principal balance of non-accrual loans.

Loan interest income includes loan fees and is computed on a fully tax equivalent basis using the federal income tax rate of 35%.

Loan fees included in interest income amounted to $1,376,000, $989,000 and $939,000 in 2001, 2000 and 1999, respectively.

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Securities

The primary purpose of the securities portfolio is to provide another source of interest income, as well as liquidity management. In managing the composition of the balance sheet, Bancorp seeks a balance among earnings sources and credit and liquidity considerations.

The carrying value of securities is summarized as follows:

	December 31		
	2001	**2000**	**1999**
		(In Thousands)	
Securities available for sale			
U.S. Treasury and federal agency obligations	$ 51,696	$ 51,553	$ 50,115
Mortgage-backed securities	4,382	996	1,128
Obligations of states and political subdivisions	18,266	15,210	9,662
Other	2,540	2,175	1,928
	$ 76,884	$ 69,934	$ 62,833

	December 31		
Securities held to maturity			
U.S. Treasury and federal agency obligations	$	$	$ 1,000
Mortgage-backed securities	5,720	7,369	8,486
Obligations of states and political subdivisions	8,158	9,520	11,912
	$ 13,878	$ 16,889	$ 21,398

The maturity distribution and weighted average interest rates of debt securities at December 31, 2001, are as follows:

	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(Dollars In Thousands)							
Securities available for sale								
U.S. Treasury and federal agencies	$ 4,096	6.75%	40,002	5.39%	6,545	5.67%	1,053	8.00%
Mortgage-backed securities					802	6.50%	3,580	6.50%
Obligations of states and political subdivisions			3,603	4.42%	5,542	4.77%	9,121	5.14%
	$ 4,096	6.75%	43,605	5.31%	12,889	5.34%	13,754	5.71%
Securities held to maturity								
Mortgage-backed securities	$		305	7.00%	904	6.00%	4,511	6.49%
Obligations of states and political subdivisions	2,556	4.88%	2,569	4.44%	3,033	4.58%		
	$ 2,556	4.88%	2,874	4.71%	3,937	4.91%	4,511	6.49%

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Loan Portfolio

Bancorp's primary source of income is interest on loans. The composition of loans as of the end of the last five years follows:

	December 31				
	2001	2000	1999	1998	1997
	(In Thousands)				
Commercial and industrial	$ 152,049	$ 137,086	$ 116,248	$ 103,345	$ 101,030
Construction and development	55,943	51,479	34,760	30,155	21,481
Real estate mortgage	506,081	417,170	349,164	277,994	217,830
Consumer	63,368	58,899	46,686	36,792	29,952
	$ 777,441	$ 664,634	$ 546,858	$ 448,286	$ 370,293

The following tables show the amounts of commercial and industrial loans, and construction and development loans at December 31, 2001 which, based on remaining scheduled repayments of principal, are due in the periods indicated. Also shown are the amounts due after one year classified according to sensitivity to changes in interest rates.

	Maturing			
	Within One Year	After One But Within Five Years	After Five Years	Total
	(In Thousands)			
Commercial and industrial	$ 59,876	$ 62,462	$ 29,711	$ 152,049
Construction and development	55,943			55,943

	Interest Sensitivity	
	Fixed Rate	Variable Rate
	(In Thousands)	
Due after one but within five years	$ 51,044	$ 11,418
Due after five years	8,908	20,803
	$ 59,952	$ 32,221

Nonperforming Loans and Assets

Information summarizing nonperforming assets, including nonaccrual loans follows:

	December 31				
	2001	2000	1999	1998	1997
	(Dollars In Thousands)				
Nonaccrual loans	$ 3,775	$ 602	$ 2,770	$ 2,163	$ 290
Loans past due 90 days or more and still accruing	1,346	2,342	1,645	197	682
Nonperforming loans	$ 5,121	$ 2,944	$ 4,415	$ 2,360	$ 972
Foreclosed real estate	63	833		1,836	
Other foreclosed property			85	58	
Nonperforming assets	$ 5,184	$ 3,777	$ 4,500	$ 4,254	$ 972
Nonperforming loans as a percentage of total loans	0.66%	0.44%	0.81%	0.53%	0.26%
Nonperforming assets as a percentage of total assets	0.55%	0.44%	0.65%	0.70%	0.20%

The increase in non-performing loans is primarily related to a few larger customers. Management believes these loans are well secured and expects little to no loss for Bancorp.

The threshold at which loans are generally transferred to nonaccrual of interest status is 90 days past due unless they are well secured and in the process of collection. Interest income recorded on nonaccrual loans for 2001 totaled $157,000. Interest income that would have been

recorded in 2001 if nonaccrual loans were on a current basis in accordance with their original terms was $512,000.

In addition to the nonperforming loans discussed above, there were loans for which payments were current or less than 90 days past due where borrowers are experiencing significant financial difficulties. At December 31, 2001, these loans totaled approximately $1,353,000. These loans are monitored by management and considered in determining the level of the allowance for loan losses. Management believes these loans do not present significant exposure to loss. The allowance for loan losses is discussed further under the heading "Provision for Loan Losses".

Allowance for Loan Losses

An allowance for loan losses has been established to provide for loans that may not be fully repaid. Loan losses arise primarily from the loan portfolio, but may also be generated from other sources such as commitments to extend credit, guarantees and standby letters of credit. The allowance for loan losses is increased by provisions charged to expense and decreased by charge-offs, net of recoveries. Loans are charged off by management when deemed uncollectible; however, collection efforts continue and future recoveries may occur.

The allowance is maintained at a level considered by management to be adequate to cover losses that are inherent in the loan portfolio. Factors considered include past loss experience, general economic conditions and information about specific borrower situations including financial position and collateral values. Estimating inherent loss on any loan is subjective and ultimate losses may vary from current estimates. Estimates are reviewed periodically and adjustments are reported in income through the provision for loan losses in the periods in which they become known. The adequacy of the allowance for loan losses is monitored by the internal loan review staff and reported quarterly to the Audit Committee of the Board of Directors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the adequacy of Bancorp's allowance for loan losses. Such agencies may require Bancorp to make additional provisions to the allowance based upon their judgments about information available to them at the time of their examinations. Management believes that the allowance for loan losses is adequate to absorb inherent losses on existing loans that may become uncollectible. See "Provision for Loan Losses" for further discussion of the allowance for loan losses.

Summary of Loan Loss Experience

The following table summarizes average loans outstanding, changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category and additions to the allowance charged to expense.

	Years Ended December 31				
	2001	2000	1999	1998	1997
	(Dollars In Thousands)				
Average loans	$ 721,576	$ 612,890	$ 492,101	$ 412,935	$ 329,162
Balance of allowance for loan losses at beginning of year	$ 9,331	$ 7,336	$ 6,666	$ 5,921	$ 5,155
Loans charged off					