

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

right to service mortgage loans is recognized as a separate asset and amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing cost). Mortgage servicing rights are periodically evaluated for impairment based on fair values.

Loan Fees

Loan origination and commitment fees, net of associated direct costs, are deferred and the net amount is amortized as an adjustment to the related loan yield on the interest method, generally over the contractual life of the related loans or commitments.

Other Real Estate Owned

Real estate, other than bank premises, is recorded at the lower of cost or fair value less selling costs at the time of acquisition. Expenses related to holding the property, net of rental income, are generally charged against earnings in the current period.

Allowance for Credit Losses

The Corporation maintains an allowance for credit losses at a level deemed sufficient to absorb losses which are inherent in the loan and lease portfolios at each balance sheet date. Management and the Corporation's Board of Directors review the adequacy of the allowance on a quarterly basis to ensure that the provision for credit losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management's assessment of probable estimated losses. The Corporation's methodology for assessing the appropriateness of the allowance for credit losses consists of several key elements. These elements include a specific allowance for primary watch list classified loans, a formula allowance based on historical trends, an additional allowance for special circumstances and an unallocated allowance. The Corporation consistently applies the following comprehensive methodology and procedure at the subsidiary bank level.

The allowance for primary watch list classified loans addresses those loans maintained on the Corporation's primary watch list which are assigned a rating of substandard, doubtful, or loss. Substandard loans are those with a well-defined weakness or a weakness which jeopardizes the repayment of the debt. A loan may be classified as substandard as a result of impairment of the borrower's financial condition and repayment capacity. Loans for which repayment plans have not been met or collateral equity margins do not protect the Corporation may also be classified as substandard. Doubtful loans have the characteristics of substandard loans with the added characteristic that collection or liquidation in full, on the basis of presently existing facts and conditions, is highly improbable. Although the possibility of loss is extremely

high for doubtful loans, the classification of loss is deferred until pending factors, which might improve the loan, have been determined. Loans rated as doubtful in whole or in part are placed in nonaccrual status. Loans which are classified as loss are considered uncollectible and are charged to the allowance for credit losses at the next meeting of the Corporation's Credit Committee after placement in this category. There were no loans classified as loss on the primary watch list as of December 31, 2002.

Loans on the primary watch list may also be impaired loans, which are defined as nonaccrual loans or troubled debt restructurings. Each of the classified loans on the primary watch list are individually analyzed to determine the level of the potential loss in the credit under the current circumstances. The specific reserve established for these criticized and impaired loans is based on careful analysis of the loan's performance, the related collateral value, cash flow considerations and the financial capability of any guarantor. The allowance for primary watch list classified loans is equal to the total amount of potential unconfirmed losses for the individual classified loans on the watch list. Primary watch list loans are managed and monitored by assigned account officers within the Corporation in conjunction with senior management.

The allowance based on historical trends uses charge-off experience of the Corporation to estimate potential unconfirmed losses in the balances of the loan and lease portfolios. The historical loss experience percentage is based on the charge-off history for the greater of the eight most recent quarters or the twenty most recent quarters. Historical loss experience percentages are applied to non-classified loans from the primary watch list as well as all other loans and leases which are not on the watch list to obtain the portion of the allowance for credit losses which is based on historical trends. Before applying the historical loss experience percentages, loan balances are reduced by the portion of the loan balances which are subject to guarantee by a government agency. Loan balances are also adjusted for unearned discount on installment loans.

The additional allowance for special circumstances provides management with the opportunity to estimate additional potential allowance amounts which may be needed to cover specific factors. The specific factors that management currently evaluates consist of portfolio risk or concentrations of credit, off balance sheet risk, economic conditions and management or staff considerations. Portfolio risks include unusual changes or recent trends in specific portfolios such as unexpected changes in the trends or levels of delinquency, unusual repossession activities or large levels of unsecured loans in a portfolio.

The Corporation also maintains an unallocated allowance. The unallocated allowance is used to cover any factors or