PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
July 29, 2011

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, 2011
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

(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 800, 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 company o

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 28, 2011 there were 34,138,304 shares of common stock, $1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
June 30, 2011

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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 express 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 reduction of Pinnacle Financial’s loan balances, and conversely, the inability of Pinnacle Financial to ultimately 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 deterioration or lack of sustained growth 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 development of any new market other than Nashville or Knoxville; (xi) a merger or acquisition; (xii) any matter that would cause Pinnacle Financial to conclude that there was impairment of any asset, including intangible assets; (xiii) the impact of governmental restrictions on entities participating in the Capital Purchase Program, of the U.S. Department of the Treasury (the “Treasury”); (xiv) further deterioration in the valuation of other real estate owned; (xv) inability to comply with regulatory capital requirements and to secure any required regulatory approvals for capital actions; (xvi) 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; and (xvii) Pinnacle Financial recording a change in the valuation allowance related to its deferred tax asset. 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 23, 2011, as updated in Part II, Item 1A, “Risk Factors,” of the Quarterly Report on Form 10-Q filed on May 5, 2011. 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)

(Unaudited)		June 30, 2011			December 31, 2010	
ASSETS						
Cash and noninterest-bearing due from banks	$	62,316,425		$	40,154,247	
Interest-bearing due from banks		147,703,476			140,647,481	
Federal funds sold		6,231,745			7,284,685	
Short-term discount notes		-			499,768	
Cash and cash equivalents		216,251,646			188,586,181	
Securities available-for-sale, at fair value		922,780,234			1,014,316,831	
Securities held-to-maturity (fair value of $2,791,215 and $4,411,856 at June 30, 2011 and December 31, 2010, respectively)		2,727,272			4,320,486	
Mortgage loans held-for-sale		14,161,572			16,206,034	
Loans		3,207,104,232			3,212,440,190	
Less allowance for loan losses		(76,970,502	)		(82,575,235	)
Loans, net		3,130,133,730			3,129,864,955	
Premises and equipment, net		79,999,621			82,374,228	
Other investments		42,757,144			42,282,255	
Accrued interest receivable		15,723,962			16,364,573	
Goodwill		244,083,193			244,090,311	
Core deposits and other intangible assets		9,273,297			10,705,105	
Other real estate owned		52,395,174			59,608,224	
Other assets		101,045,934			100,284,697	
Total assets	$	4,831,332,779		$	4,909,003,880	
LIABILITIES AND STOCKHOLDERS' EQUITY						
Deposits:						
Noninterest-bearing	$	662,017,752		$	586,516,637	
Interest-bearing		572,465,335			573,670,188	
Savings and money market accounts		1,634,633,008			1,596,306,386	
Time		892,403,408			1,076,564,179	
Total deposits		3,761,519,503			3,833,057,390	
Securities sold under agreements to repurchase		124,513,664			146,294,379	
Federal Home Loan Bank advances		111,190,714			121,393,026	
Subordinated debt		97,476,000			97,476,000	
Accrued interest payable		3,031,394			5,197,925	
Other liabilities		34,373,482			28,127,875	
Total liabilities		4,132,104,757			4,231,546,595	
Stockholders’ equity:						
		91,422,313			90,788,682	

Preferred stock, no par value; 10,000,000 shares authorized; 95,000 shares issued and outstanding at June 30, 2011, and December 31, 2010				
Common stock, par value $1.00; 90,000,000 shares authorized; 34,136,163 issued and outstanding at June 30, 2011 and 33,870,380 issued and outstanding at December 31, 2010		34,136,163		33,870,380
Common stock warrants		3,348,402		3,348,402
Additional paid-in capital		533,557,342		530,829,019
Retained earnings		19,864,142		12,996,202
Accumulated other comprehensive income, net of taxes		16,899,660		5,624,600
Total stockholders' equity		699,228,022		677,457,285
Total liabilities and stockholders' equity	$	4,831,332,779	$	4,909,003,880

See accompanying notes to consolidated financial statements.

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Interest income:				
Loans, including fees	$ 38,905,155	$ 40,323,693	$ 77,258,636	$ 81,398,800
Securities:				
Taxable	6,479,280	8,058,265	12,840,179	17,145,853
Tax-exempt	1,837,811	1,985,946	3,773,699	4,036,199
Federal funds sold	566,874	560,611	1,140,880	1,037,753
Total interest income	47,789,120	50,928,515	95,013,394	103,618,605
Interest expense:				
Deposits	8,306,751	12,925,139	17,730,992	26,388,954
Securities sold under agreements to repurchase	345,444	364,648	727,013	916,961
Federal Home Loan Bank advances and other borrowings	1,341,546	1,941,437	2,739,377	4,055,492
Total interest expense	9,993,741	15,231,224	21,197,382	31,361,407
Net interest income	37,795,379	35,697,291	73,816,012	72,257,198
Provision for loan losses	6,587,189	30,508,685	12,726,327	43,734,605
Net interest income after provision for loan losses	31,208,190	5,188,606	61,089,685	28,522,593
Noninterest income:				
Service charges on deposit accounts	2,330,206	2,429,200	4,591,663	4,794,511
Investment services	1,637,426	1,315,263	3,145,512	2,551,646
Insurance sales commissions	1,004,246	904,359	2,053,478	2,003,378
Gain on loans sold, net	789,258	908,611	1,398,635	1,423,809
Net gain on sale of investment securities	610,302	2,259,124	451,199	2,623,674
Trust fees	769,935	754,515	1,499,923	1,651,088
Other noninterest income	2,668,041	1,998,082	4,993,061	4,006,694
Total noninterest income	9,809,414	10,569,154	18,133,471	19,054,800
Noninterest expense:				
Salaries and employee benefits	18,523,531	15,847,121	36,447,153	32,851,647
Equipment and occupancy	5,060,014	5,492,406	10,066,724	10,858,593
Other real estate expense	3,825,608	7,411,206	8,159,726	12,813,359
Marketing and other business development	766,422	793,696	1,520,173	1,547,614
Postage and supplies	545,097	700,505	1,034,974	1,434,044
Amortization of intangibles	715,905	746,001	1,431,809	1,492,002
Other noninterest expense	4,920,766	5,500,424	10,397,612	11,660,655
Total noninterest expense	34,357,343	36,491,359	69,058,171	72,657,914
Income (loss) before income taxes	6,660,261	(20,733,599)	10,164,985	(25,080,521)

Income tax expense (benefit)	288,414	5,630,431	288,414	5,106,734
Net income (loss)	6,371,847	(26,364,030)	9,876,571	(30,187,255)
Preferred stock dividends	1,200,694	1,200,694	2,388,194	2,388,194
Accretion on preferred stock discount	327,657	306,466	633,631	664,459
Net income (loss) available to common stockholders	$ 4,843,496	$ (27,871,190)	$ 6,854,746	$ (33,239,908)
Per share information:				
Basic net income (loss) per common share available to common stockholders	$ 0.14	$ (0.85)	$ 0.21	$ (1.02)
Diluted net income (loss) per common share available to common stockholders	$ 0.14	$ (0.85)	$ 0.20	$ (1.02)
Weighted average shares outstanding:				
Basic	33,454,229	32,675,221	33,410,385	32,616,943
Diluted	34,095,636	32,675,221	34,054,746	32,616,943

See accompanying notes to consolidated financial statements.

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

	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Common Stock Warrants	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comp. Income, net	Sto
Balances, December 31, 2009	$89,462,633	33,029,719	$33,029,719	$3,348,402	$524,366,603	$43,372,743	$7,440,081	$70
Exercise of employee common stock options, stock appreciation rights, common stock warrants and related tax benefits	-	135,664	135,664	-	974,901	-	-	1,
Issuance of restricted common shares, net of forfeitures	-	265,360	265,360	-	(265,360)	-	-	-
Restricted shares withheld for taxes	-	(9,002)	(9,002)	-	(121,305)	-	-	(1
Compensation expense for restricted shares	-	-	-	-	1,191,571	-	-	1,
Compensation expense for stock options	-	-	-	-	857,120	-	-	85
Accretion on preferred stock dividend	664,459	-	-	-	-	(664,459)	-	-
Preferred dividends paid	-	-	-	-	-	(2,375,000)	-	(2
Comprehensive income:								
Net loss	-	-	-	-	-	(30,187,255)	-	(3
Net unrealized gains on securities available-for-sale, net of deferred tax	-	-	-	-	-	-	10,428,262	10
Total comprehensive								(1

loss								
Balances, June 30, 2010	$90,127,092	33,421,741	$33,421,741	$3,348,402	$527,003,530	$10,146,029	$17,868,343	$68
Balances, December 31, 2010	$90,788,682	33,870,380	$33,870,380	$3,348,402	$530,829,019	$12,996,202	$5,624,600	$67
Exercise of employee common stock options, and related tax benefits	-	106,919	106,919	-	612,280	-	-	71
Issuance of restricted common shares, net of forfeitures	-	158,303	158,303	-	(158,303)	-	-	-
Issuance of Salary Stock Units	-	18,680	18,680	-	272,501	-	-	29
Restricted shares withheld for taxes	-	(18,119)	(18,119)	-	(249,341)	-	-	(2
Compensation expense for restricted shares	-	-	-	-	1,570,425	-	-	1,
Compensation expense for stock options	-	-	-	-	680,761	-	-	68
Accretion on preferred stock discount	633,631	-	-	-	-	(633,631)	-	-
Preferred dividends paid	-	-	-	-	-	(2,375,000)	-	(2
Comprehensive income:								
Net income	-	-	-	-	-	9,876,571	-	9,
Net unrealized gains on securities available-for-sale, net of deferred tax	-	-	-	-	-	-	11,275,060	11
Total comprehensive income								21
Balances, June 30, 2011	$91,422,313	34,136,163	$34,136,163	$3,348,402	$533,557,342	$19,864,142	$16,899,660	$69

See accompanying notes to consolidated financial statements.

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

	Six months ended June 30, 2011	Six months ended June 30, 2010
Operating activities:		
Net income (loss)	$ 9,876,571	$ (30,187,255)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net amortization/accretion of premium/discount on securities	3,673,938	2,095,570
Depreciation and amortization	5,650,951	5,967,863
Provision for loan losses	12,726,327	43,734,605
Gain on loan sales, net	(1,398,635)	(1,481,301)
Gain on sale of investment securities, net	(451,199)	(2,623,674)
Stock-based compensation expense	2,542,367	2,048,691
Deferred tax expense (benefit)	(568,101)	16,820,471
Losses on other real estate and other investments	6,107,869	11,672,034
Excess tax benefit from stock compensation	(7,117)	(10,358)
Mortgage loans held for sale:		
Loans originated	(136,038,263)	(172,250,210)
Loans sold	139,486,474	164,340,327
Decrease in other assets	19,894,737	723,307
Increase in other liabilities	4,078,621	16,118,412
Net cash provided by operating activities	65,574,540	56,968,482
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(69,910,259)	(246,633,539)
Sales	51,116,046	147,036,923
Maturities, prepayments and calls	118,391,346	145,523,934
Activities in securities held-to-maturity:		
Sales	-	954,388
Maturities, prepayments and calls	1,584,999	1,065,613
Decrease (increase) in loans, net	(32,148,545)	142,806,911
Purchases of premises and equipment	(1,329,819)	(6,151,116)
Other investments	(255,349)	(948,641)
Net cash provided by investing activities	67,448,419	183,654,473
Financing activities:		
Net (decrease) increase in deposits	(71,503,872)	29,949,521
Net decrease in securities sold under agreements to repurchase	(21,780,716)	(115,974,899)
Advances from Federal Home Loan Bank:		
Issuances	-	70,000,000
Payments	(10,156,762)	(151,110,778)
Preferred dividends paid	(2,375,000)	(2,375,000)
Exercise of common stock options and stock appreciation rights	451,739	980,259
Excess tax benefit from stock compensation	7,117	10,358

Net cash used in financing activities		(105,357,494)		(168,520,539)
Net increase in cash and cash equivalents		27,665,465		72,102,416
Cash and cash equivalents, beginning of period		188,586,181		166,602,074
Cash and cash equivalents, end of period	$	216,251,646	$	238,704,490

See accompanying notes to consolidated financial statement

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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 National Bank (Pinnacle National.) Pinnacle National is a commercial bank headquartered in Nashville, Tennessee. Pinnacle National 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. 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 2010 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, PNFP Statutory Trust IV and Collateral Plus, LLC, 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. generally accepted accounting principles 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, the determination of any impairment of intangible assets, including goodwill, the valuation of other real estate owned, the determination of the valuation of deferred tax assets, and the valuation of our investment portfolio including other-than-temporary impairment.

Loans — Loans are reported at their outstanding principal balances, the allowance for loan losses and any deferred fees or costs on originated loans. Interest income on loans is accrued based on the principal balance outstanding. Loan origination fees, net of certain loan origination costs, are deferred and recognized as an adjustment to the related loan yield using a method which approximates the interest method. At June 30, 2011 and December 31, 2010, net deferred loan fees of $505,000 and $579,000, respectively, were included in loans on the accompanying consolidated balance sheets.

Loans are charged off when management believes that the full collectability of the loan is unlikely. As such, a loan may be partially charged-off after a “confirming event” has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

Loans are placed on nonaccrual status when there is a significant deterioration in the financial condition of the borrower, which often is determined when the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. Generally, all interest accrued but not collected for loans that are placed on nonaccrual status is reversed against current income. Interest income is subsequently recognized only to the extent cash payments are received while the loan is classified as nonaccrual, but interest income recognition is reviewed on a case-by-case basis. A nonaccrual loan is returned to accruing status once the loan has been brought current and collection is reasonably assured or the loan has been "well-secured" through other techniques. Past due status is determined based on the contractual due date per the underlying loan agreement.

All loans that are placed on nonaccrual are further analyzed to determine if they should be classified as impaired loans. At December 31, 2010 and at June 30, 2011, there were no loans classified as nonaccrual that were not also deemed to be impaired. A loan is considered to be impaired 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. This determination is made using a variety of techniques, which include a review of the borrower's financial condition, debt-service coverage ratios, global cash flow analysis, guarantor support, other loan file information, meetings with borrowers, inspection or reappraisal of collateral and/or consultation with legal counsel as well as results of reviews of other similar industry credits (e.g. builder loans, development loans, church loans, etc.). As discussed in the allowance for loan loss discussion below, an allowance is recognized if the fair value of the impaired loan is less than the recorded investment in the impaired loan.

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

Allowance for Loan Losses — The allowance for loan losses is maintained at a level that management believes to be adequate to absorb probable losses in the loan portfolio. Loan losses are charged against the allowance when they are known. Subsequent recoveries are credited to the allowance. Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, volume, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, loss experience of various loan segments, identified impaired loans and other factors related to the portfolio. This evaluation is performed quarterly and is inherently subjective, as it requires material estimates that are susceptible to significant change including the amounts and timing of future cash flows expected to be received on any impaired loans.

In assessing the adequacy of the allowance, we also consider the results of our ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, independent loan reviewers, and reviews that may have been conducted by third-party reviewers. We incorporate relevant loan review results in the loan impairment determination. In addition, regulatory agencies, as an integral part of their examination process, will periodically review Pinnacle Financial's allowance for loan losses, and may require Pinnacle Financial to record adjustments to the allowance based on their judgment about information available to them at the time of their examinations. The determination of the allowance for loan losses is composed of the results of two independent impairment analyses pursuant to the provisions of both ASC 450-20 (formerly SFAS 5) and ASC 310-10-35(formerly SFAS 114) as discussed below.

ASC 450-20, Loss Contingencies — As part of management's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial, commercial real estate, small business lending, consumer and consumer real estate. Each segment is then analyzed such that an allocation of the allowance is estimated for each loan segment. Prior to 2010, because of Pinnacle Financial's limited loss history, loss estimates were primarily derived from historical loss data by loan categories for comparable peer institutions. During 2010, we incorporated the results of the bank's own historical loan loss migration analysis into our determination of the allowance for loan losses. We believe the increased emphasis on our historical loss experience metrics provides a better estimate of losses inherent in our portfolio. This refinement of our own methodology did not result in a material change in our allowance.

The allowance allocation for commercial, commercial real estate loans and small business lending portfolios begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on our internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for our internal system of credit risk grades for commercial and commercial real estate loans is based on our historical loss experience adjusted for current factors and industry loss factors. Our historical loss experience is based on a migration analysis of all loans that were charged-off during prior years. In the first quarter of 2011, the migration analysis was based on an eight quarter look-back to capture the recent loan loss experience of the firm. In the second quarter of 2011, we extended our migration analysis to include a nine quarter look-back. In this current economic environment, we believed the extension of our look-back period was appropriate due to the risks inherent in our loan portfolio. As we move through the economic cycle, we will continue to use judgment to determine our look-back period as we seek to capture the inherent risks in our portfolio. The migration analysis assists in evaluating loan loss allocation rates for the various risk grades assigned to loans in our portfolio. We compare the migration analysis results to the other factors used to determine the loss allocation rates for the commercial, commercial real estate and small business lending portfolios. The loss allocation rates from our migration analysis and the industry loss factors are weighted to determine a weighted average loss allocation rate for these portfolios.

The allowance allocation for consumer and consumer real estate loans which includes installment, home equity, consumer mortgages, automobiles and others is established for each of the categories by estimating probable losses inherent in that particular category of consumer and consumer real estate loans. The estimated loan loss allocation rate for each category is based on consideration of our actual historical loss rates and industry loss rates. Consumer and consumer real estate loans are evaluated as a group by category (i.e. retail real estate, installment, etc.) rather than on a loan credit risk rating basis because these loans are smaller and homogeneous. We weight the allocation methodologies for the consumer and consumer real estate portfolios and determine a weighted average allocation for these portfolios.

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The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several environmental factors. The allocation for environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and is based upon quarterly trend assessments in delinquent and nonaccrual loans, unanticipated charge-offs, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These environmental factors are considered for each of the five loan segments, and the allowance allocation, as determined by the processes noted above for each component, is increased or decreased based on the incremental assessment of these various environmental factors. The environmental factors accounted for approximately 6.4% of the allowance for loan losses at June 30, 2011 compared to 6.8% of allowance for loan losses at December 31, 2010. As of June 30, 2011 and December 31, 2010, the environmental allocation was 0.16% and 0.19%, respectively, of the outstanding principal balance of commercial, commercial real estate and small business loan portfolios and 0.14% and 0.16%, respectively, of consumer and consumer real estate loans. The decrease in the environmental allocation between the two periods is based on our analysis of the above factors as of both balance sh