PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
July 31, 2013
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(mark one)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2013
or
o 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	62-1812853
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

150 Third Avenue South, Suite 900, Nashville, Tennessee	37201
(Address of principal executive offices)	(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 x No o

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 x No o

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 o	Accelerated Filer x
Non-accelerated Filer o (do not check if you are a smaller reporting company)	Smaller reporting companyo

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

As of July 30, 2013 there were 35,105,822 shares of common stock, $1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
June 30, 2013

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FORWARD-LOOKING STATEMENTS

Certain of the statements in this report 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 in the Nashville-Davidson-Murfreesboro-Franklin MSA and the Knoxville MSA; (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; (ix) the results of regulatory examinations; (x) the ability to retain large, uninsured deposits with the expiration of the FDIC's transaction account guarantee program; (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) the ability to attract additional financial advisors or 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 recently adopted changes to capital calculation methodologies and required capital maintenance levels; and, (xvii) 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 22, 2013, Pinnacle Financial's most recent quarterly report on Form 10-Q filed with the Securities and Exchange Commission on May 3, 2013, and in Part II, Item 1A. Risk Factors below. 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 release, whether as a result of new information, future events or otherwise.

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Item 1. Part I. Financial Information

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

	June 30, 2013	December 31, 2012
ASSETS		
Cash and noninterest-bearing due from banks	$70,623,888	$51,946,542
Interest-bearing due from banks	162,365,672	111,535,083
Federal funds sold and other	8,181,484	1,807,044
Cash and cash equivalents	241,171,044	165,288,669
Securities available-for-sale, at fair value	687,832,401	706,577,806
Securities held-to-maturity (fair value of $39,010,480 and $583,212 at June 30, 2013 and December 31, 2012, respectively)	40,056,711	574,863
Mortgage loans held-for-sale	27,962,675	41,194,639
Loans	3,925,364,586	3,712,162,430
Less allowance for loan losses	(68,694,868)	(69,417,437)
Loans, net	3,856,669,718	3,642,744,993
Premises and equipment, net	75,840,853	75,804,895
Other investments	30,371,218	26,962,890
Accrued interest receivable	15,654,018	14,856,615
Goodwill	243,900,240	244,040,421
Core deposits and other intangible assets	4,334,100	5,103,273
Other real estate owned	15,991,835	18,580,097
Other assets	133,383,112	98,819,455
Total assets	$5,373,167,925	$5,040,548,616
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	$1,098,887,282	$985,689,460
Interest-bearing	817,562,583	760,786,247
Savings and money market accounts	1,607,689,457	1,662,256,403
Time	572,438,682	606,455,873
Total deposits	4,096,578,004	4,015,187,983
Securities sold under agreements to repurchase	117,345,727	114,667,475
Federal Home Loan Bank advances	325,762,333	75,850,390
Subordinated debt and other borrowings	99,908,292	106,158,292
Accrued interest payable	1,037,150	1,360,598
Other liabilities	35,967,600	48,252,519
Total liabilities	4,676,599,106	4,361,477,257
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;		

35,073,763 and 34,696,597 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	35,073,763	34,696,597
Additional paid-in capital	545,963,974	543,760,439
Retained earnings	115,145,346	87,386,689
Accumulated other comprehensive income, net of taxes	385,736	13,227,634
Total stockholders' equity	696,568,819	679,071,359
Total liabilities and stockholders' equity	$5,373,167,925	$5,040,548,616

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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest income:				
Loans, including fees	$42,149,149	$39,288,048	$83,663,362	$77,925,767
Securities:				
Taxable	3,650,766	4,453,956	7,321,700	9,383,240
Tax-exempt	1,483,965	1,647,852	3,140,373	3,350,998
Federal funds sold and other	260,440	563,638	575,212	1,117,577
Total interest income	47,544,320	45,953,494	94,700,647	91,777,582
Interest expense:				
Deposits	2,955,985	4,298,849	6,368,381	9,126,325
Securities sold under agreements to repurchase	70,823	115,450	148,639	271,026
Federal Home Loan Bank advances and other borrowings	918,762	1,354,132	1,826,403	2,691,163
Total interest expense	3,945,570	5,768,431	8,343,423	12,088,514
Net interest income	43,598,750	40,185,063	86,357,224	79,689,068
Provision for loan losses	2,774,048	634,072	4,946,452	1,668,317
Net interest income after provision for loan losses	40,824,702	39,550,991	81,410,772	78,020,751
Noninterest income:				
Service charges on deposit accounts	2,540,866	2,439,376	5,021,110	4,763,338
Investment services	1,895,398	1,610,883	3,688,038	3,257,661
Insurance sales commissions	1,107,696	1,141,163	2,501,000	2,428,723
Gain on mortgage loans sold, net	1,948,531	1,456,783	3,803,942	2,951,255
(Loss) gain on sale of investment securities, net	(25,241)	98,917	(25,241)	212,517
Trust fees	880,204	770,239	1,824,536	1,565,674
Other noninterest income	2,978,266	2,392,485	6,414,691	4,680,016
Total noninterest income	11,325,720	9,909,846	23,228,076	19,859,184
Noninterest expense:				
Salaries and employee benefits	20,570,753	19,237,178	40,143,109	39,029,744
Equipment and occupancy	5,204,159	5,053,111	10,317,209	10,061,766
Other real estate expense	1,390,606	3,104,276	2,111,568	7,780,340
Marketing and other business development	987,171	739,774	1,777,842	1,525,099
Postage and supplies	517,667	615,725	1,109,155	1,179,019
Amortization of intangibles	248,186	686,067	769,173	1,372,134
Other noninterest expense	1,943,190	4,479,403	7,073,683	8,787,138
Total noninterest expense	30,861,732	33,915,534	63,301,739	69,735,240
Income before income taxes	21,288,690	15,545,303	41,337,109	28,144,695
Income tax expense	6,978,160	5,105,659	13,578,452	9,340,097
Net income	14,310,530	10,439,644	27,758,657	18,804,598
Preferred stock dividends	-	760,349	-	1,660,868
Accretion on preferred stock discount	-	1,894,525	-	2,153,172
Net income available to common stockholders	$14,310,530	$7,784,770	$27,758,657	$14,990,558

Per share information:				
Basic net income per common share available to common stockholders	$0.42	$0.23	$0.81	$0.44
Diluted net income per common share available to common stockholders	$0.42	$0.23	$0.81	$0.44
Weighted average shares outstanding:				
Basic	34,172,274	33,885,779	34,080,281	33,848,825
Diluted	34,431,054	34,470,794	34,319,796	34,447,526

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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income	$14,310,530	$7,784,770	$27,758,657	$14,990,558
Other comprehensive income, net of tax:				
Change in fair value on available-for-sale securities, net of tax	(13,933,693)	1,066,735	(16,204,604)	288,357
Increase in fair value of cash flow hedges, net of income tax	3,347,367	-	3,347,367	-
Net gain (loss) on sale of investment securities reclassified from other comprehensive income into net income, net of tax	15,339	(60,112)	15,339	(129,147)
Total comprehensive income	$3,739,543	$8,791,393	$14,916,759	$15,149,768

See accompanying notes to consolidated financial statements (unaudited).

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

	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Common Stock Warrants	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comp. Income, net	Tota Stoc Equ
Balances, December 31, 2011	$69,096,828	34,354,960	$34,354,960	$3,348,402	$536,227,537	$49,783,584	$17,333,257	$71
Exercise of employee common stock options and related tax benefits	-	213,760	213,760	-	1,150,474	-	-	1,3
Repurchase of preferred stock	(71,250,000)	-	-	-	-	-	-	(71
Issuance of restricted common shares, net of forfeitures	-	94,110	94,110	-	(94,110)	-	-	-
Issuance of salary stock units	-	57,508	57,508	-	942,565	-	-	1,0
Restricted shares withheld for taxes	-	(44,425)	(44,425)	-	(686,321)	-	-	(73
Compensation expense for restricted shares	-	-	-	-	1,671,568	-	-	1,6
Compensation expense for stock options	-	-	-	-	250,653	-	-	25
Accretion on preferred stock discount	2,153,172	-	-	-	-	(2,153,172)	-	-
Preferred dividends paid	-	-	-	-	-	(2,127,605)	-	(2,
Net income	-	-	-	-	-	18,804,598	-	18
Other comprehensive income	-	-	-	-	-	-	159,212	15
Balances, June 30, 2012	$-	34,675,913	$34,675,913	$3,348,402	$539,462,366	$64,307,405	$17,492,469	$65

Balances, December 31, 2012	$-	34,696,597	$34,696,597	$-	$543,760,439	$87,386,689	$13,227,634	$67
Exercise of employee common stock options and related tax benefits	-	123,239	123,239	-	1,282,323	-	-	1,4
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)	-	-	(82
Compensation expense for restricted shares	-	-	-	-	1,983,339	-	-	1,9
Compensation expense for stock options	-	-	-	-	12,470	-	-	12
Net income	-	-	-	-	-	27,758,657	-	27
Other comprehensive loss	-	-	-	-	-	-	(12,841,898)	(12
Balances, June 30, 2013	$-	35,073,763	$35,073,763	$-	$545,963,974	$115,145,346	$385,736	$69

See accompanying notes to consolidated financial statements (unaudited).

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

	Six months ended June 30, 2013	2012
Operating activities:		
Net income	$27,758,657	$18,804,598
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization/accretion of premium/discount on securities	2,373,927	3,879,647
Depreciation and amortization	4,622,942	4,923,028
Provision for loan losses	4,946,452	1,668,317
Gain on mortgage loans sold, net	(3,803,942)	(2,951,255)
Loss (gain) on sale of investment securities, net	25,241	(212,517)
Stock-based compensation expense	1,995,809	2,922,294
Deferred tax benefit	67,794	1,664,563
Losses on dispositions of other real estate and other investments	1,877,964	7,222,829
Excess tax benefit from stock compensation	(140,181)	(11,243)
Mortgage loans held for sale:		
Loans originated	(226,714,093)	(222,373,087)
Loans sold	243,750,000	224,388,000
Decrease in other assets	10,576,616	18,852,041
Decrease in other liabilities	(12,608,365)	(2,652,747)
Net cash provided by operating activities	54,728,821	56,124,468
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(128,922,089)	(37,244,793)
Sales	1,213,584	32,632,321
Maturities, prepayments and calls	77,932,668	106,431,284
Activities in securities held-to-maturity:		
Purchases	(2,045,030)	-
Maturities, prepayments and calls	2,325,000	1,575,000
Increase in loans, net	(221,126,597)	(166,516,932)
Purchases of software, premises and equipment	(3,388,292)	(1,940,817)
Purchase of bank owned life insurance	(30,000,000)	-
Increase in other investments	(3,325,587)	(1,149,065)
Net cash used in investing activities	(307,336,343)	(66,213,002)
Financing activities:		
Net increase in deposits	81,390,021	55,480,883
Net increase (decrease) in securities sold under agreements to repurchase	2,678,252	(3,968,857)
Advances from Federal Home Loan Bank:		
Issuances	324,038,282	285,000,000
Payments/maturities	(74,091,731)	(240,035,833)
(Decrease) increase in other borrowings	(6,250,000)	25,000,000
Exercise of common stock options and stock appreciation rights	584,892	633,487
Excess tax benefit from stock compensation	140,181	11,243
Preferred dividends paid	-	(2,127,605)

Repurchase of preferred shares outstanding	-	(71,250,000)
Net cash provided by financing activities	328,489,897	48,743,318
Net increase in cash and cash equivalents	75,882,375	165,288,669
Cash and cash equivalents, beginning of period	165,288,669	172,163,040
Cash and cash equivalents, end of period	$241,171,044	$210,817,824

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 2012 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, 2012. 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, 2012.

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 other comprehensive income for the three and six months ended June 30, 2013, Pinnacle Financial reclassified approximately $15,000 of net losses out of other comprehensive income into gain (loss) on the sale of investment securities, net compared to reclassifications of net gains for the three and six months ended June 30, 2012, of approximately $60,000, and $129,000, respectively, 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, 2013 and 2012 was as follows:

	For the six months ended June 30, 2013	2012
Cash Transactions:		
Interest paid	$8,701,479	$12,717,236
Income taxes paid, net	15,600,009	(1,474,106)
Noncash Transactions:		
Loans charged-off to the allowance for loan losses	11,377,491	8,774,855
Loans foreclosed upon and transferred to other real estate owned	1,780,131	7,103,792
Available-for-sale securities transferred to held-to-maturity portfolio	39,959,647	-

Income Per Common Share — Basic net income per common share available to common stockholders (EPS) is computed by dividing net income available to common stockholders by the weighted average common shares outstanding for the period. For the three and six months ended June 30, 2012, weighted average common shares outstanding also include salary stock units issued to the named executive officers. 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, warrants and restricted shares with time-based vesting criteria. The dilutive effect of outstanding options, common stock appreciation rights, warrants and restricted shares with time-based vesting criteria is reflected in diluted EPS by application of the treasury stock method.

For the three and six months ended June 30, 2013, there were 258,780 and 239,515 shares associated with dilutive stock options, stock appreciation rights and restricted shares with time-based vesting criteria that were included in the net income per share calculation. For the three and six months ended June 30, 2012, there were 585,015 and 598,701 shares associated with dilutive stock options, stock appreciation rights, warrants and time-based restricted shares with time-based vesting criteria outstanding to purchase common shares that were included in the net income per share calculation.

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The following is a summary of the basic and diluted net income per share calculations for the three and six months ended June 30, 2013 and 2012:

	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Basic net income per share calculation:				
Numerator - Net income available to common stockholders	$14,310,530	$7,784,770	$27,758,657	$14,990,558
Denominator - Average common shares outstanding	34,172,274	33,885,779	34,080,281	33,848,825
Basic net income per share available to common stockholders	$0.42	$0.23	$0.81	$0.44
Diluted net income per share calculation:				
Numerator – Net income available to common stockholders	$14,310,530	$7,784,770	$27,758,657	$14,990,558
Denominator - Average common shares outstanding	34,172,274	33,885,779	34,080,281	33,848,825
Dilutive shares contingently issuable	258,780	585,015	239,515	598,701
Average diluted common shares outstanding	34,431,054	34,470,794	34,319,796	34,447,526
Diluted net income per share available to common stockholders	$0.42	$0.23	$0.81	$0.44

Note 2. Participation in U.S. Treasury Capital Purchase Program (CPP)

On December 12, 2008, Pinnacle Financial issued 95,000 shares of preferred stock to the U.S. Treasury (the Treasury) for $95 million pursuant to the CPP. For the time the CPP preferred stock was outstanding, the CPP preferred stock was non-voting, other than having class voting rights on certain matters, and paid cumulative dividends quarterly at a rate of 5% per annum. Pinnacle Financial redeemed the preferred shares issued to the Treasury under the CPP in two transactions. During the fourth quarter of 2011, Pinnacle Financial redeemed 23,750 of the preferred shares in a transaction totaling approximately $23.9 million, including accrued but unpaid dividends of $142,000. During the second quarter of 2012, Pinnacle Financial completed the redemption of the remaining 71,250 preferred shares outstanding in a transaction totaling $71.6 million which included accrued but unpaid dividends of $346,000. Concurrently, Pinnacle Financial accelerated the accretion of the remaining preferred stock discount of approximately $1.7 million during the second quarter of 2012.

Additionally, Pinnacle Financial issued warrants to purchase 534,910 shares of common stock to the Treasury as a condition to its participation in the CPP. The warrants had an exercise price of $26.64 each, were immediately exercisable and expired 10 years from the date of issuance. On June 16, 2009, Pinnacle Financial completed the sale of 8,855,000 shares of its common stock in a public offering, resulting in net proceeds to Pinnacle Financial of approximately $109 million. As a result, and pursuant to the terms of the warrants, the number of shares issuable upon exercise of the warrants was reduced by 50%, or 267,455 shares. During the third quarter of 2012, Pinnacle Financial repurchased all of the remaining outstanding warrants held by the Treasury for $755,000.

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at June 30, 2013 and December 31, 2012 are summarized as follows (in thousands):

	June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$4,998	$ -	$ -	$4,998

U.S. government agency securities	139,602	11	9,999	129,614
Mortgage-backed securities	383,634	9,938	6,299	387,273
State and municipal securities	131,716	6,903	745	137,874
Asset-backed securities	17,426	-	112	17,314
Corporate notes and other	9,631	1,136	8	10,759
	$687,007	$ 17,988	$ 17,163	$687,832
Securities held-to-maturity:				
State and municipal securities	$40,057	$ 4	$ 1,051	$39,010
	$40,057	$ 4	$ 1,051	$39,010

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$-	$ -	$ -	$-
U.S. government agency securities	110,817	49	414	110,452
Mortgage-backed securities	360,504	15,770	623	375,651
State and municipal securities	177,364	14,489	126	191,727
Asset-backed securities	17,361	-	9	17,352
Corporate notes and other	9,881	1,519	4	11,396
	$675,927	$ 31,827	1,176	$706,578
Securities held-to-maturity:				
State and municipal securities	$575	$ 8	$ -	$583
	$575	$ 8	$ -	$583

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At June 30, 2013, approximately $643.6 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.

During the first quarter of 2013, approximately $40.0 million of available-for-sale securities were transferred to the held-to-maturity portfolio. The transfers of debt securities into the held-to-maturity category from the available-for-sale category were made at fair value at the date of transfer. The unrealized holding gain or loss at the date of transfer was retained in other comprehensive income and in the carrying value of the held-to-maturity securities. Such amounts will be amortized to interest income over the remaining life of the securities.

The amortized cost and fair value of debt securities as of June 30, 2013 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):

	June 30, 2013			
	Available-for-sale		Held-to-maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$8,453	$8,471	$736	$735
Due in one year to five years	26,983	27,553	12,414	12,276
Due in five years to ten years	142,827	143,297	16,011	15,553
Due after ten years	107,684	103,924	10,896	10,446
Mortgage-backed securities	383,634	387,273	-	-
Asset-backed securities	17,426	17,314	-	-
	$687,007	$687,832	$40,057	$39,010

At June 30, 2013 and December 31, 2012, the following investments had unrealized losses. The information 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, 2013:						
U.S. Treasury securities	$-	$ -	$ -	$ -	$-	$ -
U.S. government agency securities	132,918	9,999	-	-	132,918	9,999
Mortgage-backed securities	146,214	6,299	-	-	146,214	6,299
State and municipal securities	47,838	1,796	-	-	47,838	1,796
Asset-backed securities	17,314	112	-	-	17,314	112
Corporate notes	807	8	-	-	807	8
Total temporarily-impaired securities	$345,091	$ 18,214	$ -	$ -	$345,091	$ 18,214

At December 31, 2012:

U.S. Treasury securities	$-	$ -	$ -	$ -	$-	$ -
U.S. government agency securities	78,899	414	-	-	78,899	414
Mortgage-backed securities	40,988	623	-	-	40,988	623
State and municipal securities	5,179	126	-	-	5,179	126
Asset-backed securities	17,353	9	-	-	17,353	9
Corporate notes	162	4	-	-	162	4
Total temporarily-impaired securities	$142,581	$ 1,176	$ -	$ -	$142,581	$ 1,176

The applicable dates for determining when securities are in an unrealized loss position are June 30, 2013 and December 31, 2012. 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, 2013 and December 31, 2012, but is in the "Investments with an Unrealized Loss of less than 12 months" category above.

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As shown in the tables above, at June 30, 2013, Pinnacle Financial had approximately $18.2 million in unrealized losses on $345.1 million of securities. Any unrealized losses associated with these investment securities are driven by changes in interest rates and are not due to the credit quality of the securities. 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. Because Pinnacle Financial currently does not intend to sell those securities that have an unrealized loss at June 30, 2013, 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, 2013.

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, 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. Available-for-sale securities of $1.2 million were sold during the quarter ended June 30, 2013.

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.

Note 4. 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, 2013, approximately 76% 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 policy requires that every risk rated loan of $500,000 or more be subject to a formal credit risk review process. Each loan grade is also subject to review by our independent loan review department, which reviews a significant 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, 2013 and December 31, 2012 (in thousands):

June 30, 2013	Commercial real estate - mortgage	Consumer real estate - mortgage	Construction and land development	Commercial and industrial	Consumer and other	Total
Accruing loans						
Pass	$ 1,238,668	$ 671,079	$ 249,392	$ 1,451,678	$ 116,086	$ 3,726,903
Special Mention	14,325	2,711	35,715	22,251	-	75,002
Substandard (1)	29,381	15,108	11,963	26,021	-	82,473
Total	1,282,374	688,898	297,070	1,499,950	116,086	3,884,378
Impaired loans						
Nonaccrual loans						
Substandard-nonaccrual	12,513	4,581	1,320	2,088	59	20,561
Doubtful-nonaccrual	-	-	-	-	-	-
Total nonaccrual loans	12,513	4,581	1,320	2,088	59	20,561
Troubled debt restructurings(2)						
Pass	312	2,762	119	376	262	3,831
Special Mention	-	-	-	-	-	-
Substandard	13,674	1,249	-	1,672	-	16,595
Total troubled debt restructurings	13,986	4,011	119	2,048	262	20,426
Total impaired loans	26,499	8,592	1,439	4,136	321	40,987
Total loans	$ 1,308,873	$ 697,490	$ 298,509	$ 1,504,086	$ 116,407	$ 3,925,365

December 31, 2012	Commercial real estate - mortgage	Consumer real estate - mortgage	Construction and land development	Commercial and industrial	Consumer and other	Total
Accruing loans						
Pass	$ 1,093,628	$ 649,571	$ 259,878	$ 1,390,207	$ 93,712	$ 3,486,996
Special Mention	12,670	4,242	29,472	23,133	-	69,517
Substandard (1)	42,343	13,896	19,622	29,513	-	105,374
Total	1,148,641	667,709	308,972	1,442,853	93,712	3,661,887
Impaired loans						
Nonaccrual loans						
Substandard-nonaccrual	9,290	5,877	4,509	3,035	79	22,790
Doubtful-nonaccrual	1	29	-	3	-	33
Total nonaccrual loans	9,291	5,906	4,509	3,038	79	22,823
Troubled debt restructurings(2)						
Pass	4,705	3,623	71	502	119	9,020
Special Mention	-	-	-	-	-	-
Substandard	15,559	2,688	-	185	-	18,432
Total troubled debt restructurings	20,264	6,311	71	687	119	27,452
Total impaired loans	29,555	12,217	4,580	3,725	198	50,275
Total loans	$ 1,178,196	$ 679,926	$ 313,552	$ 1,446,578	$ 93,910	$ 3,712,162

(1) 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 substandard nonaccrual loans and substandard troubled debt restructurings. Potential problem loans, which are not included in nonaccrual loans, amounted to approximately $82.5 million at June 30, 2013, compared to $105.4 million at December 31, 2012.

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

At June 30, 2013 and December 31, 2012, all loans classified as nonaccrual were deemed to be impaired. The principal balances of these nonaccrual loans amounted to $20.6 million and $22.8 million at June 30, 2013 and December 31, 2012, respectively, and are included in the table above. For the six months ended June 30, 2013, the average balance of nonaccrual loans was $22.3 million as compared to $38.4 million for the twelve months ended December 31, 2012. 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 $573,000, for the six months ended June 30, 2013 and by $618,000, for the six months ended June 30, 2012.

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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, 2013 and December 31, 2012 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, 2013			For the six months ended June 30, 2013	
	Recorded investment	Unpaid principal balance	Related allowance(1)	Average recorded investment	Interest income recognized
Collateral dependent nonaccrual loans:					
Commercial real estate – mortgage	$12,034	$13,267	$ -	$12,592	$ -
Consumer real estate – mortgage	2,419	2,425	-	2,615	-
Construction and land development	978	1,946	-	1,690	-
Commercial and industrial	1,592	1,712	-	1,653	-
Consumer and other	-	-	-	-	-
Total	$17,023	$19,350	$ -	$18,550	$ -
Cash flow dependent nonaccrual loans:					
Commercial real estate – mortgage	$484	$547	$ 157	$486	$ -
Consumer real estate – mortgage	2,160	2,369	699	2,276	-
Construction and land development	340	380	110	341	-
Commercial and industrial	495	856	66	545	-
Consumer and other	59	61	19	60	-
Total	$3,538	$4,213	$ 1,051	$3,708	$ -
Total nonaccrual loans	$20,561	$23,563	$ 1,051	$22,258	$ -

	At December 31, 2012			For the year ended December 31, 2012	
	Recorded investment	Unpaid principal balance	Related allowance(1)	Average recorded investment	Interest income recognized
Collateral dependent nonaccrual loans:					
Commercial real estate – mortgage	$8,740	$11,187	$ -	$11,194	$ -
Consumer real estate – mortgage	3,641	6,394	-	6,394	-
Construction and land development	1,546	2,062	-	2,063	-
Commercial and industrial	1,547	1,761	-	1,896	-
Consumer and other	-	-	-	-	-
Total	$15,474	$21,404	$ -	$21,547	$ -
Cash flow dependent nonaccrual loans:					
Commercial real estate – mortgage	$551	$1,841	$ 154	$3,228	$ -
Consumer real estate – mortgage	2,265	4,473	573	5,828	-
Construction and land development	2,963	4,701	201	5,102	-
Commercial and industrial	1,491	2,459	814	2,528	-
Consumer and other	79	179	22	180	-
Total	$7,349	$13,653	$ 1,764	$16,866	$ -

Total nonaccrual loans	$22,823	$35,057	$ 1,764	$38,413	$ -

(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, 2013 or during the year ended December 31, 2012.

Impaired loans also include loans that Pinnacle Bank has elected to formally restructure when, 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, 2013 and December 31, 2012, there were $20.4 million and $27.5 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, 2013 and 2012 (dollars in thousands):

	Three months ended June 30, 2013			Six months ended June 30, 2013		
	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment, net of related allowance	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded 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

	Three months ended June 30, 2012			Six months ended June 30, 2012		
	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment, net of related allowance	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment, net of related allowance
Commercial real estate – mortgage	9	$ 19,040	$ 16,283	9	$ 19,040	$ 16,283
Consumer real estate – mortgage	14	5,702	4,970	15	6,045	5,258
Construction and land development	2	734	407	2	434	407
Commercial and industrial	12	947	814	13	983	846
Consumer and other	3	124	107	3	124	107
	40	$ 26,547	$ 22,581	42	$ 26,626	$ 22,901

There were no troubled debt restructurings that defaulted during the three month periods ended June 30, 2013 or 2012. During the six months ended June 30, 2013, two consumer real estate loans totaling $1.0 million which were previously classified as troubled debt restructurings subsequently defaulted due to their lack of performance. During the six months ended June 30, 2012, four commercial loans totaling $194,000 and two consumer loans totaling $154,000 which were previously classified as troubled debt restructurings defaulted due to their lack of performance. A default is defined as an occurrence which violates the terms of the receivable's contract.

In addition to the loan metrics above, 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, 2013 with the comparative exposures for December 31, 2012 (in thousands):

	At June 30, 2013			
	Outstanding Principal Balances	Unfunded Commitments	Total exposure	Total Exposure at December 31, 2012
Lessors of nonresidential buildings	$431,666	$ 42,692	$474,358	$ 440,237
Lessors of residential buildings	222,869	23,778	246,647	215,899
Land subdividers	79,644	14,085	93,729	108,283

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The table below presents past due balances at June 30, 2013 and December 31, 2012, by loan classification and segment allocated between accruing and nonaccrual status (in thousands):

June 30, 2013	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
Commercial real estate:						
Owner-occupied	$ 2,882	$ -	$ 2,882	$ 8,232	$ 636,005	$ 647,119
All other	-	-	-	4,281	657,468	661,749
Consumer real estate – mortgage	6,267	747	7,014	4,581	685,897	697,492
Construction and land development	1,817	-	1,817	1,320	295,373	298,510
Commercial and industrial	2,769	-	2,769	2,088	1,499,231	1,504,088
Consumer and other	1,019	-	1,019	59	115,329	116,407
	$ 14,754	$ 747	$ 15,501	$ 20,561	$ 3,889,303	$ 3,925,365

December 31, 2012	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
Commercial real estate:						
Owner-occupied	$ 462	$ -	$ 462	$ 8,091	$ 585,848	$ 594,401
All other	41	-	41	1,200	582,554	583,795
Consumer real estate – mortgage	3,870	-	3,870	5,906	670,150	679,926
Construction and land development	3,511	-	3,511	4,509	305,532	313,552
Commercial and industrial	2,549	-	2,549	3,038	1,440,991	1,446,578
Consumer and other	444	-	444	79	93,387	93,910
	$ 10,877	$ -	$ 10,877	$ 22,823	$ 3,678,462	$ 3,712,162

(1) Approximately $10.6 million and $9.4 million of nonaccrual loans as of June 30, 2013 and December 31, 2012, respectively, are currently performing pursuant to their contractual terms.

The following table shows the allowance allocation by loan classification and accrual status at June 30, 2013 and December 31, 2012 (in thousands):

			Impaired Loans					
	Accruing Loans		Nonaccrual Loans		Troubled Debt Restructurings[1]		Total Allowance for Loan Losses	
	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012
Commercial real estate –mortgage	$ 17,722	$ 16,642	$ 157	$ 154	$ 2,121	$ 2,838	$ 20,000	$ 19,634
Consumer real estate – mortgage	7,419	7,336	699	573	572	853	8,690	8,762
Construction and land development	8,082	8,953	110	201	18	10	8,210	9,164
Commercial and industrial	23,929	23,829	66	814	292	95	24,287	24,738

Consumer and other	1,384	1,055	19	22	39	17	1,442	1,094
Unallocated	-	-	-	-	-	-	6,066	6,025
	$58,536	$ 57,815	$1,051	$ 1,764	$3,042	$ 3,813	$68,695	$ 69,417

(1) Troubled debt restructurings of $20.4 million and $27.5 million as of June 30, 2013 and December 31, 2012, 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, 2011 to December 31, 2012 to June 30, 2013 by loan classification (in thousands):

	Commercial real estate – mortgage	Consumer real estate – mortgage	Construction and land development	Commercial and industrial	Consumer and other	Unallocated	Total
Balances, December 31, 2011	$ 23,397	$ 10,302	$ 12,040	$ 20,789	$ 1,125	$ 6,322	$ 73,975
Charged-off loans	(4,667)	(6,731)	(2,530)	(4,612)	(1,117)	-	(19,657)
Recovery of previously charged-off loans	285	818	1,155	7,175	97	-	9,530
Provision for loan losses	619	4,373	(1,501)	1,386	989	(297)	5,569
Balances, December 31, 2012	$ 19,634	$ 8,762	$ 9,164	$ 24,738	$ 1,094	$ 6,025	$ 69,417
Charged-off loans	(3,260)	(997)	(1,351)	(5,085)	(684)	-	(11,377)
Recovery of previously charged-off loans	129	920	708	3,785	166	-	5,708
Provision for loan losses	3,497	5	(311)	849	866	41	4,947
Balances, June 30, 2013	$ 20,000	$ 8,690	$ 8,210	$ 24,287	$ 1,442	$ 6,066	$ 68,695

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, 2013, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately $5.2 million to current directors, executive officers, and their related entities, of which $4.4 million had been drawn upon. At December 31, 2012, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately $8.8 million to directors, executive officers, and their related entities, of which approximately $8.1 million had been drawn upon. These loans and extensions of credit were made on substantially the same terms customary for other persons similarly situated for the type of loan involved. None of these loans to directors, executive officers, and their related entities were impaired at June 30, 2013 or December 31, 2012.

Residential Lending

At June 30, 2013, Pinnacle Financial had approximately $28.0 million of mortgage loans held-for-sale compared to approximately $41.2 million at December 31, 2012. Pinnacle Financial generally has an agreement for the subsequent sale of the mortgage loan prior to the loan being closed with the borrower. Pinnacle Financial sells loans to third-party investors on a loan-by-loan basis and 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, 2013, Pinnacle Financial recognized $1.9 million in gains on the sale of these loans, net of commissions paid, compared to $1.5 million during the six months ended June 30, 2012.

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 best efforts 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. Generally, loans sold to the HUD/VA are underwritten by Pinnacle Bank while the majority of the loans sold to other investors are underwritten by the purchaser of the loans.

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.

From inception of Pinnacle Bank's mortgage department in January 2003 through June 30, 2013, Pinnacle Bank originated and sold approximately 14,000 mortgage loans totaling $3.1 billion to third-party purchasers. Of the approximately 14,000 mortgage loans, Pinnacle Bank underwrote approximately 3,700 conventional loans at an 80% or less loan-to-value that were sold to other investors and underwrote 3,100 loans that were sold to the HUD/VA. The remaining mortgage loans were underwritten by the purchasers of those loans, but funded by Pinnacle Bank until settlement with the purchaser. To date, repurchase activity pursuant to the terms of these representations and warranties has been insignificant to Pinnacle Bank.

Based on information currently available, management believes that it does not have material exposure to losses that may arise relating to the representations and warranties that it has made in connection with its mortgage loan sales.

Due to the focus on foreclosure practices of financial institutions nationwide, Pinnacle Bank has evaluated its foreclosure process related to home equity and consumer mortgage loans within its loan portfolio. At June 30, 2013, Pinnacle Bank has $762.4 million of home equity and consumer mortgage loans which are secured by first or second liens on residential properties. Foreclosure activity in this portfolio has been minimal. Any foreclosures on these loans are handled by designated Pinnacle Bank personnel and external legal counsel, as appropriate, following established policies regarding legal and regulatory requirements. Pinnacle Bank has not imposed any freezes on foreclosures. Based on information currently available, management believes that it does not have material exposure to faulty foreclosure practices.

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Note 5. Income Taxes

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, 2013, 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, 2013. As of June 30, 2013, Pinnacle Financial has accrued no interest and no penalties related to uncertain tax positions.

Pinnacle Financial and its subsidiaries file consolidated U.S. Federal and state of Tennessee income tax returns. The IRS concluded its examination of the 2007, 2008, and 2009 federal tax returns during 2011. Pinnacle Financial remains open to audit under the statute of limitations by the IRS for the years ended December 31, 2010 through 2012 and by the State of Tennessee from December 31, 2009 through 2012.

Pinnacle Financial's effective tax rate for the three and six months ended June 30, 2013 was 32.8% compared to 32.8% and 33.2%, respectively, for the three and six months ended June 30, 2012. 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, our real estate investment trust and bank-owned life insurance offset in part by meals and entertainment expense and executive compensation expense, portions of which are non-deductible.

Note 6. 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, 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, 2013, these commitments amounted to $1.1 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, 2013, 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, 2013, and December 31, 2012, Pinnacle Financial had accrued $1.1 million and $1.9 million, respectively, for the inherent risks associated with these off balance sheet commitments. At March 31, 2013, the allowance for off-balance sheet exposures totaled $2.9 million, of which $2.0 million was specifically attributable to one standby letter of credit. Subsequent to March 31, 2013, Pinnacle Bank funded the standby letter of credit. Accordingly, the off-balance sheet allowance related to this one standby letter of credit was reduced in the second quarter of 2013. In conjunction with the resolution of this loan during the second quarter of 2013, Pinnacle Financial recorded a charge-off of $3.0 million against the allowance for loan losses related to this relationship.

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 support of his claims, the plaintiff asserts theories of breach of contract, breach of implied covenant of good faith and fair dealing, unjust enrichment or unconscionability. The plaintiff is seeking, among other remedies, an award of unspecified compensatory damages, pre-judgment interest, costs and attorneys' fees. Pinnacle Financial and Pinnacle Bank are vigorously contesting this matter. On January 17, 2012, Pinnacle Financial and Pinnacle Bank filed a motion to dismiss the complaint. The motion to dismiss was granted without prejudice to Pinnacle Financial and denied as to Pinnacle Bank on April 13, 2012, and Pinnacle Bank filed an answer on May 30, 2012. Pinnacle Financial and Pinnacle Bank reached a tentative settlement agreement with the plaintiff during the second quarter of 2013. Although the settlement has not yet been finalized, Pinnacle Financial does not believe that any liability arising from this legal matter will 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, 2013 will not have a material impact on Pinnacle Financial's financial statements.

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Note 7. Stock Options, Stock Appreciation Rights and Restricted Shares

As described more fully in the Annual Report on Form 10-K, Pinnacle Financial has two equity incentive plans. Additionally, Pinnacle Financial has assumed equity plans in connection with acquisitions of Cavalry Bancorp, Inc. (Cavalry) and Mid-America Bancshares, Inc. (Mid-America) under which it has granted stock options and stock appreciation rights to its employees to purchase common stock at or above the fair market value on the date of grant and granted restricted share awards to employees and directors.

At June 30, 2013, there were approximately 543,000 shares available for future issuances under these plans.

Common Stock Options and Stock Appreciation Rights

As of June 30, 2013, there were 1,156,471 stock options and 6,427 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, 2013 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters is as follows:

	Number	Weighted-Average Exercise Price	Weighted-Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value (000's)	
Outstanding at December 31, 2012	1,318,701	$ 23.36	3.14	$ 2,203	(1)
Granted	-				
Exercised	(122,829)				
Stock appreciation rights exercised	(1,066)				
Forfeited	(31,908)				
Outstanding at June 30, 2013	1,162,898	$ 24.64	2.78	$ 3,758	(2)
Outstanding and expected to vest as of June 30, 2013	1,162,898	$ 24.64	2.78	$ 3,758	(2)
Options exercisable at June 30, 2013	1,162,898	$ 24.64	2.78	$ 3,758	(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 $18.84 per common share at December 31, 2012 for the approximately 331,571 options and stock appreciation rights that were in-the-money at December 31, 2012.

(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 $25.71 per common share at June 30, 2013 for the approximately 621,084 options and stock appreciation rights that were in-the-money at June 30, 2013.

During the six months ended June 30, 2013, approximately 33,000 option awards vested at an average exercise price of $21.51 with an intrinsic value of $137,218 at the time of vesting.

During the three and six months ended June 30, 2013, Pinnacle Financial recorded stock option compensation expense of $12,000, based on Black-Scholes valuation at the date of grant compared to $97,000 and $251,000 for the three and six months ended June 30, 2012. For these awards, Pinnacle Financial recognized compensation expense using a straight-line amortization method. As of June 30, 2013, there was no unrecognized compensation cost related to unvested stock options granted under our equity incentive plans.

Restricted Share Awards

Additionally, Pinnacle Financial's 2004 Equity Incentive Plan and the plans assumed in connection with the acquisition of Mid-America provide 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, 2013 under any of these plans. During the six months ended June 30, 2013, Pinnacle Financial awarded 147,015 shares of restricted common stock to certain associates and outside directors and 193,189 restricted stock units converted to restricted share awards for certain associates.

A summary of activity for unvested restricted share awards for the six months ended June 30, 2013 is as follows:

	Number	Grant Date Weighted-Average Cost
Unvested at December 31, 2012	739,909	$ 15.45
Shares awarded	147,015	20.82
Conversion of restricted share units to restricted share awards	193,189	21.51
Restrictions lapsed and shares released to associates/directors	(153,543)	16.45
Shares forfeited[1]	(46,808)	16.05
Unvested at June 30, 2013	879,762	$ 17.55

(1) Represents 18,257 shares forfeited due to failure to meet performance targets and 28,551 shares forfeited due to employee termination and/or retirement.

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Pinnacle Financial grants restricted share awards to associates, executive management and outside directors with a combination of time and 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, 2013:

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)]						
2013	Associates	5	135,725	-	2,625	133,100
Performance Based Awards[(3)]						
2013	Leadership team	5	193,189	-	-	193,189
Outside Director Awards[(4)]						
2013	Outside directors	1	11,290	-	-	11,290

(1) Groups include our employees (referred to as associates above) and our outside directors. When the restricted shares are awarded, a participant receives voting 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 shares to pay the applicable income taxes associated with the award.

(2) These shares vest 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 (or alternatively, the cumulative vesting period).

(4) 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 board member meeting their attendance goals for the various board and board committee meetings to which each member was scheduled to attend.

(5) These shares represent forfeitures resulting from associate terminations during the year-to-date period ended June 30, 2013.

Compensation expense associated with performance-based restricted share awards, which are issued from time-to-time, is recognized over the performance period that the restrictions associated with the awards are anticipated to lapse based on a graded vesting schedule such that each performance tranche is amortized separately. Compensation expense associated with the time-based restricted share awards is recognized on a straight-line basis over the time period that the restrictions associated with the awards lapse based on the total cost of the award at the grant date. For the three and six months ended June 30, 2013, Pinnacle Financial recognized approximately $1,032,000 and $1,983,000, respectively, in compensation costs attributable to all restricted share awards, compared to $814,000 and $1,672,000, respectively, for the three and six months ended June 30, 2012.

Restricted Share Units

Pinnacle Financial granted 128,018 restricted share units to the senior executive officers and the Leadership Team in the first quarter of 2013. These restricted share units will be converted to restricted shares in 2014 on a tiered scale based on actual 2013 results. The number of units that ultimately convert to unvested restricted shares will be determined after the 2013 earnings are finalized based upon the achievement of certain predetermined profitability goals for 2013 that were established on January 11, 2013 by the Human Resources and Compensation Committee of Pinnacle Financial's board of directors (HRCC). The number of restricted shares issuable in settlement of these restricted share units could range between 0% to 100% based on the level of 2013 profitability. Once these restricted share units are converted to restricted share awards, the forfeiture restrictions on the number of restricted shares issued in settlement of these restricted share units will lapse in 20% increments over the following five years based on the achievement of soundness thresholds to be set by the HRCC in January of each respective fiscal year. As the specific value of the award that will ultimately be granted to the recipients of these restricted share units and the associated performance targets cannot yet be determined, no grant was deemed to have been made, and therefore, no expense has been recognized related to these awards.

Note 8. Regulatory Matters

Pursuant to Tennessee banking law, Pinnacle Bank may not, without the prior consent of the TDFI, pay any dividends to Pinnacle Financial in a calendar year in excess of the total of Pinnacle Bank's net income for that year plus the retained net income for the preceding 2 years. During the six months ended June 30, 2013, Pinnacle Bank paid $3.9 million in dividends to Pinnacle Financial. As of June 30, 2013, Pinnacle Bank could pay approximately $85.4 million of additional dividends to Pinnacle Financial without prior TDFI approval. Pinnacle Financial has not paid any cash dividends on its common stock since inception; however, it is possible the Board of Directors may consider a dividend program at some point in the future. Our future dividend policy will depend on our 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.

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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, 2013, 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		Minimum Capital Requirement		Minimum To Be Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At June 30, 2013						
Total capital to risk weighted assets:						
Pinnacle Financial	$586,570	12.9 %	$362,619	8.0 %	$454,568	10.0 %
Pinnacle Bank	$575,109	12.7 %	$361,853	8.0 %	$453,623	10.0 %
Tier I capital to risk weighted assets:						
Pinnacle Financial	$529,749	11.7 %	$181,309	4.0 %	$272,741	6.0 %
Pinnacle Bank	$518,406	11.5 %	$180,927	4.0 %	$272,174	6.0 %
Tier I capital to average assets (*):						
Pinnacle Financial	$529,749	10.7 %	$198,563	4.0 %	$N/A	N/A
Pinnacle Bank	$518,406	10.5 %	$197,945	4.0 %	$247,431	5.0 %

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

As noted above, Pinnacle Bank had 10.5% of Tier 1 capital to average assets and 12.7% of total capital to risk-weighted assets at June 30, 2013.

Note 9. 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. 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 as of June 30, 2013 and December 31, 2012 is included in the following table (in thousands):

	June 30, 2013		December 31, 2012	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate swap agreements:				
Pay fixed / receive variable swaps	$248,892	$11,796	$236,377	$16,132
Pay variable / receive fixed swaps	248,892	(12,077)	236,377	(16,366)
Total	$497,784	$(281)	$472,754	$(234)

During the second quarter of 2013, Pinnacle Financial entered into a forward cash flow hedge relationship to manage our 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 Notional Amount	Variable Interest Rate	Fixed Interest Rate	Term	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income
Interest Rate Swap	$ 33,000	3 month LIBOR	1.428%	April 2015-April 2018	$ 602	$ 366
Interest Rate Swap	33,000	3 month LIBOR	1.857%	October 2015-April 2019	817	496
Interest Rate Swap	33,000	3 month LIBOR	1.996%	October 2015-October 2019	915	556
Interest Rate Swap	33,000	3 month LIBOR	2.265%	April 2016-April 2020	943	573
Interest Rate Swap	33,000	3 month LIBOR	2.646%	April 2016-April 2022	1,283	780
Interest Rate Swap	33,000	3 month LIBOR	2.523%	October 2016-October 2020	948	576

(1) Pinnacle Financial will pay the fixed interest rate and the counterparties pay Pinnacle Financial the variable rate.
(2) No cash will be exchanged prior to the term.

The cash flow hedges were determined to be fully effective during the period presented. Additionally, 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 other comprehensive income (loss). If a hedge was deemed to be ineffective, the amount included in accumulated other comprehensive income (loss) would be reclassified to current earnings. 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. Pinnacle Financial does not expect any amounts to be reclassified from other comprehensive income (loss) over the next 12 months.

Note 10. 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.

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 expense is 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.

Alternative investments – Included in other investments are alternative investments in certain nonpublic private equity funds. The valuation of nonpublic private equity investments requires significant 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 underling investments of such funds are often privately-held and/or start-up companies for which market-values are not readily available.

Other real estate owned – Other real estate owned (OREO) represents real estate foreclosed upon by Pinnacle Bank through loan defaults by customers. 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.

Other assets – Included in other assets are certain assets carried at fair value, including interest rate swap agreements to facilitate customer transactions and the cash flow hedging contract. The carrying amount of interest rate swap agreements is based on Pinnacle Financial's pricing models that utilize observable market inputs obtained. The fair value of the cash flow hedge is determined using the income approach by comparing the discounted fixed rate cash flows with the discounted variable rate cash flows. The difference between these discounted cash flows represents the fair value of the hedge. 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.

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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.

The following tables present financial instruments measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, by caption on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above) (in thousands):

June 30, 2013	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)