



25 Gateway Road  
Cross Lanes, West Virginia 25313  
[www.cityholding.com](http://www.cityholding.com)



Dear Shareholder:

The year 2007 represents several anniversaries in our Company. Fifty years ago, on April 1, 1957, City National Bank first opened its doors in Kanawha City. Twenty-five years ago, in March of 1982, City National Bank formed a one-bank holding company known as City Holding Company. Since 1957 the bank has experienced considerable growth. Along the way, City has combined with historic banking franchises such as the Bank of Cross Lanes (1985), Peoples Bank of Pt. Pleasant (1987), Bank of Ripley (1988), First State Bank and Trust in Rainelle (1988), Home National Bank of Sutton (1992), The Buffalo Bank of Eleanor (1992), First National Bank of Beckley (1994), First Merchants Bancorp (1995), which consisted of Merchants National Bank of Montgomery and Gauley National Bank, Old National Bank of Huntington (1997), Blue Ridge Bank, NA in Martinsburg (1997), Bank of Raleigh (1999), Greenbrier Valley National Bank (1999), The National Bank of Summers of Hinton (1999), First National Bank in Marlinton (1999), The Twentieth Street Bank in Huntington (1999), First Federal Savings Bank of Ironton (2005), Citizens Bank of Grayson (2005), The First National Bank of Paintsville (2005), and Classic Bank (2005).

Today City Holding Company operates out of 68 separate branch offices, making it the 104<sup>th</sup> largest publicly traded bank in the U.S. based upon the number of branches. City serves more than 180,000 customers in West Virginia, Kentucky and Ohio and has total assets of \$2.5 billion. During 2006, City Holding Company continued a tradition of providing strong shareholder returns while maintaining a well-diversified balance sheet and a conservative business strategy.

### **Top-tier Performance**

For 2006, the Company reported net income of \$53.2 million and diluted earnings per share of \$2.99 as compared to earnings of \$50.3 million and diluted earnings per share of \$2.84 in 2005. As a result of its strong and sustained earnings, the Company has announced an increase in its dividend to \$1.24 per share (annualized) beginning with the April 2007 payment. This represents an annualized growth in dividends of 12.1% from \$0.88 per share (annualized) during 2004. With a dividend payout ratio in 2006 of approximately 37%, and a tangible equity ratio of 10.06% as of December 31, 2006, the Company is optimistic that it will continue to increase its dividend rate meaningfully in forthcoming years.

By almost any measure, City's financial performance is one of the best in banking. Among 249 publicly traded banking institutions with total assets between \$1 and \$10 billion in 2006, the Company consistently earns superior rankings. With respect to overall profitability in 2006 within this peer group, the Company achieved the #3 spot on Return on Assets at 2.11% and was in the top 10% on Return on Tangible Equity at 22.37%. The Company achieves this high level of profitability by focusing on maintaining a strong net interest margin earned on its loans and deposits; by earning a significant amount of revenues from various sources of non-interest income; and by effectively managing its expenses.



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The Company's net interest margin, a measure of the profitability of its loan and deposits, was 4.56% in 2006, up from 4.49% in 2005. This net interest margin places the Company in the top 20% within its peer group in 2006. With respect to non-interest income, the Company earned 34% of its revenue from various sources of non-interest income, earning the Company a top 10% position within its peer group for maintaining diverse sources of revenue. The Company's Efficiency Ratio, which is calculated as the Company's non-interest expenses as a percent of total revenue, in 2006 was 44.5%, and was in the top 10% of the peer group.

In addition to being one of the most profitable banking institutions, the Company also earns top marks for safeguarding investors by maintaining a conservative business strategy – maintaining strong capital, high liquidity, a solid core deposit franchise, and excellent asset quality. The Company was strongly capitalized with a 10.6% tangible equity ratio, placing the Company in the top 10% of the peer group. As a measure of the Company's liquidity, its Loan to Deposit ratio placed it in the top 25% of its peer group. The quality of City's core deposit franchise placed the company in the top 20% of its peer group in terms of the cost of interest paid on deposits and other liabilities as a percent of total assets. Regarding asset quality, the Company's allowance for loan losses was 384.9% of non-performing loans, placing the Company in the top 20% of its peer group.

### Growth

While it is clear that City Holding Company is a highly profitable franchise with a strong balance sheet, the Company also continues to grow its franchise. A strong West Virginia



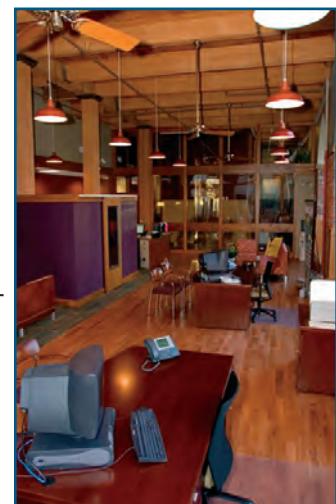
*The spacious, state-of-the-art Ranson banking center opened in October 2006.*



*A rendering of our Princeton facility set to open in late 2007.*

economy helped enable the Company to grow its commercial lending and commercial real estate loan portfolios 11% in 2006 following growth of over 10% in 2005 (excluding loans acquired via the merger with Classic Bancshares). Home equity loans grew 6.6% in 2006. As a result of changes in state law, the Company has hired a team of 6 insurance professionals as part of City Insurance to provide worker's compensation insurance to West Virginia businesses – a move that is expected to lift insurance revenues by nearly 50% during 2007. The Company has also hired a team of insurance agents in Beckley, WV to drive significant expansion of the Company's personal lines insurance business throughout our footprint.

In March 2006, the Company opened a new location in downtown Charleston, providing commercial, trust and depository services to the Charleston business community. In October 2006, the Company opened its first new free standing branch in over 10 years. The Potomac Marketplace branch is located in Ranson, West Virginia – a fast growing area in the state's Eastern Panhandle. This banking facility provides a model for future de novo growth. Construction on the Company's new Eastern Panhandle Regional headquarters in Martinsburg continues, with completion targeted for summer 2007. In March 2007, the Company opened a second location in Ripley, West Virginia. The Company has also announced its intention to expand in 2007 into both the Princeton/Bluefield WV-VA market and the Hurricane, West Virginia mar-



*Located in the historic One Bridge Place in Charleston, the Hale Street office features open ceilings, brick walls, wooden beams and hardwood floors.*

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ket. The strategy of adding new locations is successfully enhancing the Company's franchise in targeted markets, expanding reach to additional retail and commercial customers.

### **Board Changes**

It is with considerable regret that I announce the retirement of Edward (Ned) M. Payne III as a Director of City Holding Company and City National Bank at the annual meeting in April 2007. Ned, who has been City Holding Company's Chairman since August 2005, has reached the age of retirement set by City's by-laws.

Ned has served on the Boards of City and its predecessors, Horizon Bancorp and the Bank of Raleigh, since 1964. His guidance and counsel to me over the past 18 months have been invaluable, as they were to the CEOs who preceded me. Ned has seen this company safely through economic downturns, significant management changes, and a continually evolving regulatory environment. He contributed meaningfully to many successes that allowed City to reach its current position of strength and profitability. For all of this, and much more, the entire Board wishes to thank him for his wisdom, patience, sound advice, and dedicated service to the Company and its shareholders. He will be missed.

In January 2007, the Board appointed John Elliot, President & CEO of AMFM, Inc, as a Director to serve until the annual meeting in April 2007 and further nominated John to a two-year term as a Class I Director. The Board would like to welcome John to the Company and thank him for his willingness to serve on behalf of its shareholders.

As we continue throughout 2007, we are confident City has the financial strength and opportunities to continue to grow while remaining highly profitable. We believe City's future is bright, thanks to the strong guidance of our Board of Directors, committed employees, and a loyal, growing base of customers.



Charles R. Hageboeck  
President & CEO





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**About Form 10-K**

A copy of the Company's annual report on Form 10-K, as filed with the Securities and Exchange Commission, will be forwarded without charge to any shareholder upon written request to:

**Investor Relations**

**City Holding Company**

**Post Office Box 7520**

**Charleston, West Virginia 25356-0520**

City Holding Company's common stock trades on  
The NASDAQ Stock Market under the symbol  
CHCO.



## **CITY HOLDING COMPANY DIRECTORS AS OF MARCH 2007**

<b>Name</b>	<b>Principal Occupation</b>
Samuel M. Bowling	President and Treasurer, Dougherty Co., Inc.
Hugh R. Clonch	President, Clonch Industries.
Oshel B. Craigo	Chief Executive Officer, Better Foods, Inc.
John R. Elliot	Owner and President, AMFM, Inc., Owner and President, Capitol Conference Center, Owner and President, Continental Health Care, Inc., Owner and President, John Elliot Assoc.
William H. File III	Partner, File Payne Scherer & File, PLLC.
Robert D. Fisher	Partner, Adams, Fisher & Chappell, PLLC.
Jay C. Goldman	President, Goldman and Associates.
Charles R. Hageboeck	President and Chief Executive Officer, City Holding Company and City National Bank.
David W. Hambrick	Self-employed attorney.
Tracy W. Hylton II	President, Eller, Inc., member, Harper Hotel LLC, member, HMTWH, LLC, President, Lightning, Inc, member, M & T, LLC, Vice President, Nell Jean Enterprises, Inc., President, New Land Leasing Company, Inc., President, Patience, Inc., member, T & M, LLC.
C. Dallas Kayser	Senior Partner, Kayser, Layne & Clark, PLLC (formerly C. Dallas Kayser, LC).
Philip L. McLaughlin	Retired, Chairman of the Board, City Holding Company
Sharon H. Rowe	Senior Consultant, Gallagher/Goodwin-Gregg Communications Group.
James L. Rossi	Owner & President, James Rossi CPA, A.C., member, Mason Development Group, LLC.
James E. Songer II	President, Songer Insurance Agency. Owner, Homeseekers LLC.
Mary E. Hooten Williams	Vice President and Treasurer, Virginia Street Properties Corp. and Hooten Properties.

### **Executive Officers**

Charles R. Hageboeck  
President & CEO

Craig G. Stilwell  
Executive Vice President  
Retail Banking

John A. DeRito  
Executive Vice President  
Commercial Banking

David L. Bumgarner  
Chief Financial Officer

John W. Alderman  
General Legal Counsel





# The Financial Review

Selected Financial Data.....	1
Two Year Summary of Common Stock Prices and Dividends .....	2
Management's Discussion and Analysis of Financial Condition and Results of Operations .....	2-21
Report on Management's Assessment of Internal Control Over Financial Reporting .....	22
Reports of Independent Registered Public Accounting Firm .....	23-24
Consolidated Financial Statements	
Consolidated Balance Sheets .....	25
Consolidated Statements of Income.....	26
Consolidated Statements of Changes In Shareholders' Equity.....	27-28
Consolidated Statements of Cash Flows.....	29
Notes to Consolidated Financial Statements.....	30-49



# SELECTED FINANCIAL DATA

**TABLE ONE**  
**FIVE-YEAR FINANCIAL SUMMARY**

(in thousands, except per share data)

	2006	2005	2004	2003	2002
<b>Summary of Operations</b>					
Total interest income	\$ 156,123	\$ 135,518	\$ 118,881	\$ 117,290	\$ 128,965
Total interest expense	53,724	38,438	31,871	31,785	42,299
Net interest income	102,399	97,080	87,010	85,505	86,666
Provision for (recovery of) loan losses	3,801	1,400	—	(6,200)	1,800
Total other income	54,203	50,091	50,036	38,738	33,525
Total other expenses	71,285	69,113	66,333	64,498	69,210
Income before income taxes	81,516	76,658	70,713	65,945	49,181
Income tax expense	28,329	26,370	24,369	22,251	16,722
Net income	53,187	50,288	46,344	43,694	32,459
<b>Per Share Data</b>					
Net income basic	\$ 3.00	\$ 2.87	\$ 2.79	\$ 2.63	\$ 1.93
Net income diluted	2.99	2.84	2.75	2.58	1.90
Cash dividends declared	1.12	1.00	0.88	0.80	0.45
Book value per share	17.46	16.14	13.03	11.46	9.93
<b>Selected Average Balances</b>					
Total loans	\$ 1,649,864	\$ 1,514,367	\$ 1,337,172	\$ 1,219,917	\$ 1,255,890
Securities	581,747	666,922	705,032	561,437	515,700
Interest-earning assets	2,268,173	2,186,003	2,051,044	1,862,200	1,884,667
Deposits	1,960,657	1,814,474	1,659,143	1,593,521	1,617,782
Long-term debt	85,893	137,340	201,218	109,947	124,874
Shareholders' equity	296,966	264,954	206,571	178,372	158,011
Total assets	2,517,061	2,402,058	2,211,853	2,006,992	2,042,164
<b>Selected Year-End Balances</b>					
Net loans	\$ 1,662,064	\$ 1,596,037	\$ 1,336,959	\$ 1,270,765	\$ 1,175,887
Securities	519,898	605,363	679,774	704,961	517,794
Interest-earning assets	2,249,801	2,222,641	2,037,778	2,036,594	1,895,625
Deposits	1,985,217	1,928,420	1,672,723	1,636,762	1,564,580
Long-term debt	48,069	98,425	148,836	190,836	112,500
Shareholders' equity	305,307	292,141	216,080	190,690	165,393
Total assets	2,507,807	2,502,597	2,213,230	2,214,430	2,047,911
<b>Performance Ratios</b>					
Return on average assets	2.11%	2.09%	2.10%	2.18%	1.59%
Return on average equity	17.91	18.98	22.43	24.50	20.54
Return on average tangible equity	22.37	22.34	23.15	25.43	21.47
Net interest margin	4.56	4.49	4.29	4.65	4.68
Efficiency ratio	44.49	46.66	48.67	51.63	58.24
Dividend payout ratio	37.33	34.84	31.54	30.42	23.32
<b>Asset Quality</b>					
Net charge-offs to average loans	0.23%	0.38%	0.27%	0.07%	1.75%
Provision for (recovery of) loan losses to average loans	0.23	0.09	—	(0.51)	0.14
Allowance for loan losses to nonperforming loans	384.93	401.96	487.28	528.78	948.24
Allowance for loan losses to total loans	0.92	1.04	1.31	1.66	2.37
<b>Consolidated Capital Ratios</b>					
Total	16.19%	16.38%	16.64%	13.17%	13.36%
Tier I Risk-based	15.30	15.41	15.47	11.93	9.87
Tier I Leverage	10.79	10.97	10.47	10.04	8.49
Average equity to average assets	11.80	11.03	9.34	8.89	7.74
Average tangible equity to average tangible assets	9.67	9.53	9.08	8.59	7.43
Full-time equivalent employees	779	770	691	701	737



# TWO-YEAR SUMMARY OF COMMON STOCK PRICES AND DIVIDENDS

	Cash Dividends Per Share*	Market Value	
		Low	High
<b>2006</b>			
<b>Fourth Quarter</b>	<b>\$ 0.28</b>	<b>\$ 37.49</b>	<b>\$ 41.87</b>
<b>Third Quarter</b>	<b>0.28</b>	<b>35.42</b>	<b>40.19</b>
<b>Second Quarter</b>	<b>0.28</b>	<b>34.53</b>	<b>37.31</b>
<b>First Quarter</b>	<b>0.28</b>	<b>35.26</b>	<b>37.64</b>
<b>2005</b>			
Fourth Quarter	\$ 0.25	\$ 32.68	\$ 37.62
Third Quarter	0.25	34.69	39.21
Second Quarter	0.25	27.57	37.00
First Quarter	0.25	29.01	36.61

\*As more fully discussed under the caption *Liquidity* in Management's Discussion and Analysis and in Note Eighteen of Notes to Consolidated Financial Statements, the Company's ability to pay dividends to its shareholders is dependent upon the ability of City National to pay dividends to City Holding ("Parent Company").

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### CITY HOLDING COMPANY

City Holding Company (the "Company"), a West Virginia corporation headquartered in Charleston, West Virginia, is a bank holding company that provides diversified financial products and services to consumers and local businesses. Through its network of 67 banking offices in West Virginia (56), Kentucky (9), and Ohio (2), the Company provides credit, deposit, trust and investment management, and insurance products and services to its customers. In addition to its branch network, the Company's delivery channels include ATMs, check cards, interactive voice response systems, and internet technology. The Company's business activities are currently limited to one reportable business segment, which is community banking. The Company has approximately 7% of the deposit market in West Virginia and is the third largest bank headquartered in West Virginia based on deposit share. In the Company's key markets, the Company's primary subsidiary, City National Bank of West Virginia ("City National"), generally ranks in the top three relative to deposit market share.

### CRITICAL ACCOUNTING POLICIES

The accounting policies of the Company conform to U.S. generally accepted accounting principles and require management to make estimates and develop assumptions that affect the amounts reported in the financial statements and related footnotes. These estimates and assumptions are based on information available to management as of the date of the financial statements. Actual results could differ significantly from management's estimates. As this information changes,

The Company's common stock trades on the NASDAQ stock market under the symbol CHCO. This table sets forth the cash dividends paid per share and information regarding the market prices per share of the Company's common stock for the periods indicated. The price ranges are based on transactions as reported on the NASDAQ stock market. At December 31, 2006, there were 3,303 shareholders of record.

management's estimates and assumptions used to prepare the Company's financial statements and related disclosures may also change. The most significant accounting policies followed by the Company are presented in Note One of Notes to Consolidated Financial Statements included herein. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses, income taxes and previously securitized loans to be the accounting areas that require the most subjective or complex judgments and, as such, could be most subject to revision as new information becomes available.

Pages 14-17 of this Annual Report to Shareholders provide management's analysis of the Company's allowance for loan losses and related provision. The allowance for loan losses is maintained at a level that represents management's best estimate of probable losses in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses is based upon an evaluation of individual credits in the loan portfolio, historical loan loss experience, current economic conditions, and other relevant factors. This determination is inherently subjective, as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The allowance for loan losses related to loans considered to be impaired is generally evaluated based on the discounted cash flows using the impaired loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Pages 9-10 of this Annual Report to Shareholders provide management's analysis of the Company's income taxes. The Company is subject to federal and state income taxes in the jurisdictions in which it conducts business. In computing the provision for income taxes, management must make judgments regarding interpretation of laws in those jurisdictions. Because the application of tax laws and regulations for many types of transactions is susceptible to varying interpretations, amounts reported in the financial statements could be changed at a later date upon final determinations by taxing authorities. On a quarterly basis, the Company estimates its annual effective tax rate for the year and uses that rate to provide for income taxes on a year-to-date basis.

Note Six of Notes to Consolidated Financial Statements, on page 37 of this Annual Report to Shareholders, and pages 17-18 provide management's analysis of the Company's previously securitized loans. The carrying value of previously securitized loans is determined using assumptions with regard to loan prepayment and default rates. Using cash flow modeling techniques that incorporate these assumptions, the Company estimated total future cash collections expected to be received from these loans and determined the yield at which the resulting discount would be accreted into income. If, upon periodic evaluation, the estimate of the total probable collections is increased or decreased but is still greater than the sum of the original carrying amount less subsequent collections plus the discount accreted to date, and it is probable that collection will occur, the amount of the discount to be accreted is adjusted accordingly and the amount of periodic accretion is adjusted over the remaining lives of the loans. If, upon periodic evaluation, the discounted present value of estimated future cash flows declines below the recorded value of previously securitized loans, an impairment charge would be provided through the Company's provision for loan losses. Please refer to Note One of Notes to Consolidated Financial Statements, on page 31 for further discussion.

## FINANCIAL SUMMARY

The Company's financial performance over the previous three years is summarized in the following table:

	2006	2005	2004
Net income ( <i>in thousands</i> )	\$ 53,187	\$ 50,288	\$ 46,344
Earnings per share, basic	\$ 3.00	\$ 2.87	\$ 2.79
Earnings per share, diluted	\$ 2.99	\$ 2.84	\$ 2.75
ROA*	2.11%	2.09%	2.10%
ROE*	17.91%	18.98%	22.43%

\* ROA (Return on Average Assets) is a measure of the effectiveness of asset utilization. ROE (Return on Average Equity) is a measure of the return on shareholders' investment.

As illustrated in the preceding table, the Company continued to experience favorable results in each of these measures of financial performance during 2006. The Company's operating results in 2006 were positively affected by a \$5.3 million increase in net interest income due to the acquisition of Classic during the second quarter of 2005, a rising interest rate environment, and growth in the Company's traditional loan portfolio (see Net Interest Income). Additionally, net of investment securities gains and the gain from the sale of the Company's credit card portfolio, non-interest income increased \$2.7 million, or 5.4%, over 2005 primarily as a result of higher service charge revenues, which grew 8.9% from the prior year. Non-interest expenses increased \$2.2 million from 2005 primarily as a result of the Classic acquisition during the second quarter of 2005, which increased non-interest expenses by \$1.8 million from 2005. In addition, the Company recognized \$1.4 million of losses from the early redemption of \$12.0 million of its trust preferred securities during 2006. Other expenses decreased \$1.3 million from 2005 due to a charge recorded in 2005 that was associated with interest rate floors utilized in the Company's interest rate risk management process. Excluding these items, non-interest expenses increased by \$0.3 million from 2005. These fluctuations are more fully discussed under the captions Non-Interest Income and Expense. The Company recorded a provision for loan losses of \$3.8 million in 2006. Despite the increase in the provision from 2005, the quality of its loan portfolio remains solid as evidenced by its ratio of non-performing assets to total loans and other real estate owned of 0.25% at December 31, 2006.

## BALANCE SHEET ANALYSIS

Total loans increased \$64.6 million, or 4.0%, from December 31, 2005, as growth in commercial, home equity, and residential real estate loans was partially offset by declines in consumer loans and previously securitized loans. Commercial loan balances increased \$69.0 million, or 11.0%, in 2006, as compared to 2005. Home equity loans increased \$20.0, or 6.6%, from 2005, while the outstanding balance of residential real estate loans increased \$6.0 million, or 1.0%, from 2005. Consumer lending decreased \$15.7 million primarily due to the sale of the Company's retail credit card portfolio.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

Between 1997 and 1999, the Company originated and securitized \$760 million in 125% loan-to-value junior-lien mortgages in six separate pools. The Company had a retained interest in the residual cash flows associated with these underlying mortgages after satisfying priority claims. When the notes were redeemed during 2003 and 2004, the Company became the beneficial owner of the mortgage loans and recorded the loans as "Previously Securitized Loans" within the loan portfolio. At December 31, 2006, the Company reported "Previously Securitized Loans" of \$15.6 million compared to \$30.3 million at December 31, 2005, a decrease of 48.5%.

Total investment securities decreased \$85.5 million, or 14.1%, from \$605.4 million at December 31, 2005, to \$519.9 million at December 31, 2006. The decrease in the securities portfolio in 2006 was related primarily to funding commercial loans, repaying long-term borrowings, and to the maturities of securities.

Total deposits increased \$56.8 million from \$1.93 billion at December 31, 2005 to \$1.99 billion at December 31, 2006. This increase was primarily attributable to increased time deposits, which grew \$108 million from December 31, 2005.

Short-term debt balances decreased \$15.7 million, or 10.3%, from December 31, 2005 to December 31, 2006. This decrease was primarily attributable to a decrease of \$54.9 million in federal funds borrowed that was partially offset by an increase of \$40.2 million in security repurchase agreements. The Company does not depend on security repurchase agreements, which are subject to significant fluctuations for funding or liquidity.

Long-term debt balances decreased \$50.4 million, or 51.2%, from 2005 to 2006. This decrease was primarily due to the maturity of FHLB advances.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

**TABLE TWO**  
**AVERAGE BALANCE SHEETS AND NET INTEREST INCOME**  
(in thousands)

	2006			2005			2004		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
<b>ASSETS</b>									
Loan portfolio (1):									
Residential real estate	\$ 598,017	\$ 34,483	5.77%	\$ 545,280	\$ 30,570	5.61%	\$ 454,890	\$ 26,869	5.91%
Home equity	311,854	24,384	7.82	305,525	19,088	6.25	298,703	14,004	4.69
Commercial, financial, and agriculture	670,243	50,165	7.48	564,612	36,287	6.43	443,484	24,632	5.55
Installment loans to individuals	47,477	5,507	11.60	56,091	6,368	11.35	59,944	6,882	11.48
Previously securitized loans	22,273	9,406	42.23	42,859	11,401	26.60	80,151	13,712	17.11
Total loans	1,649,864	123,945	7.51	1,514,367	103,714	6.85	1,337,172	86,099	6.44
Securities:									
Taxable	539,634	28,418	5.27	623,155	29,804	4.78	666,863	30,110	4.52
Tax-exempt (2)	42,113	2,741	6.51	43,767	2,904	6.64	38,169	2,784	7.29
Total securities	581,747	31,159	5.36	666,922	32,708	4.90	705,032	32,894	4.67
Loans held for sale	2,496	322	12.90	-	-	-	-	-	-
Deposits in depository institutions	30,633	1,478	4.82	4,609	109	2.36	5,347	52	0.97
Federal funds sold	3,433	179	5.21	105	4	3.81	193	3	1.55
Retained interests	-	-	-	-	-	-	3,300	808	24.48
Total interest-earning assets	2,268,173	157,083	6.93	2,186,003	136,535	6.25	2,051,044	119,856	5.84
Cash and due from banks	50,571			48,562			43,616		
Premises and equipment	43,111			39,109			34,804		
Other assets	171,214			145,899			102,179		
Less: Allowance for loan losses	(16,008)			(17,515)			(19,790)		
Total assets	\$2,517,061			\$2,402,058			\$2,211,853		
<b>LIABILITIES</b>									
Interest-bearing demand deposits	\$ 433,244	\$ 5,284	1.22%	\$ 433,831	\$ 3,866	0.89%	\$ 405,865	\$ 2,599	0.64%
Savings deposits	314,732	3,983	1.27	295,045	2,070	0.70	279,174	1,456	0.52
Time deposits	877,592	34,779	3.96	743,725	22,869	3.07	662,068	19,152	2.89
Short-term borrowings	143,705	5,099	3.55	157,264	3,369	2.14	120,849	1,082	0.90
Long-term debt	85,893	4,579	5.33	137,340	6,264	4.56	201,218	7,582	3.77
Total interest-bearing liabilities	1,855,166	53,724	2.90	1,767,205	38,438	2.18	1,669,174	31,871	1.91
Noninterest-bearing demand deposits	335,089			341,873			312,036		
Other liabilities	29,840			28,026			24,072		
Shareholders' equity	296,966			264,954			206,571		
Total liabilities and shareholders' equity	\$ 2,517,061			\$ 2,402,058			\$2,211,853		
Net interest income		\$103,359			\$ 98,097			\$ 87,985	
Net yield on earning assets			4.56%			4.49%			4.29%

(1) For purposes of this table, loans on nonaccrual status have been included in average balances.

(2) Computed on a fully federal tax-equivalent basis assuming a tax rate of approximately 35%.



# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

## NET INTEREST INCOME

### 2006 vs. 2005

On a tax-equivalent basis, the Company's net interest income increased by \$5.3 million, or 5.4%, from 2005 to 2006 (Table Three), despite a decrease of \$2.0 million in interest income from previously securitized loans from 2005 and a decrease of \$0.9 million in interest income from credit cards. This increase was primarily due to the acquisition of Classic during the second quarter of 2005 and from increased interest income from the Company's traditional loan portfolio (excluding previously securitized loans).

Exclusive of interest income from previously securitized loans and credit cards, interest income from all other loans increased \$23.4 million from 2005 and the yield on these loans increased 81 basis points. The average balances of these loans increased \$167 million during 2006 due to both internal growth and the acquisition of Classic during the second quarter of 2005. Interest income attributable to this growth totaled \$10.3 million, while the improvement in yield increased interest income by \$13.1 million.

Increases in interest income were partially offset by an increase of \$15.3 million in interest expense. The average rate paid on deposits increased 75 basis points during 2006 and resulted in additional deposit interest expense of \$11.0 million. Due to the Classic acquisition and internal growth, the Company experienced growth of \$153 million, or 10.4%, in average deposit balances that increased deposit interest expense by \$4.3 million.

These increases in interest income were also partially offset by decreased interest income on previously securitized loans. The average balances of previously securitized loans decreased from \$42.9 million for the year ended December 31, 2005, to \$22.3 million for the year ended December 31, 2006. This decrease was partially mitigated as the yield on previously securitized loans rose from 26.60% for the year ended December 31, 2005, to 42.2% for the year ended December 31, 2006 (see *Previously Securitized Loans*). The net result of the decreases in balances of 48.0% and the increased yield was a decrease in interest income from previously securitized loans of \$2.0 million from 2005 to 2006.

Average earning assets increased by \$82.0 million in 2006 due to increases associated with internal loan growth and the acquisition of Classic during the second quarter of 2005 that were partially offset by lower investment balances. Average loan balances (excluding previously securitized loans) increased by \$156 million from 2005 to 2006. This increase was partially offset by decreases in average balances of previously securitized loans of \$21 million (see *Previously Securitized Loans*) and in average balances of securities of \$85 million. Excluding the impact of previously securitized loans, the Classic acquisition, and the sale of the credit card portfolio, average earning assets increased \$28 million from

2005 to 2006 as increases attributable to commercial loans, residential real estate loans, and deposits in depository institutions were partially offset by declines in investments balances. The Company's average commercial loans grew \$85 million and average residential real estate loans grew \$16 million. Average securities decreased due to maturities, repayment of long-term borrowings, and funding of commercial loans. The net increase in average earning assets was accompanied by an increase in average interest-bearing deposits of \$153 million primarily as a result of the acquisition of Classic and increased balances of time deposits. Average interest-bearing liabilities decreased by \$65 million while average non-interest bearing liabilities decreased by \$7 million. Excluding the Classic acquisition, average deposits increased \$59 million while average total borrowings decreased \$78 million.

The net interest margin for the year ended December 31, 2006 of 4.56% represented a 7 basis point increase from the year ended December 31, 2005's net interest margin of 4.49%. In 2005, the Company positioned its balance sheet to benefit from rising interest rates by emphasizing variable rate loan products. As interest rates rose during 2005 and 2006, the Company's interest rate risk position offset the decreasing balances of previously securitized loans and resultant reduced levels of interest income from these assets. Excluding previously securitized loans, the sale of the Company's credit card portfolio, and the impact of the Classic acquisition, the Company's net interest margin increased 24 basis points and net interest income increased \$5.9 million from 2005.

### 2005 vs. 2004

On a tax-equivalent basis, the Company's net interest income increased by \$10.1 million, or 11.5%, from 2004 to 2005 (Table Three). This increase was primarily due to the Classic acquisition and from increased interest income from the Company's traditional loan portfolio (excluding previously securitized loans). The Classic acquisition contributed \$7.5 million of net interest income during 2005. Exclusive of the Classic acquisition and interest income from previously securitized loans and retained interests (see below), net interest income increased \$5.8 million from 2004 to 2005. This increase was primarily attributable to an increase in the net interest spread, loan growth, and an increase in average demand deposits and shareholders' equity. Due to increases in the Federal Funds rate, the positioning of the Company's balance sheet, and its strong core-deposit base, the yield on the loan portfolio (exclusive of Classic and previously securitized loans) increased 49 basis points while the cost of deposits increased only 22 basis points. As a result, net interest income improved \$3.4 million in 2005. Exclusive of previously securitized loans and Classic, average loans increased \$66.7 million, or 5.3%, from 2004 to 2005 and average demand deposits and shareholders' equity increased \$49.2 million during the same period. These increases combined to increase net interest income \$2.4 million during 2005.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

These increases were partially offset by decreased interest income associated with previously securitized loans and retained interests. The average balances of previously securitized loans and retained interests decreased from \$83.4 million for the year ended December 31, 2004, to \$42.9 million for the year ended December 31, 2005. This decrease was partially mitigated as the yield on previously securitized loans rose from 17.11% for the year ended December 31, 2004, to 26.60% for the year ended December 31, 2005 (see *Previously Securitized Loans*). The net result of the decreases in balances of 48.6% and the increased yield was a decrease in interest income from previously securitized loans and retained interests of \$3.1 million from 2004 to 2005.

Average earning assets increased by \$135 million in 2005 due to increases associated with the acquisition of Classic. Average loan balances (excluding previously securitized loans) increased by \$214 million from 2004 to 2005. This increase was partially offset by decreases in average balances of previously securitized loans and retained interests of \$41 million (see *Previously Securitized Loans*) and in average balances of securities of \$38 million. Excluding the acquisition of Classic and the impact of previously securitized loans and retained interests, average earning assets were flat from 2004 to 2005 as increases attributable to commercial loans and residential real estate loans were essentially offset by declines in investments and consumer loan balances. Exclusive of the Classic acquisition, the Company had increases in average commercial loans of \$68 million and average residential real estate loans of \$20 million. Average

securities decreased due to maturities, repayment of long-term borrowings, and funding of commercial loans. In addition, average balances of installment loans fell by \$22 million without the acquisition of Classic, as the Company continued its strategy of emphasizing real estate secured loans. The net increase in average earning assets was accompanied by an increase in average interest-bearing deposits of \$125 million primarily as a result of the Classic acquisition. Average interest-bearing liabilities increased by \$98 million while average non-interest bearing liabilities increased by \$34 million and average equity grew by \$58 million. Excluding the Classic acquisition, average deposits were flat while average total borrowings decreased \$49 million.

The net interest margin for the year ended December 31, 2005, of 4.49% represented a 20 basis point increase from the year ended December 31, 2004's net interest margin of 4.29%. To offset the effects of decreasing balances of high yielding previously securitized loans, the Company positioned its balance sheet to benefit from rising interest rates. Since December 2004, the Federal Funds rate has increased 200 basis points from 2.25% to 4.25% in December 2005. These increases improved the Company's yield on variable rate lending products, while the Company's deposit rates increased at a slower pace due to its solid core-deposit base. As a result, the yield on interest-bearing assets excluding previously securitized loans and retained interests increased 49 basis points from 5.35% in 2004 to 5.84% in 2005, while the cost of interest bearing deposits increased only 24 basis points from 1.72% in 2004 to 1.96% in 2005.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

**TABLE THREE**

## **RATE/VOLUME ANALYSIS OF CHANGES IN INTEREST INCOME AND EXPENSE**

(in thousands)

	2006 vs. 2005 Increase (Decrease) Due to Change In:			2005 vs. 2004 Increase (Decrease) Due to Change In:		
	Volume	Rate	Net	Volume	Rate	Net
<b>Interest-Earning Assets</b>						
Loan portfolio:						
Residential real estate	\$ 2,957	\$ 956	\$ 3,913	\$ 5,339	\$ (1,638)	\$ 3,701
Home equity	395	4,901	5,296	320	4,764	5,084
Commercial, financial, and agriculture	6,789	7,089	13,878	6,723	4,932	11,655
Installment loans to individuals	(978)	118	(860)	(442)	(72)	(514)
Previously securitized loans	(5,476)	3,481	(1,995)	(6,380)	4,069	(2,311)
Total loans	3,687	16,545	20,232	5,560	12,055	17,615
Securities:						
Taxable	(3,995)	2,609	(1,386)	(1,973)	1,667	(306)
Tax-exempt (1)	(110)	(53)	(163)	408	(288)	120
Total securities	(4,105)	2,556	(1,549)	(1,565)	1,379	(186)
Loans held for sale	322	-	322	-	-	-
Deposits in depository institutions	615	754	1,369	(7)	64	57
Federal funds sold	127	48	175	(1)	2	1
Retained interests	-	-	-	(808)	-	(808)
<b>Total interest-earning assets</b>	<b>\$ 646</b>	<b>\$ 19,903</b>	<b>\$ 20,549</b>	<b>\$ 3,179</b>	<b>\$ 13,500</b>	<b>\$ 16,679</b>
<b>Interest-Bearing Liabilities</b>						
Interest-bearing demand deposits	\$ (5)	\$ 1,423	\$ 1,418	\$ 179	\$ 1,088	\$ 1,267
Savings deposits	138	1,775	1,913	83	531	614
Time deposits	4,116	7,794	11,910	2,362	1,355	3,717
Short-term borrowings	(290)	2,021	1,731	326	1,961	2,287
Long-term debt	(2,346)	661	(1,685)	(2,407)	1,089	(1,318)
<b>Total interest-bearing liabilities</b>	<b>\$ 1,613</b>	<b>\$ 13,674</b>	<b>\$ 15,287</b>	<b>\$ 543</b>	<b>\$ 6,024</b>	<b>\$ 6,567</b>
<b>Net interest income</b>	<b>\$ (967)</b>	<b>\$ 6,229</b>	<b>\$ 5,262</b>	<b>\$ 2,636</b>	<b>\$ 7,476</b>	<b>\$ 10,112</b>

(1) Fully federal taxable equivalent using a tax rate of approximately 35%.

## **NONINTEREST INCOME AND EXPENSE**

### **2006 vs. 2005**

The Company focuses much of its efforts on retail banking and enhancing its retail deposit franchise within its markets. As a result of its strong retail banking operation, service charge revenues have provided significant revenue growth for the Company over the past three years. During 2006, non-interest income (excluding security transactions and the gain from the sale of the Company's credit card portfolio) increased approximately \$2.7 million, or 5.4%, from 2005. This increase was primarily attributable to the Company's continued increase in service charge revenues of \$3.5 million, or 8.9%, from \$39.1 million during 2005 to \$42.6 million during 2006. This increase was partially due to the acquisition of Classic Bancshares, Inc. during the second quarter of 2005. This increase was partially mitigated by a \$0.4 million decrease in bank-owned life insurance revenues from the settlement of insured claims and a \$0.4 million decrease in other income due primarily to lower credit card fee income as a result of the sale of the credit card portfolio.

Noninterest expenses increased \$2.2 million, or 3.1%, from \$69.1 million in 2005 to \$71.3 million in 2006. The increase was primarily a result of the Classic acquisition during the second quarter of 2005, which increased non-interest expenses by \$1.8 million from 2005. In addition, the Company recognized \$1.4 million of losses from the early redemption of \$12.0 million of its trust preferred securities during 2006. Other expenses decreased \$1.3 million from 2005 due to a charge recorded in 2005 that was associated with interest rate floors utilized in the Company's interest rate risk management process. Exclusive of these items, non-interest expenses increased by \$0.3 million from 2005 due to increased advertising expenses. Advertising expenses increased 9.4%, from \$2.9 million in 2005 to \$3.2 million in 2006. The increase was primarily attributed to the Company's focused efforts to attract and grow new customer relationships.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

## 2005 vs. 2004

During 2005, non-interest income (excluding security transactions and legal settlements) increased approximately \$6.5 million, or 15.0%, from 2004. This increase was primarily attributable to the Company's continued increase in service charge revenues of \$6.5 million, or 19.9%, from \$32.6 million during 2004 to \$39.1 million during 2005. The acquisition of Classic accounted for \$2.0 million of this increase, while the remaining \$4.5 million increase was due to additional services utilized by our customers.

In addition to the Company's continued success in expanding services it provides to its customers, other income also increased from \$3.1 million in 2004 to \$3.7 million in 2005. This increase was primarily attributable to increased sales of fixed rate mortgage loans as a result of the flat yield curve.

2004's non-interest income included \$5.5 million recognized in connection with the settlement of a derivative action brought against certain current and former directors and former executive officers of the Company and City National seeking to recover alleged damages on behalf of the Company and City National.

Noninterest expenses increased \$2.8 million, or 4.2%, from \$66.3 million in 2004 to \$69.1 million in 2005. Non-interest expenses increased \$3.4 million due to the Classic acquisition, and \$1.4 million from changes in market value of interest rate floors. During 2005, the Company entered into interest rate floor arrangements to protect the future income stream from certain variable rate loans should interest rates decline below certain specified levels. During the fourth quarter of 2005, management determined that the changes in the market value of the floors should be charged to operations. Partially offsetting these increases was a decrease in compensation expense of \$2.4 million incurred in 2004 related to an obligation to five current and former executive officers for severance payments as provided under their respective employment agreements. Exclusive of the Classic acquisition, market adjustment on interest rate floors, and executive severance obligations, non-interest expenses increased by \$0.4 million between 2004 and 2005.

Advertising expenses increased \$0.5 million, or 24.3%, from \$2.4 million in 2004 to \$2.9 million in 2005. The increase was primarily attributed to an expanded territory as a result of the Classic acquisition and the Company's focused efforts to attract and grow customer relationships.

Bankcard expenses increased \$0.6 million from 2004 to 2005 as a result of increased customer usage of electronic banking services and an increase in customers as a result of the Classic acquisition.

Excluding the Classic acquisition and market adjustment on interest rate floors, other expenses increased \$0.4 million,

or 4.6%, from 2004 to 2005 primarily as a result of increased business franchise taxes incurred by the Company.

Partially offsetting these increases in non-interest expenses was a decrease in professional fees and litigation expenses of \$1.3 million from \$3.3 million in 2004 to \$2.0 million in 2005. The decrease was primarily related to legal expenses incurred during 2004 associated with the derivative action previously discussed.

## INCOME TAXES

The Company recorded income tax expense of \$28.3 million, \$26.4 million, and \$24.4 million in 2006, 2005, and 2004, respectively. The Company's effective tax rates for 2006, 2005, and 2004 were 34.6%, 34.4%, and 34.5%, respectively. A reconciliation of the effective tax rate to the statutory rate is included in Note Thirteen of Notes to Consolidated Financial Statements.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The Company's net deferred tax assets decreased from \$27.9 million at December 31, 2005 to \$23.7 million at December 31, 2006. The components of the Company's net deferred tax assets are disclosed in Note Thirteen of Notes to Consolidated Financial Statements. Realization of the most significant net deferred tax assets is primarily dependent on future events taking place that will reverse the current deferred tax assets. For example, realization of the deferred tax asset attributable to the allowance for loan losses is expected to occur as additional loan charge-offs, which have already been provided for within the Company's financial statements, are recognized for tax purposes. The deferred tax asset associated with the allowance for loan losses declined from \$7.6 million at December 31, 2005 to \$6.0 million at December 31, 2006. The deferred tax asset associated with the Company's previously securitized loans is expected to be realized as the Company recognizes income for financial statement purposes from these loans in future periods. The deferred tax asset associated with these loans remained consistent at \$10.2 million at December 31, 2006 and at December 31, 2005. As discussed in Note Six of Notes to Consolidated Financial Statements, the Company had net recoveries on previously securitized loans of \$4.1 million during 2006 that were taxable for income tax purposes, but will be recognized in future periods for financial reporting purposes. The deferred tax asset associated with unrealized securities losses is the tax impact of the unrealized losses on the Company's available for sale security portfolio. At December 31, 2006, the Company had a deferred tax asset of \$1.8 million associated with unrealized securities losses as compared to a deferred tax asset of \$3.2 million associated with unrealized securities losses at December 31, 2005. The impact of the Company's unrealized losses/(gains) is noted in the Company's Consolidated Statements of Changes in



# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

Shareholder Equity as an adjustment to Accumulated Other Comprehensive Income (Loss). The deferred tax asset at December 31, 2006, would be realized if the unrealized losses on the Company's securities were realized from sales or maturities of the related securities. The Company believes that it is more likely than not that each of the net deferred tax assets will be realized and that no valuation allowance is necessary as of December 31, 2006 or 2005.

## RISK MANAGEMENT

Market risk is the risk of loss due to adverse changes in current and future cash flows, fair values, earnings, or capital due to adverse movements in interest rates and other factors, including foreign exchange rates and commodity prices. Because the Company has no significant foreign exchange activities and holds no commodities, interest rate risk represents the primary risk factor affecting the Company's balance sheet and net interest margin. Significant changes in interest rates by the Federal Reserve could, in turn, result in similar changes in LIBOR interest rates, prime rates, and other benchmark interest rates that could affect the estimated fair value of the Company's investment securities portfolio, interest paid on the Company's short-term and long-term borrowings, interest earned on the Company's loan portfolio, and interest paid on its deposit accounts.

The Company's Asset and Liability Committee ("ALCO") has been delegated the responsibility of managing the Company's interest-sensitive balance sheet accounts to maximize earnings while managing interest rate risk. ALCO, comprised of various members of executive and senior management, is also responsible for establishing policies to monitor and limit the Company's exposure to interest rate risk and to manage the Company's liquidity position. ALCO satisfies its responsibilities through monthly meetings during which product pricing issues, liquidity measures, and interest sensitivity positions are monitored.

In order to measure and manage its interest rate risk, the Company uses an asset/liability management and simulation software model to periodically update the interest sensitivity position of the Company's balance sheet. The model is also used to perform analyses that measure the impact on net interest income and capital as a result of various changes in the interest rate environment. Such analyses quantify the effects of various interest rate scenarios on projected net interest income.

At December 31, 2005 the Company reported that it expected to benefit from rising interest rates. The Fed Funds rate was 4.25% on December 31, 2005, and rose 100 basis points by December 31, 2006. The Company's interest rate risk model estimated that the results of a 100 basis point parallel increase in interest rates would be to increase the net interest margin by 13 basis points. In fact, the Company's net interest margin rose by 7 basis points in 2006.

The Company's policy objective is to avoid negative fluctuations in net income or the economic value of equity of more than 15% within a 12-month period, assuming an immediate parallel increase or decrease of 300 basis points. The Company measures the long-term risk associated with sustained increases and decreases in rates through analysis of the impact to changes in rates on the economic value of equity.

However, it is important to understand that a parallel downward shift of 300 basis points in interest rates from the current rate would result in both a 2.25% Fed Funds rate and long-term interest rates of bank borrowings of approximately 2.00%. While it is true that short-term interest rates such as the Fed Funds rate have been at these low levels in the recent past, long-term interest rates have not reached levels as low as would be associated with this "worst-case" interest rate environment in well over 30 years. Based upon the Company's belief that the likelihood of an immediate 300 basis point decline in both long-term and short-term interest rates from current levels is remote, the Company has chosen to reflect only its risk to a decrease of 200 basis points from current rates in its analysis.

The Company has entered into interest rate floors with a total notional value of \$600 million, with terms of 3, 4, and 5 years to facilitate the management of its short-term interest rate risk at December 31, 2006. These derivative instruments provide the Company protection against the impact declining interest rates on future income streams from certain variable rate loans. Please refer to Notes One and Twelve of Notes to Consolidated Financial Statements for further discussion of the use and accounting for such derivative instruments.

The following table summarizes the sensitivity of the Company's net income to various interest rate scenarios. The results of the sensitivity analyses presented below differ from the results used internally by ALCO in that, in the analyses below, interest rates are assumed to have an immediate and sustained parallel shock. The Company recognizes that rates are volatile, but rarely move with immediate and parallel effects. Internally, the Company considers a variety of interest rate scenarios that are deemed to be possible while considering the level of risk it is willing to assume in "worst-case" scenarios such as shown by the following:

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Immediate Basis Point Change in Interest Rates	Implied Federal Funds Rate Associated with Change in Interest Rates	Estimated Increase (Decrease) in Net Income Over 12 Months	Estimated Increase (Decrease) in Economic Value of Equity
<b>2006:</b>			
+300	8.25%	+5.2%	+0.2%
+200	7.25	+3.4	+0.2
+100	6.25	+1.6	+0.4
-100	4.25	(2.3)	(2.5)
-200	3.25	(5.2)	(5.1)
<b>2005:</b>			
+300	7.25%	+10.1%	+2.2%
+200	6.25	+8.1	+2.1
+100	5.25	+4.4	+1.4
-100	3.25	(6.7)	(3.4)
-200	2.25	(10.0)	(4.9)

These results are highly dependent upon assumptions made by management, including, but not limited to, assumptions regarding the manner in which interest-bearing demand deposit and saving deposit accounts reprice in different interest rate scenarios, pricing behavior of competitors, prepayments of loans and deposits under alternative rate environments, and new business volumes and pricing. As a result, there can be no assurance that the results above will be achieved in the event that interest rates increase or decrease during 2007 and beyond. The results above do not necessarily imply that the Company will experience increases in net income if market interest rates rise. The table above indicates how the Company's net income and the economic value of equity behave *relative* to an increase or decrease in rates compared to what would otherwise occur if rates remain stable. Based upon the current level of interest rates in the general economy, the Company believes that its net interest margin will continue to compress through 2007.

Based upon the results above, the Company believes that its net income is positively correlated with increasing rates as compared to the level of net income the Company would expect if interest rates remain flat. However, these results do not necessarily imply that the Company will experience increases in net income if market interest rates rise. In fact, the Company has significant exposure due to projected decreases in outstanding balances of previously securitized loans. Between January 2007 and December 2007, based upon the Company's projected reductions in outstanding balances of previously securitized loans, assuming that market interest rates remain unchanged, and assuming that other loan and deposit balances remain unchanged, the Company anticipates a reduction in net interest income of approximately 3.1% and a corresponding reduction in net income of approximately 2.4%. The Company believes that average loan growth of approximately 2.5% in 2007 would be required to mitigate the anticipated reduction in net interest income associated with

declining balances of previously securitized loans during 2007.

## LIQUIDITY

The Company evaluates the adequacy of liquidity at both the Parent Company level and at City National. At the Parent Company level, the principal source of cash is dividends from City National. Dividends paid by City National to the Parent Company are subject to certain legal and regulatory limitations. Generally, any dividends in amounts that exceed the earnings retained by City National in the current year plus retained net profits for the preceding two years must be approved by regulatory authorities. During 2005 and 2006, City National received regulatory approval to pay \$144.8 million of cash dividends to the Parent Company, while generating net profits of \$106.6 million. Therefore, City National will be required to obtain regulatory approval prior to declaring any cash dividends to the Parent Company during 2007. Although regulatory authorities have approved prior cash dividends, there can be no assurance that future dividend requests will be approved.

During 2006, the Parent Company used cash obtained from the dividends received primarily to: (1) pay common dividends to shareholders, (2) remit interest payments on the Company's junior subordinated debentures, (3) redeem \$12.0 million of the Company's junior subordinated debentures, (4) invested \$40 million in the formation of a new capital management subsidiary, and (5) fund repurchases of the Company's common shares. Additional information concerning sources and uses of cash by the Parent Company is reflected in Note Twenty of Notes to Consolidated Financial Statements, on page 48.

Over the next 12 months, the Parent Company has an obligation to remit interest payments approximating \$1.5 million on the junior subordinated debentures held by City Holding Capital Trust. However, interest payments on the debentures can be deferred for up to five years under certain circumstances and dividends to shareholders can, if necessary, be suspended. Additionally, the Parent Company anticipates continuing the payment of dividends, which would approximate \$19.6 million on an annualized basis for 2007 based on common shareholders on record at December 31, 2006. In addition to these anticipated cash needs for 2007, the Parent Company has operating expenses and other contractual obligations, which are estimated to require \$0.3 million of additional cash over the next 12 months. As of December 31, 2006, the Parent Company reported a cash balance of approximately \$43.0 million.

Excluding the interest and dividend payments discussed above, the Parent Company has no significant commitments or obligations in years after 2007 other than the repayment of its \$16.8 million obligation under the debentures held by City Holding Capital Trust. However, this obligation does not mature until April 2028, or earlier at the option of the Parent

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Company. It is expected that the Parent Company will be able to obtain the necessary cash, either through dividends obtained from City National or the issuance of other debt, to fully repay the debentures at their maturity. Table Ten on page 19 of this Annual Report to Shareholders summarizes the contractual obligations of the Parent Company and City National, combined.

City National manages its liquidity position in an effort to effectively and economically satisfy the funding needs of its customers and to accommodate the scheduled repayment of borrowings. Funds are available to City National from a number of sources, including depository relationships, sales and maturities within the investment securities portfolio, and borrowings from the FHLB and other financial institutions. As of December 31, 2006, deposits and capital significantly fund City National's assets. However, City National maintains borrowing facilities with the FHLB and other financial institutions that are accessed as necessary to fund operations and to provide contingency funding mechanisms. As of December 31, 2006, City National has the capacity to borrow an additional \$177.7 million from the FHLB under existing borrowing facilities. City National maintains a contingency funding plan, incorporating these borrowing facilities, to address liquidity needs in the event of an institution-specific or systematic financial industry crisis. Additionally, City National maintains a significant percentage (90.9% or \$472.4 million at December 31, 2006) of its investment securities portfolio in the highly liquid available-for-sale classification. As such, these securities could be liquidated, if necessary, to provide an additional funding source. City National also manages certain mortgage loans, mortgage-backed securities, and other investment securities in a separate subsidiary so that it can separately monitor the asset quality of these primarily mortgage-related assets, which could be used to raise cash through securitization transactions or obtain additional equity or debt financing if necessary.

The Company manages its asset and liability mix to balance its desire to maximize net interest income against its desire to minimize risks associated with capitalization, interest rate volatility, and liquidity. With respect to liquidity, the Company has chosen a conservative posture and believes that its liquidity position is strong. As illustrated in the Consolidated Statements of Cash Flows, the Company generated \$59.1 million of cash from operating activities during 2006, primarily from interest income received on loans and investments, net of interest expense paid on deposits and borrowings.

The Company's net loan to asset ratio is 66.3% at December 31, 2006 as compared to its peers (defined as U.S. banks with total assets between \$1 billion and \$3 billion as published by the Federal Financial Institution Examination

Council) of 71.1% as of September 30, 2006. The Company has obligations to extend credit, but these obligations are primarily associated with existing home equity loans that have predictable borrowing patterns across the portfolio. The Company has significant investment security balances with carrying values that totaled \$519.9 million at December 31, 2006, and that greatly exceeded the Company's non-deposit sources of borrowing which totaled \$217.3 million.

The Company primarily funds its assets with deposits, which fund 79.2% of total assets as compared to 59.7% for its peers. Further, the Company's deposit mix has a very high proportion of transaction and savings accounts that fund 42.5% of the Company's total assets. And, the Company uses fewer time deposits over \$100,000 than its peers, funding just 8.9% of total assets as compared to peers, which fund 16.7% of total assets with such deposits. And, as described under the caption *Certificates of Deposit*, the Company's large CDs are primarily small retail depositors rather than public and institutional deposits.

## INVESTMENTS

The Company's investment portfolio decreased from \$605.4 million at December 31, 2005 to \$519.9 million at December 31, 2006. This decrease was primarily related to funding the increase in commercial loans, repayment of long-term borrowings, and maturities of investment securities.

The investment portfolio remains highly liquid at December 31, 2006, with 90.9% of the portfolio classified as available-for-sale, including \$46.4 million invested in an open-end, short-term investment fund. The investment portfolio is structured to provide flexibility in managing liquidity needs and interest rate risk, while providing acceptable rates of return.

The majority of the Company's investment securities continue to be mortgage-backed securities. The mortgage-backed securities in which the Company has invested are predominantly underwritten to the standards of, and guaranteed by, government-sponsored agencies such as FNMA and FHLMC.

During the third quarter of 2006, the Company sold approximately \$55 million of investment securities and realized a loss of approximately \$2.1 million. As part of a strategy to reposition the Company's balance sheet in response to the decline in interest income from the sale of its credit card portfolio, the Company replaced the investment securities with higher yielding investment securities.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

**TABLE FOUR**  
**INVESTMENT PORTFOLIO**

(in thousands)	Carrying Values as of December 31		
	2006	2005	2004
<b>Securities Available-for-Sale:</b>			
U.S. Treasury and other U.S. government corporations and agencies	\$ 244	\$ 243	\$ 23,695
States and political subdivisions	40,448	44,034	31,652
Mortgage-backed securities	320,806	392,210	494,428
Other debt securities	52,317	51,433	41,045
Total debt securities available-for-sale	413,815	487,920	590,820
Equity securities and investment funds	58,583	62,046	29,214
<b>Total Securities Available-for-Sale</b>	<b>472,398</b>	<b>549,966</b>	<b>620,034</b>
<b>Securities Held-to-Maturity:</b>			
States and political subdivisions	5,708	8,333	12,504
Other debt securities	41,792	47,064	47,236
<b>Total Securities Held-to-Maturity</b>	<b>47,500</b>	<b>55,397</b>	<b>59,740</b>
<b>Total Securities</b>	<b>\$ 519,898</b>	<b>\$ 605,363</b>	<b>\$ 679,774</b>

Included in equity securities and investment funds in the table above at December 31, 2006 are \$4.0 million of Federal Home Loan Bank stock, \$6.7 million of Federal Reserve Bank stock, and \$46.4 million the Company had invested in Federated Prime Obligations Fund ("the Fund"). The Fund is an open-end fund traded on the NASDAQ National Market,

which invests primarily in high quality, short-term, fixed income securities issued by banks, corporations, and the U.S. government. At December 31, 2006, there were no securities of any non-governmental issuers whose aggregate carrying or market value exceeded 10% of shareholders' equity.

(dollars in thousands)	Maturing							
	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
<b>Securities Available-for-Sale:</b>								
U.S. Treasury and other U.S. government corporations and agencies	\$ —	— %	\$ 244	4.51%	\$ —	— %	\$ —	— %
States and political subdivisions	1,441	5.18	6,087	5.32	15,571	6.72	17,349	4.11
Mortgage-backed securities	1,337	5.42	5,773	5.52	10,955	5.55	302,741	4.83
Other debt securities	—	—	—	—	3,870	5.70	48,447	7.50
<b>Total debt securities available-for-sale</b>	<b>2,778</b>	<b>5.30</b>	<b>12,104</b>	<b>5.40</b>	<b>30,396</b>	<b>6.17</b>	<b>368,537</b>	<b>5.15</b>
<b>Securities Held-to-Maturity:</b>								
States and political subdivisions	1,343	4.56	4,056	6.83	309	4.05	—	—
Other debt securities	—	—	—	—	—	—	41,792	8.37
<b>Total debt securities held-to-maturity</b>	<b>1,343</b>	<b>4.56</b>	<b>4,056</b>	<b>6.83</b>	<b>309</b>	<b>4.05</b>	<b>41,792</b>	<b>8.37</b>
<b>Total debt securities</b>	<b>\$ 4,121</b>	<b>5.06%</b>	<b>\$ 16,160</b>	<b>5.76%</b>	<b>\$ 30,705</b>	<b>6.15%</b>	<b>\$410,329</b>	<b>5.48%</b>

Weighted-average yields on tax-exempt obligations of states and political subdivisions have been computed on a fully federal tax-equivalent basis using a tax rate of 35%. Average yields on investments available-for-sale are

computed based on amortized cost. Mortgage-backed securities have been allocated to their respective maturity groupings based on their contractual maturity.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

## LOANS

**TABLE FIVE**  
**LOAN PORTFOLIO**

The composition of the Company's loan portfolio at December 31 follows:

(in thousands)	2006	2005	2004	2003	2002
Real estate - mortgage	\$ 598,502	\$ 592,521	\$ 469,458	\$ 446,134	\$ 471,806
Home equity	321,708	301,728	308,173	282,481	210,753
Commercial, financial, and agriculture	698,719	629,670	472,112	427,451	389,227
Installment loans to individuals	42,943	58,652	46,595	77,337	132,605
Previously securitized loans	15,597	30,256	58,436	58,788	—
<b>Gross loans</b>	<b>\$ 1,677,469</b>	<b>\$ 1,612,827</b>	<b>\$ 1,354,774</b>	<b>\$ 1,292,191</b>	<b>\$ 1,204,391</b>

During 2006, the Company continued its strategy of focusing on the growth of its real estate secured lending portfolio. During 2006, commercial loans increased \$69.0 million, or 11.0%, from \$629.7 million at December 31, 2005, to \$698.7 million at December 31, 2006. The Company's ability to successfully attract new commercial relationships contributed significantly to this increase. Home equity loans increased \$20.0 million from \$301.7 million at December 31, 2005, to \$321.7 million at December 31, 2006. Residential real estate loans increases \$6.0 million, or 1.0%, from \$592.5 million at December 31, 2005 to \$598.5 million at December 31, 2006.

Installment loans decreased \$15.7 million \$58.7 million at December 31, 2005 to \$42.9 million at December 31, 2006. This decrease is primarily a result of the sale of the Company's retail credit card portfolio during the third quarter of 2006.

As of December 31, 2006, the Company reported \$15.6 million of loans classified as "previously securitized loans." These loans were recorded as a result of the Company's early redemption of the outstanding notes attributable to the Company's six loan securitization trusts (see *Retained Interests and Previously Securitized Loans*). As the outstanding notes were redeemed during 2004 and 2003, the Company became the beneficial owner of the remaining mortgage loans and recorded the carrying amount of those loans within the loan portfolio, classified as "previously securitized loans." These loans are junior lien mortgage loans on one- to four-family residential properties located throughout the United States. The loans generally have contractual terms of 25 or 30 years and have fixed interest rates. The Company expects this balance to continue to decline as borrowers remit principal payments on the loans. The following table shows the scheduled maturity of loans outstanding as of December 31, 2006:

(in thousands)	Within One Year	After One But Within Five Years	After Five Years	Total
Real estate - mortgage	\$ 89,685	\$ 243,056	\$ 265,761	\$ 598,502
Home equity	60,487	192,499	68,722	321,708
Commercial, financial, and agriculture	278,318	333,169	87,232	698,719
Installment loans to individuals	25,307	17,538	98	42,943
Previously securitized loans	4,690	5,534	5,373	15,597
<b>Total loans</b>	<b>\$ 458,487</b>	<b>\$ 791,796</b>	<b>\$ 427,186</b>	<b>\$ 1,677,469</b>

Loans maturing after one year with interest rates that are:

Fixed until maturity	\$ 259,905
Variable or adjustable	959,077
<b>Total</b>	<b>\$ 1,218,982</b>

## ALLOWANCE AND PROVISION FOR LOAN LOSSES

Management systematically monitors the loan portfolio and the adequacy of the allowance for loan losses on a quarterly basis to provide for probable losses inherent in the portfolio. Management assesses the risk in each loan type based on historical trends, the general economic environment of its local markets, individual loan performance, and other relevant factors. Individual credits are selected throughout the year for detailed loan reviews, which are utilized by management to assess the risk in the portfolio and the adequacy of the allowance. Due to the nature of commercial lending, evaluation of the adequacy of the allowance as it relates to these loan types is often based more upon specific credit review, with consideration given to the potential impairment of certain credits and historical charge-off percentages, adjusted for general economic conditions and other inherent risk factors. Conversely, due to the homogeneous nature of the real estate and installment

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

portfolios, the portions of the allowance allocated to those portfolios are primarily based on prior loss history of each portfolio, adjusted for general economic conditions and other inherent risk factors.

In evaluating the adequacy of the allowance for loan losses, management considers both quantitative and qualitative factors. Quantitative factors include actual repayment characteristics and loan performance, cash flow analyses, and estimated fair values of underlying collateral. Qualitative factors generally include overall trends within the portfolio, composition of the portfolio, changes in pricing or underwriting, seasoning of the portfolio, and general economic conditions.

The allowance not specifically allocated to individual credits is generally determined by analyzing potential exposure and other qualitative factors that could negatively impact the adequacy of the allowance. Loans not individually evaluated for impairment are grouped by pools with similar risk characteristics and the related historical loss percentages are adjusted to reflect current inherent risk factors, such as unemployment, overall economic conditions, concentrations of credit, loan growth, classified and impaired loan trends, staffing, adherence to lending policies, and loss trends.

Determination of the adequacy of the allowance for loan losses is subjective in nature and requires management to periodically reassess the validity of its assumptions. Differences between actual losses and estimated losses are assessed such that management can timely modify its evaluation model to ensure that adequate provision has been made for risk in the total loan portfolio.

Subsequent to changes the Company implemented in its underwriting standards beginning in 2001, the quality of the Company's loan portfolio has been solid over the past four years as evidenced by the stability of its ratio of non-performing assets to total loans and other real estate owned, which was 0.25% on December 31, 2006. Although the Company's asset quality has consistently improved and the required level of the allowance has decreased, the Company began recording a provision in the third quarter of 2005 based upon its detailed analysis described above. Based on management's analysis of the adequacy of the allowance for loan losses during 2006, management determined it was appropriate to record a provision for loan losses of \$3.8 million for 2006. The provision for loan losses recorded during 2006 was the result of increases in allocations to commercial loans. While the provision recorded by the Company increased \$2.4 million from 2005, the amount of provision recorded was favorably impacted by continued improvement in the quality of the loan portfolio. Changes in the amount of the provision and related allowance are based on the Company's detailed methodology and are directionally consistent with growth, changes in the quality of the Company's loan portfolio, and loss experience.

The Company's ratio of non-performing assets to total loans and other real estate owned, which ranged from 0.34% in 2003 to 0.25% at December 31, 2006, compares quite favorably relative to the Company's peer group (bank holding companies with total assets between \$1 and \$5 billion), which reported average non-performing assets as a percentage of loans and other real estate owned for the most recently reported quarter ended September 30, 2006 of 0.70%. The composition of the Company's loan portfolio, which is weighted more heavily toward residential mortgage loans and less towards non-real estate secured commercial loans than peers, has allowed it to maintain a lower allowance in comparison to peers. In addition, the sale of the Company's credit card portfolio resulted in a reduction of the allowance by \$1.4 million during 2006. As a result, the Company's allowance as a percentage of loans outstanding is 0.92% at December 31, 2006. The Company believes its methodology for determining the adequacy of its allowance adequately provides for probable losses inherent in the loan portfolio and produces a provision for loan losses that is directionally consistent with changes in asset quality and loss experience.

The allowance allocated to the commercial loan portfolio increased \$0.7 million, or 9.4%, from \$7.6 million at December 31, 2005 to \$8.3 million at December 31, 2006. This increase was due primarily to increases in commercial balances. As of December 31, 2006, commercial balances totaled \$698.7 million, a \$69.0 million (11.0%) increase from December 31, 2005.

The allowance allocated to the real estate portfolio remained at \$4.0 million at December 31, 2006. Improvements in the asset quality of this portfolio have been partially offset by increases in balances in this portfolio of 3% from December 31, 2005.

The allowance allocated to the consumer loan portfolio decreased \$2.0 million, or 71.6%, from \$2.8 million at December 31, 2005 to \$0.8 million at December 31, 2006. This decrease was primarily due to the sale of the Company's retail credit card portfolio during 2006. Excluding this reduction, the allowance allocated to the consumer loan portfolio decreased \$0.3 million from December 31, 2005. This reduction was primarily due to a continued trend of decreasing consumer loan balances. Excluding the credit card portfolio loans that were sold, consumer loans have declined \$3.8 million, or 8.1%, from December 31, 2005 to December 31, 2006. In addition, the historical loss percentages for installment loans decreased 34% from December 31, 2005 to December 31, 2006.

With the introduction of new depository account products and services in 2002 and the growth experienced in this product line from 2002 to 2006, the Company began allocating a portion of the allowance for loan losses to overdraft deposit account borrowings in 2003. Certain products offered by the Company permit customers to overdraft their depository accounts. While the Company

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

generates service charge revenues for providing this service to the customer, certain deposit account overdrafts are not fully repaid by the customer resulting in losses incurred. The Company has provided for probable losses resulting from overdraft deposit account borrowings through its allowance for loan losses. As reflected in Table Six, the Company reported net charge-offs on depository accounts of \$2.1 and \$2.4 million during 2006 and 2005, respectively. As of December 31, 2006, the balance of overdraft deposit accounts was \$3.9 million and is included in installment loans to individuals in Note Four of Notes to Consolidated Financial Statements. The Company allocated \$2.3 million (see Table Eight) of its allowance for loan losses as of December 31, 2006, to provide for probable losses resulting from overdraft deposit accounts.

As previously discussed, the carrying value of the previously securitized loans incorporates an assumption for expected cash flows to be received over the life of these loans.

To the extent that the present value of expected cash flows is less than the carrying value of these loans, the Company would provide for such losses through the provision and allowance for loan losses.

Based on the Company's analysis of the adequacy of the allowance for loan losses and in consideration of the known factors utilized in computing the allowance, management believes that the allowance for loan losses as of December 31, 2006, is adequate to provide for probable losses inherent in the Company's loan portfolio. Future provisions for loan losses will be dependent upon trends in loan balances including the composition of the loan portfolio, changes in loan quality and loss experience trends, and recoveries of previously charged-off loans, among other factors. The Company believes that its methodology for determining its allowance for loan losses adequately provides for probable losses inherent in the loan portfolio at December 31, 2006.

**TABLE SIX**  
**ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES**

An analysis of changes in the allowance for loan losses follows:

(in thousands)	2006	2005	2004	2003	2002
Balance at beginning of year	\$ 16,790	\$ 17,815	\$ 21,426	\$ 28,504	\$ 48,635
Allowance from acquisition	-	3,265	-	-	-
Reduction of allowance for loans sold	(1,368)	-	-	-	-
Charge-offs:					
Commercial, financial, and agricultural	(1,279)	(1,673)	(2,040)	(1,189)	(19,063)
Real estate-mortgage	(935)	(1,491)	(1,164)	(1,878)	(7,360)
Installment loans to individuals	(898)	(1,711)	(2,071)	(3,076)	(4,814)
Overdraft deposit accounts	(3,823)	(3,584)	(2,614)	(1,680)	-
Totals	(6,935)	(8,459)	(7,889)	(7,823)	(31,237)
Recoveries:					
Commercial, financial, and agricultural	210	605	1,809	3,244	5,671
Real estate-mortgage	575	303	576	1,811	1,849
Installment loans to individuals	598	679	792	1,300	1,786
Overdraft deposit accounts	1,734	1,182	1,101	590	-
Totals	3,117	2,769	4,278	6,945	9,306
Net charge-offs	(3,818)	(5,690)	(3,611)	(878)	(21,931)
Provision for (recovery of) loan losses	3,801	1,400	-	(6,200)	1,800
Balance at end of year	\$ 15,405	\$ 16,790	\$ 17,815	\$ 21,426	\$ 28,504
<b>As a Percent of Average Total Loans</b>					
Net charge-offs	0.23%	0.38%	0.27%	0.07%	1.75%
Provision for (recovery of) loan losses	0.23	0.09	-	(0.51)	0.14
<b>As a Percent of Nonperforming and Potential Problem Loans</b>					
Allowance for loan losses	384.93%	401.96%	487.28%	528.78%	948.24%



# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

**TABLE SEVEN**

## **NON-ACCRUAL, PAST-DUE AND RESTRUCTURED LOANS**

Nonperforming assets at December 31 follows:

(in thousands)	2006	2005	2004	2003	2002
Non-accrual loans	\$ 3,319	\$ 2,785	\$ 2,147	\$ 2,140	\$ 2,126
Accruing loans past due 90 days or more	635	1,124	677	1,195	880
Previously securitized loans past due 90 days or more	48	268	832	717	–
	<b>\$ 4,002</b>	<b>\$ 4,177</b>	<b>\$ 3,656</b>	<b>\$ 4,052</b>	<b>\$ 3,006</b>

The Company recognized approximately \$0.1 million of interest income received in cash on non-accrual and impaired loans in both 2006 and 2005, with no such income recognized during 2004. Approximately \$0.2 million, \$0.2 million and \$0.1 million of interest income would have been recognized during 2006, 2005 and 2004, respectively, if such loans had been current in accordance with their original terms. There were no commitments to provide additional funds on non-accrual, impaired, or other potential problem loans at December 31, 2006 and 2005.

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. The accrual of interest income is generally discontinued when a loan becomes 90 days past due as to principal or interest unless the loan is well collateralized and in the process of collection. When interest accruals are discontinued, interest credited to income in the current year that is unpaid and deemed uncollectible is charged to operations. Prior-year interest accruals that are unpaid and deemed uncollectible are charged to the allowance for loan losses, provided that such amounts were specifically reserved.

**TABLE EIGHT**

## **ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES**

A summary of the allocation of the allowance for loan losses by loan type at December 31 follows:

(dollars in thousands)	2006		2005		2004		2003		2002	
	Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total	
	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans
Commercial, financial and agricultural	\$ 8,330	40%	\$ 7,613	39%	\$ 10,655	35%	\$ 13,554	33%	\$ 17,039	32%
Real estate-mortgage	3,981	56	3,977	57	3,151	62	2,874	61	7,363	57
Installment loans to individuals	801	4	2,819	4	2,552	3	3,558	6	4,102	11
Overdraft deposit accounts	2,293	–	2,381	–	1,457	–	1,440	–	–	–
	<b>\$ 15,405</b>	<b>100%</b>	<b>\$ 16,790</b>	<b>100%</b>	<b>\$ 17,815</b>	<b>100%</b>	<b>\$ 21,426</b>	<b>100%</b>	<b>\$ 28,504</b>	<b>100%</b>

## **PREVIOUSLY SECURITIZED LOANS**

**Overview:** Between 1997 and 1999, the Company originated and securitized approximately \$759.8 million in 125% loan to junior-lien underlying mortgages in six separate pools. The Company had a retained interest in the securitizations. Principal amounts owed to investors in the securitizations were evidenced by securities ("Notes"). The Notes were subject to redemption, in whole but, not in part, at

the option of the Company, as owner of the retained interests, or at the option of the Note insurer, on or after the date on which the related Note balance had declined to 5% or less of the original Note balance. Once the Notes were redeemed, the Company became the beneficial owner of the underlying mortgage loans and recorded the loans as assets of the Company within the loan portfolio. During 2004 and 2003, the Notes outstanding on each of the Company's six

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

securitizations declined below the 5% threshold and the Company exercised its early redemption option on each of those securitizations.

As the Company redeemed the outstanding Notes, no gain or loss was recognized in the Company's financial statements and the remaining mortgage loans were recorded in the Company's loan portfolio as "previously securitized loans," at the lower of carrying value or fair value. Because the carrying value of the mortgage loans incorporated assumptions for expected prepayment and default rates, the carrying value of the loans was generally less than the actual outstanding contractual balance of the loans. As of December 31, 2006 and 2005, the Company reported a carrying value of previously securitized loans of \$15.6 million and \$30.3 million, respectively, while the actual outstanding contractual balance of these loans was \$33.3 million and \$48.1 million, respectively. The Company accounts for the difference between the carrying value and the outstanding balance of previously securitized loans as an adjustment of the yield earned on these loans over their remaining lives. The discount is accreted to income over the period during which payments are probable of collection and are reasonably estimable. Effective January 1, 2005, the Company adopted Statement of Position 03-3 to determine the collectibility of previously securitized loans. If upon evaluation of estimated collections and collections to date, the estimated total amount of collections is reduced below the original value of the loans, the loans will be considered impaired and subject to further evaluation. For a further discussion of the accounting policies for previously securitized loans, please see Note One to the Consolidated Financial Statements, on page 31 of this Annual Report to Shareholders.

During 2006 and 2005, the Company recognized \$9.4 million and \$11.4 million, respectively, of interest income on its previously securitized loans. Cash receipts for 2006 and 2005 are summarized in the following table:

(in thousands)	2006	2005
Principal receipts	\$ 18,829	\$ 30,201
Interest receipts	5,374	9,146
Total cash receipts	<u>\$ 24,203</u>	<u>\$ 39,347</u>

Key assumptions used in estimating the cash flows and fair value of the Company's previously securitized loans as of December 31, 2006 and 2005, were as follows:

	December 31 2006	2005
Prepayment speed (CPR):		
From January 2006 – December 2006	–	30%
From January 2007 – September 2007	17%	30%
From September 2007 – December 2007	17%	20%
From January 2008 – December 2008	13%	20%
From January 2009 – December 2009	9%	20%
From January 2010 – December 2010	8%	20%
Thereafter	5%	20%
Weighted-average cumulative defaults	10.19%	10.54%

The balances of previously securitized loans are compromised of six different pools. The Company monitors prepayments by pool and as a result of updated information, the prepayment factors are updated accordingly.

The projected cumulative default rate is computed using actual loan defaults experienced life-to-date plus forecasted loan defaults projected over the remaining expected life of the loans.

**Summary:** The following table summarizes the activity with the reported balance of previously securitized loans during 2006 and 2005 and illustrates the impact on these balances of converting the retained interest asset to loans:

(in thousands)	Previously Securitized Loans
<b>Balance at December 31, 2004</b>	<b>\$ 58,436</b>
Principal payments on mortgage loans received from borrowers	(30,201)
Discount accretion	2,021
<b>Balance at December 31, 2005</b>	<b>\$ 30,256</b>
Principal payments on mortgage loans received from borrowers	(18,829)
Discount accretion	4,170
<b>Balance at December 31, 2006</b>	<b>\$ 15,597</b>

## GOODWILL

The Company evaluates the recoverability of goodwill and indefinite lived intangible assets annually as of November 30, or more frequently if events or changes in circumstances warrant, such as a material adverse change in the business. Goodwill is considered to be impaired when the carrying value of a reporting unit exceeds its estimated fair value. Indefinite-lived intangible assets are considered impaired if their carrying value exceeds their estimated fair value. As described in Note One of the Company's Consolidated Financial Statements, the Company conducts its business activities through one reportable business segment – community banking. Fair values are estimated by reviewing the Company's stock price as it compares to book value and the Company's reported earnings.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

In addition, the impact of future earnings and activities are considered in the Company's analysis. The Company has \$54.9 million of goodwill at December 31, 2006.

## CERTIFICATES OF DEPOSIT

Scheduled maturities of time certificates of deposit of \$100,000 or more outstanding at December 31, 2006, are

summarized in Table Nine. The Company has time certificates of deposit of \$100,000 or more totaling \$222.1million. These deposits are primarily small retail depositors of the bank as demonstrated by the average balance of time certificates of deposit of \$100,000 or more being less than \$131,000.

**TABLE NINE**  
**MATURITY DISTRIBUTION OF CERTIFICATES OF DEPOSIT OF \$100,000 OR MORE**

(in thousands)	Amounts	Percentage
Three months or less	\$ 31,858	14%
Over three months through six months	36,177	16
Over six months through twelve months	75,503	34
Over twelve months	78,512	36
Total	\$ 222,050	100%

## CONTRACTUAL OBLIGATIONS

The Company has various financial obligations that may require future cash payments according to the terms of the obligations. Demand, both noninterest- and interest-bearing, and savings deposits are, generally, payable immediately upon demand at the request of the customer. Therefore, the contractual maturity of these obligations is presented in the following table as "less than one year." Time deposits, typically CDs, are customer deposits that are evidenced by an agreement between the Company and the customer that

specify stated maturity dates and early withdrawals by the customer are subject to penalties assessed by the Company. Short-term borrowings and long-term debt represent borrowings of the Company and have stated maturity dates. The Company is not a party to any material capital or operating leases as of December 31, 2006. The composition of the Company's contractual obligations as of December 31, 2006 is presented in the following table:

**TABLE TEN**  
**CONTRACTUAL OBLIGATIONS**

(in thousands)	Contractual Maturity in				Total
	Less than One Year	Between One and Three Years	Between Three and Five Years	Greater than Five Years	
Noninterest-bearing demand deposits	\$ 321,038	\$ –	\$ –	\$ –	\$ 321,038
Interest-bearing demand deposits <sup>(1)</sup>	428,207	–	–	–	428,207
Savings deposits <sup>(1)</sup>	326,111	–	–	–	326,111
Time deposits <sup>(1)</sup>	616,475	308,952	47,654	466	973,547
Short-term borrowings <sup>(1)</sup>	142,592	–	–	–	142,592
Long-term debt <sup>(1)</sup>	2,715	46,218	4,413	1,257	54,603
<b>Total Contractual Obligations</b>	<b>\$ 1,837,138</b>	<b>\$ 355,170</b>	<b>\$ 52,067</b>	<b>\$ 1,723</b>	<b>\$ 2,246,098</b>

<sup>(1)</sup> – Includes interest on both fixed- and variable-rate obligations. The interest associated with variable-rate obligations is based upon interest rates in effect at December 31, 2006. The contractual amounts to be paid on variable-rate obligations are affected by market interest rates that could materially affect the contractual amounts to be paid.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

## OFF –BALANCE SHEET ARRANGEMENTS

As disclosed in Note Sixteen of Notes to Consolidated Financial Statements, the Company has also entered into agreements to extend credit or provide conditional payments pursuant to standby and commercial letters of credit. While the outstanding commitment obligation is not recorded in the Company's financial statements, the estimated fair value, which is not material to the Company's financial statements, of the standby letters of credit is recorded in the Company's Consolidated Balance Sheets as of December 31, 2006 and 2005.

## CAPITAL RESOURCES

During 2006, Shareholders' Equity increased \$13.2 million, or 4.5%, from \$292.1 million at December 31, 2005, to \$305.3 million at December 31, 2006. This increase was due to reported net income of \$53.2 million for 2006 and a \$2.5 million increase in accumulated other comprehensive income that were partially offset by cash dividends declared during the year of \$19.7 million and common stock purchases of \$24.3 million.

During December 2006, the Board of Directors authorized the Company to buy back up to 1,000,000 shares of its common shares (approximately 5% of outstanding shares) in open market transactions at prices that are accretive to the earnings per share of continuing shareholders. No time limit was placed on the duration of the share repurchase program. During 2006, the Company acquired 666,753 shares of its common stock at an average price of \$36.45 per share. However, there can be no assurance that the Company will continue to reacquire its common shares or to what extent the repurchase program will be successful.

The \$2.5 million increase in accumulated other comprehensive income was primarily due to a \$2.2 million, net of tax, unrealized gain on the Company's available for sale investment securities (see Note Three of Notes to Consolidated Financial Statements) and a \$0.5 million, net of tax, decrease in underfunded pension obligations (see Note Fourteen of Notes to Consolidated Financial Statements). These increases were partially offset by a \$0.2 million, net of tax, unrealized loss on interest rate floors.

During 2005, Shareholders' Equity increased \$76.0 million, or 35.2%, from \$216.1 million at December 31, 2004, to \$292.1 million at December 31, 2005. This increase was primarily due to reported net income of \$50.3 million for 2005 and the issuance of 1,580,034 common shares, net of 108,373 common shares owned and transferred to treasury, for the acquisition of Class B shares that increased equity by \$54.3 million. These increases were partially offset by cash dividends declared during the year of \$17.7 million, common stock purchases of \$11.9 million, and a \$6.8 million reduction in accumulated other comprehensive income.

Regulatory guidelines require the Company to maintain a minimum total capital to risk-adjusted assets ratio of 8.00%, with at least one-half of capital consisting of tangible common shareholders' equity and a minimum Tier I leverage ratio of 4.00%. Similarly, City National is also required to maintain minimum capital levels as set forth by various regulatory agencies. Under capital adequacy guidelines, City National is required to maintain minimum total capital, Tier I capital, and leverage ratios of 8.00%, 4.00%, and 4.00%, respectively. To be classified as "well capitalized," City National must maintain total capital, Tier I capital, and leverage ratios of 10.00%, 6.00%, and 5.00%, respectively.

The Capital Securities issued by City Holding Capital Trust ("Trust I") qualify as regulatory capital for the Company under guidelines established by the Federal Reserve Board. The Company's regulatory capital ratios remained strong for both City Holding and City National as of December 31, 2006, as illustrated in the following table:

	Minimum	Well-Capitalized	Actual	
			December 31	
			2006	2005
<b>City Holding:</b>				
Total	8.00%	10.00%	<b>16.19%</b>	16.38%
Tier I Risk-based	4.00	6.00	<b>15.30</b>	15.41
Tier I Leverage	4.00	5.00	<b>10.79</b>	10.97
<b>City National:</b>				
Total	8.00%	10.00%	<b>13.42%</b>	13.99%
Tier I Risk-based	4.00	6.00	<b>12.53</b>	13.01
Tier I Leverage	4.00	5.00	<b>8.81</b>	9.24

In March 2005, the Federal Reserve Board issued a final rule that retains the inclusion of trust preferred securities in Tier 1 of capital of bank holding companies. After a five year transition period ending March 31, 2009, the aggregate amount of trust preferred securities and certain other capital elements, will be limited to 25% of Tier 1 capital elements, net of goodwill less associated deferred tax liability. Amounts of restricted core capital elements in excess of this limit generally may be included in Tier 2 capital.

## LEGAL ISSUES

The Company and City National are engaged in various legal actions in the ordinary course of business. As these legal actions are resolved, the Company or City National could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately decided. There can be no assurance that current actions will have immaterial results, either positive or negative, or that no material actions will be presented in the future.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS *(CONTINUED)*

## RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

Note One, "Recent Accounting Pronouncements," of Notes to Consolidated Financial Statements discusses recently issued new accounting pronouncements and their expected impact on the Company's consolidated financial statements.

## FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain forward-looking statements that are included pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such information involves risks and uncertainties that could cause the Company's actual results to differ from those projected in the forward-looking information. Important factors that could cause actual results to differ materially from those discussed in such forward-looking statements include, but are not limited to, (1) the Company may incur additional provision for loan losses due to negative credit quality trends in the future that may lead to a deterioration of asset quality; (2) the Company may incur increased charge-offs in the future; (3) the Company may experience increases in the default rates on previously securitized loans that would result in impairment losses or lower the yield on such loans; (4) the Company may continue to benefit from strong recovery efforts on previously securitized loans resulting in improved yields on this asset; (5) the Company could have adverse legal actions of a material nature; (6) the Company may face competitive loss of customers; (7) the Company may be unable to manage its expense levels; (8) the Company may have difficulty retaining key employees; (9) changes in the interest rate environment may have results on the Company's operations materially different from those anticipated by the Company's market risk management functions; (10) changes in general economic conditions and increased competition could adversely affect the Company's operating results; (11) changes in other regulations and government policies affecting bank holding companies and their subsidiaries, including changes in monetary policies, could negatively impact the Company's operating results; and (12) the Company may experience difficulties growing loan and deposit balances. Forward-looking statements made herein reflect management's expectations as of the date such statements are made. Such information is provided to assist stockholders and potential investors in understanding current and anticipated financial operations of the Company and is included pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances that arise after the date such statements are made.

# REPORT ON MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of City Holding Company is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements of City Holding Company have been prepared in accordance with U.S. generally accepted accounting principles and, necessarily include some amounts that are based on the best estimates and judgments of management.

The management of City Holding Company is responsible for establishing and maintaining adequate internal control over financial reporting that is designed to produce reliable financial statements in conformity with U.S. generally accepted accounting principles. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audits with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 based upon the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on our assessment, management believes that, as of December 31, 2006, the Company's system of internal control over financial reporting is effective based on those criteria. Ernst & Young, LLP, the Company's independent registered public accounting firm, has issued an attestation report on management's assessment of the Company's internal control over financial reporting. This report appears on page 23.

February 28, 2007



Charles R. Hageboeck  
President and Chief Executive Officer



David L. Bumgarner  
Chief Financial Officer

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Audit Committee of the Board of Directors and the Shareholders of City Holding Company

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control Over Financial Reporting, that City Holding Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). City Holding Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that City Holding Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, City Holding Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006 of City Holding Company and our report dated February 28, 2007 expressed an unqualified opinion thereon.

*Ernst & Young LLP*

Charleston, West Virginia  
February 28, 2007



# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON CONSOLIDATED FINANCIAL STATEMENTS

Audit Committee of the Board of Directors and the  
Shareholders of City Holding Company

We have audited the accompanying consolidated balance sheets of City Holding Company and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of City Holding Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of City Holding Company and subsidiaries at December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of City Holding Company's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2007 expressed an unqualified opinion thereon.

*Ernst & Young LLP*

Charleston, West Virginia  
February 28, 2007

# CONSOLIDATED BALANCE SHEETS

## CITY HOLDING COMPANY AND SUBSIDIARIES

(in thousands)	December 31	
	2006	2005
<b>Assets</b>		
Cash and due from banks	\$ 58,014	\$ 81,822
Interest-bearing deposits in depository institutions	27,434	4,451
Federal funds sold	25,000	—
<b>Cash and Cash Equivalents</b>	<b>110,448</b>	<b>86,273</b>
Investment securities available-for-sale, at fair value	472,398	549,966
Investment securities held-to-maturity, at amortized cost (approximate fair value at December 31, 2006 and 2005 - \$49,955 and \$58,892, respectively)	47,500	55,397
<b>Total Investment Securities</b>	<b>519,898</b>	<b>605,363</b>
Gross loans	1,677,469	1,612,827
Allowance for loan losses	(15,405)	(16,790)
<b>Net Loans</b>	<b>1,662,064</b>	<b>1,596,037</b>
Bank-owned life insurance	55,195	52,969
Premises and equipment	44,689	42,542
Accrued interest receivable	12,337	13,134
Net deferred tax assets	23,652	27,929
Intangible assets	58,857	59,559
Other assets	20,667	18,791
<b>Total Assets</b>	<b>\$ 2,507,807</b>	<b>\$ 2,502,597</b>
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing	\$ 321,038	\$ 376,076
Interest-bearing:		
Demand deposits	422,925	437,639
Savings deposits	321,075	302,571
Time deposits	920,179	812,134
<b>Total Deposits</b>	<b>1,985,217</b>	<b>1,928,420</b>
Short-term borrowings	136,570	152,255
Long-term debt	48,069	98,425
Other liabilities	32,644	31,356
<b>Total Liabilities</b>	<b>2,202,500</b>	<b>2,210,456</b>
<b>Shareholders' Equity</b>		
Preferred stock, par value \$25 per share: 500,000 shares authorized; none issued	—	—
Common stock, par value \$2.50 per share: 50,000,000 shares authorized; 18,499,282 shares issued at December 31, 2006 and 2005, including 1,009,095 and 395,465 shares in treasury, respectively	46,249	46,249
Capital surplus	104,043	104,435
Retained earnings	194,213	160,747
Cost of common stock in treasury	(33,669)	(11,278)
Accumulated other comprehensive income:		
Unrealized loss on securities available-for-sale	(2,649)	(4,839)
Unrealized loss on derivative instruments	(210)	—
Underfunded pension liability	(2,670)	(3,173)
<b>Total Accumulated Other Comprehensive Income</b>	<b>(5,529)</b>	<b>(8,012)</b>
<b>Total Shareholders' Equity</b>	<b>305,307</b>	<b>292,141</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 2,507,807</b>	<b>\$ 2,502,597</b>

See notes to consolidated financial statements.

# CONSOLIDATED STATEMENTS OF INCOME

## CITY HOLDING COMPANY AND SUBSIDIARIES

(in thousands, except per share data)	Year Ended December 31		
	2006	2005	2004
<b>Interest Income</b>			
Interest and fees on loans	\$ 123,945	\$ 103,714	\$ 86,099
Interest on investment securities:			
Taxable	28,418	29,804	30,110
Tax-exempt	1,782	1,887	1,809
Interest on loans held for sale	322	–	–
Interest on retained interests	–	–	808
Interest on deposits in depository institutions	1,477	109	52
Interest on federal funds sold	179	4	3
<b>Total Interest Income</b>	<b>156,123</b>	<b>135,518</b>	<b>118,881</b>
<b>Interest Expense</b>			
Interest on deposits	44,046	28,805	23,207
Interest on short-term borrowings	5,099	3,369	1,082
Interest on long-term debt	4,579	6,264	7,582
<b>Total Interest Expense</b>	<b>53,724</b>	<b>38,438</b>	<b>31,871</b>
<b>Net Interest Income</b>	<b>102,399</b>	<b>97,080</b>	<b>87,010</b>
Provision for loan losses	3,801	1,400	–
<b>Net Interest Income After Provision for Loan Losses</b>	<b>98,598</b>	<b>95,680</b>	<b>87,010</b>
<b>Noninterest Income</b>			
Investment securities (losses) gains	(1,995)	151	1,173
Service charges	42,559	39,091	32,609
Insurance commissions	2,335	2,352	2,733
Trust and investment management fee income	2,140	2,025	2,026
Bank-owned life insurance	2,352	2,779	2,931
Gain on sale of credit card portfolio	3,563	–	–
Net proceeds from litigation settlements	–	–	5,453
Other income	3,249	3,693	3,111
<b>Total Noninterest Income</b>	<b>54,203</b>	<b>50,091</b>	<b>50,036</b>
<b>Noninterest Expense</b>			
Salaries and employee benefits	34,484	33,479	34,245
Occupancy and equipment	6,481	6,295	5,984
Depreciation	4,219	4,096	3,932
Professional fees and litigation expense	1,760	2,021	3,265
Postage, delivery, and statement mailings	2,832	2,666	2,474
Advertising	3,216	2,941	2,366
Telecommunications	2,048	2,248	1,820
Bankcard expenses	1,964	2,137	1,501
Insurance and regulatory	1,528	1,496	1,323
Office supplies	1,578	1,193	1,048
Repossession asset (gains), net of expenses	(98)	(78)	(77)
Loss on early extinguishment of debt	1,368	–	263
Other expenses	9,905	10,619	8,189
<b>Total Noninterest Expense</b>	<b>71,285</b>	<b>69,113</b>	<b>66,333</b>
<b>Income Before Income Taxes</b>	<b>81,516</b>	<b>76,658</b>	<b>70,713</b>
Income tax expense	28,329	26,370	24,369
<b>Net Income</b>	<b>\$ 53,187</b>	<b>\$ 50,288</b>	<b>\$ 46,344</b>
Basic earnings per common share	\$ 3.00	\$ 2.87	\$ 2.79
Diluted earnings per common share	\$ 2.99	\$ 2.84	\$ 2.75
Dividends declared per common share	\$ 1.12	\$ 1.00	\$ 0.88
Average common shares outstanding:			
Basic	17,701	17,519	16,632
Diluted	17,762	17,690	16,882

See notes to consolidated financial statements.

# CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

## CITY HOLDING COMPANY AND SUBSIDIARIES

(in thousands)	Common Stock (Par Value)	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Shareholders' Equity
Balances at December 31, 2003	\$ 42,298	\$ 57,364	\$ 96,460	\$ 1,371	\$ (6,803)	\$ 190,690
Comprehensive income:						
Net income	—	—	46,344	—	—	46,344
Other comprehensive loss, net of deferred income tax benefit of \$1,678:						
Unrealized loss on securities of \$5,308, net of tax and reclassification adjustments for gains included in net income of \$1,173	—	—	—	(2,481)	—	(2,481)
Increase in underfunded pension liability of \$57, net of tax	—	—	—	(34)	—	(34)
Total comprehensive income						43,829
Cash dividends declared (\$0.88 per share)	—	—	(14,629)	—	—	(14,629)
Exercise of 140,730 stock options, including tax benefit of \$252	—	(1,852)	—	—	3,900	2,048
Purchase of 197,040 common shares for treasury	—	—	—	—	(5,858)	(5,858)
Balances at December 31, 2004	42,298	55,512	128,175	(1,144)	(8,761)	216,080
Comprehensive income:						
Net income	—	—	50,288	—	—	50,288
Other comprehensive loss, net of deferred income tax benefit of \$4,579:						
Unrealized loss on securities of \$10,049, net of tax and reclassification adjustments for losses included in net income of \$151	—	—	—	(6,120)	—	(6,120)
Increase in underfunded pension liability of \$1,247, net of tax	—	—	—	(748)	—	(748)
Total comprehensive income						43,420
Cash dividends declared (\$1.00 per share)	—	—	(17,716)	—	—	(17,716)
Issuance of 1,580,034 shares for acquisition of Classic Bancshares, net 108,173 shares owned and transferred to treasury	3,951	53,739	—	—	(3,351)	54,339
Issuance of 18,800 stock award shares	—	(422)	—	—	569	147
Exercise of 367,675 stock options, including tax benefit of \$4,124	—	(4,394)	—	—	12,177	7,783
Purchase of 342,576 common shares for treasury	—	—	—	—	(11,912)	(11,912)
Balances at December 31, 2005	\$ 46,249	\$ 104,435	\$ 160,747	\$ (8,012)	\$ (11,278)	\$ 292,141

See notes to consolidated financial statements.

# **CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY** *(CONTINUED)* CITY HOLDING COMPANY AND SUBSIDIARIES

<b>(in thousands)</b>	<b>Common Stock (Par Value)</b>	<b>Capital Surplus</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>Treasury Stock</b>	<b>Total Shareholders' Equity</b>
Balances at December 31, 2005	\$ 46,249	\$ 104,435	\$ 160,747	\$ (8,012)	\$(11,278)	\$ 292,141
Comprehensive income:						
Net income	—	—	53,187	—	—	53,187
Other comprehensive gain, net of deferred income tax benefit of \$1,655:						
Unrealized gain on securities of \$5,645, net of tax and reclassification adjustments for losses included in net income of \$1,995	—	—	—	2,190	—	2,190
Unrealized loss on interest rate floors of \$350, net of tax	—	—	—	(210)	—	(210)
Decrease in underfunded pension liability of \$838, net of tax	—	—	—	503	—	503
Total comprehensive income						55,670
Cash dividends declared (\$1.12 per share)	—	—	(19,721)	—	—	(19,721)
Issuance of 6,700 stock award shares, net	—	239	—	—	245	484
Exercise of 46,243 stock options	—	(900)	—	—	1,698	798
Excess tax benefit on stock-based compensation	—	269	—	—	—	269
Purchase of 666,753 common shares for treasury	—	—	—	—	(24,334)	(24,334)
Balances at December 31, 2006	\$ 46,249	\$ 104,043	\$ 194,213	\$ (5,529)	\$(33,669)	\$ 305,307

*See notes to consolidated financial statements.*

# CONSOLIDATED STATEMENTS OF CASH FLOWS

## CITY HOLDING COMPANY AND SUBSIDIARIES

(in thousands)	Year Ended December 31		
	2006	2005	2004
<b>Operating Activities</b>			
Net income	\$ 53,187	\$ 50,288	\$ 46,344
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization and accretion	(2,596)	1,740	1,572
Depreciation of premises and equipment	4,219	4,096	3,932
Provision for loan losses	3,801	1,400	—
Loss on early extinguishments of debt	1,368	—	263
Deferred income tax expense	2,516	3,435	3,990
Net periodic pension cost	246	49	—
Increase in retained interests	—	—	(802)
Increase in value of bank-owned life insurance	(2,352)	(2,779)	(2,931)
Proceeds from bank-owned life insurance	126	1,109	846
Gain from sale of credit card portfolio	(3,563)	—	—
Loss (gain) on sale of premises and equipment	15	(74)	89
Realized investment securities losses (gains)	1,995	(151)	(1,173)
Decrease (increase) in accrued interest receivable	797	(1,720)	348
Increase in other assets	(2,690)	(1,661)	(792)
Increase (decrease) in other liabilities	2,078	(3,359)	2,545
<b>Net Cash Provided by Operating Activities</b>	<b>59,147</b>	<b>52,373</b>	<b>54,231</b>
<b>Investing Activities</b>			
Proceeds from maturities and calls of securities held to maturity	7,667	4,068	4,963
Purchases of securities held-to-maturity	—	—	(5,701)
Proceeds from sale of money market and mutual fund available-for-sale securities	1,092,400	1,262,300	819,800
Purchases of money market and mutual fund available-for-sale securities	(1,093,411)	(1,296,750)	(747,500)
Proceeds from sales of securities available-for-sale	57,526	9,187	11,034
Proceeds from maturities and calls of securities available-for-sale	79,138	137,650	152,114
Purchases of securities available-for-sale	(57,650)	(12,329)	(215,098)
Net increase in loans	(75,475)	(27,855)	(17,417)
Redemption of asset-backed notes	—	—	(12,560)
Sales of premises and equipment	—	202	791
Purchases of premises and equipment	(6,381)	(4,501)	(4,081)
Proceeds from sale of credit card portfolio	13,920	—	—
Acquisition, net of cash received	—	(7,121)	—
<b>Net Cash Provided by (Used in) Investing Activities</b>	<b>17,734</b>	<b>64,851</b>	<b>(13,655)</b>
<b>Financing Activities</b>			
Net (decrease) increase in non-interest-bearing deposits	(55,038)	21,601	9,719
Net increase (decrease) in interest-bearing deposits	111,932	(18,038)	26,242
Net decrease in short-term borrowings	(38,406)	(53,416)	(78,220)
Proceeds from long-term debt	—	—	35,000
Repayment of long-term debt	(15,575)	(12,090)	(22,200)
Redemption of trust preferred securities	(13,002)	—	—
Purchases of treasury stock	(24,334)	(11,912)	(5,858)
Proceeds from stock options exercises	798	3,659	1,796
Excess tax benefits from stock-based compensation arrangements	269	—	—
Dividends paid	(19,350)	(16,839)	(14,309)
<b>Net Cash Used in Financing Activities</b>	<b>(52,706)</b>	<b>(87,035)</b>	<b>(47,830)</b>
<b>Increase (Decrease) in Cash and Cash Equivalents</b>	<b>24,175</b>	<b>30,189</b>	<b>(7,254)</b>
Cash and cash equivalents at beginning of year	86,273	56,084	63,338
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 110,448</b>	<b>\$ 86,273</b>	<b>\$ 56,084</b>

See notes to consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## CITY HOLDING COMPANY AND SUBSIDIARIES

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### NOTE ONE

#### SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

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**Summary of Significant Accounting and Reporting Policies:** The accounting and reporting policies of City Holding Company and its subsidiaries (the “Company”) conform with U. S. generally accepted accounting principles and require management to make estimates and develop assumptions that affect the amounts reported in the financial statements and related footnotes. Actual results could differ from management’s estimates. The following is a summary of the more significant policies.

**Principles of Consolidation:** The consolidated financial statements include the accounts of City Holding Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

The Company determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity in conformity with U. S. generally accepted accounting principles. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity’s activities. The Company consolidates voting interest entities in which it has all, or at least a majority of, the voting interest. As defined in applicable accounting standards, variable interest entities (VIEs) are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in an entity is present when an enterprise has a variable interest, or a combination of variable interests, that will absorb a majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, or both. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE. The Company’s wholly owned subsidiaries, City Holding Capital Trust, is a VIE for which the Company is not the primary beneficiary. Accordingly, the accounts of this entity are not included in the Company’s consolidated financial statements.

**Description of Principal Markets and Services:** The Company is a bank holding company headquartered in Charleston, West Virginia, and conducts its principal activities through its wholly-owned subsidiary, City National Bank of West Virginia (“City National”). City National is a retail and consumer-oriented community bank with 67 offices in West Virginia, Kentucky, and Ohio. Principal activities include providing deposit, credit, trust and investment management,

and insurance related products and services. The Company conducts its business activities through one reportable business segment - community banking.

**Cash and Due from Banks:** The Company considers cash, due from banks, and interest-bearing federal deposits in depository institutions as cash and cash equivalents.

**Securities:** Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold debt securities to maturity, they are classified as investment securities held-to-maturity and are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts. Debt securities for which the Company does not have the intent or ability to hold to maturity are classified as investment securities available-for-sale along with the Company’s investment in equity securities. Securities available-for-sale are carried at fair value, with the unrealized gains and losses, net of tax, reported in comprehensive income. Securities classified as available-for-sale include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in interest rates, resultant prepayment risk, and other factors.

The specific identification method is used to determine the cost basis of securities sold.

**Loans:** Loans, excluding previously securitized loans, which are discussed separately below, are reported at the principal amount outstanding, net of unearned income.

Interest income on loans is accrued and credited to operations based upon the principal amount outstanding, using methods that generally result in level rates of return. Loan origination fees, and certain direct costs, are deferred and amortized as an adjustment to the yield over the term of the loan. The accrual of interest income generally is discontinued when a loan becomes 90 days past due as to principal or interest. Other indicators considered for placing a loan on non-accrual status include the borrower’s involvement in bankruptcies, foreclosures, repossessions, litigation and any other situation resulting in doubt as to whether full collection of contractual principal and interest is attainable. When interest accruals are discontinued, unpaid interest recognized in income in the current year is reversed, and interest accrued in prior years is charged to the allowance for loan losses. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral exceeds the principal balance and related accrued interest, and the loan is in process of collection.

Interest income during the period the loan is non-performing is recorded on a cash basis after recovery of principal is reasonably assured. Cash payments received on



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(CONTINUED)*

## CITY HOLDING COMPANY AND SUBSIDIARIES

nonperforming loans are typically applied directly against the outstanding principal balance until the loan is fully repaid. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

Residential and home equity loans are generally subject to charge-off when the loan becomes 120 days past due, depending on the estimated fair value of the collateral less cost to dispose, versus the outstanding loan balance. Unsecured commercial loans are generally charged off when the loan becomes 120 days past due. Secured commercial loans are generally evaluated for charge-off when the loan becomes 180 days past due. Closed-end consumer loans are generally charged off when the loan becomes 120 days past due and open-end consumer loans are generally charged off when the loan becomes 180 days past due.

**Retained Interests:** When the Company sold certain receivables in securitizations of high loan-to-value loans, it retained a financial interest in the securitizations. Because quoted market prices were not readily available for retained interests, the Company estimated their fair values using cash flow modeling techniques that incorporated management's best estimates of key assumptions—loan default rates, loan prepayment rates, and discount rates commensurate with the risks involved.

The Company recognized the excess cash flows attributable to the retained interests over the carrying value of the retained interests as interest income over the life of the retained interests using the effective yield method. The Company held no retained interests at December 31, 2006 and 2005.

**Previously Securitized Loans:** Amounts reported in Note Four of Notes to Consolidated Financial Statements as "previously securitized loans" represent the carrying value of loans beneficially owned by the Company as a result of having fully redeemed the obligations owed to investors ("notes") in certain of the Company's securitization transactions. The loans were recorded at the lower of fair value or their carrying values, which was the carrying value of the related retained interest asset underlying the securitization plus amounts remitted by the Company to the noteholders to redeem the notes. Because the carrying value of the retained interests incorporated assumptions with regard to expected prepayment and default rates on the loans and also considered the expected timing and amount of cash flows to be received by the Company, the carrying value of the retained interests and the carrying value of the loans was less than the actual outstanding balance of the loans. No gain or loss was recognized in the Company's financial statements upon recording the loans into the Company's loan portfolio and, as

a result, the loans are recorded at a discount to their actual outstanding balances.

The Company is accounting for the difference between the carrying value and the expected cash flows from these loans as an adjustment of the yield on the loans over their remaining lives. The discount is accreted to income over the period during which payments are probable of collection and are reasonably estimable.

The excess of expected cash flows over contractual cash flows is recognized prospectively through an adjustment to the yield over the remaining lives of the loans. If upon evaluation of estimated collections and collections to date, the estimated total amount of collections is reduced below the original value of the loans, the loans are considered impaired for further evaluation.

**Allowance for Loan Losses:** The allowance for loan losses is maintained at a level that represents management's best estimate of probable losses in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses is based upon an evaluation of individual credits in the loan portfolio, historical loan loss experience, current economic conditions, and other relevant factors. This determination is inherently subjective, as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. These evaluations are conducted at least quarterly and more frequently if deemed necessary. The allowance for loan losses related to loans considered to be impaired is generally evaluated based on the discounted cash flows using the impaired loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. Loan losses are charged against the allowance and recoveries of amounts previously charged are credited to the allowance. A provision for loan losses is charged to operations based on management's periodic evaluation of the adequacy of the allowance after considering factors noted above, among others.

In evaluating the adequacy of its allowance for loan losses, the Company stratifies the loan portfolio into seven major groupings, including commercial real estate, other commercial, residential real estate, home equity, and others. Historical loss experience, as adjusted, is applied to the then outstanding balance of loans in each classification to estimate probable losses inherent in each segment of the portfolio. Historical loss experience is adjusted using a systematic weighted probability of potential risk factors that could result in actual losses deviating from prior loss experience. Risk factors considered by the Company in completing this analysis include: (1) unemployment and economic trends in the Company's markets, (2) concentrations of credit, if any, among any industries, (3) trends in loan growth, loan mix, delinquencies, losses or credit impairment, (4) adherence to

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

lending policies and others. Each risk factor is designated as low, moderate/increasing, or high based on the Company's assessment of the risk to loss associated with each factor. Each risk factor is then weighted to consider probability of occurrence.

Additionally, all loans within the portfolio are subject to internal risk grading. Risk grades are generally assigned by the primary lending officer and are periodically evaluated by the Company's internal loan review process. Based on an individual loan's risk grade, estimated loss percentages are applied to the outstanding balance of the loan to determine the amount of probable loss.

**Premises and Equipment:** Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily by the straight-line method over the estimated useful lives of the assets. Depreciation of leasehold improvements is computed using the straight-line method over the lesser of the term of the respective lease or the estimated useful life of the respective asset. Maintenance and repairs are charged to expense as incurred, while improvements that extend the useful life of premises and equipment are capitalized and depreciated over the estimated remaining life of the asset.

**Goodwill and Other Intangible Assets:** Goodwill is the excess of the cost of an acquisition over the fair value of tangible and intangible assets acquired. Goodwill is not amortized. Intangible assets represent purchased assets that also lack physical substance, but can be separately distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Intangible assets with determinable useful lives, such as core deposits, are amortized over their estimated useful lives.

The Company performs an annual review for impairment in the recorded value of goodwill and indefinite lived intangible assets. Goodwill is tested for impairment between the annual tests if an event occurs or circumstances change that more than likely reduce the fair value of a reporting unit below its carrying value. An indefinite-lived intangible asset is tested for impairment between the annual tests if an event occurs or circumstances change indicating that the asset might be impaired.

**Derivative Financial Instruments:** The Company enters into derivative transactions principally to protect against the risk of adverse price or interest rate movements on the value of certain assets and liabilities and on future cash flows. All derivative instruments are carried at fair value on the balance sheet. The change in the fair value of the hedged item related to the risk being hedged is recognized in earnings in the same

period and in the same income statement caption as the change in the fair value of the derivative. The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking each hedge transaction.

Derivative instruments designated in a hedge relationship to mitigate exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. The Company has not entered into any fair value hedges as of December 31, 2006. Derivative instruments designated in a hedge relationship to mitigate exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

Cash flow hedges are accounted for by recording the fair value of the derivative instrument on the balance sheet as either a freestanding asset or liability, with a corresponding offset recorded in other comprehensive income within shareholders' equity, net of income taxes. Amounts are reclassified from other comprehensive income to the income statement in the period or periods the hedged forecasted transaction affects earnings.

For the Company's cash flow hedges, derivative gains and losses not effective in hedging the change in fair value or expected cash flows of the hedged item are recognized immediately in the income statement. At the hedge's inception and at least quarterly thereafter, a formal assessment is performed to determine whether changes in the fair values or cash flows of the derivative instruments have been highly effective in offsetting changes in the fair values or cash flows of the hedged items and whether they are expected to be highly effective in the future. If it is determined a derivative instrument has not been or will not continue to be highly effective as a hedge, hedge accounting is discontinued.

**Income Taxes:** The consolidated provision for income taxes is based upon reported income and expense. Deferred income taxes are provided for temporary differences between financial reporting and tax bases of assets and liabilities, computed using enacted tax rates. The Company files a consolidated income tax return. The respective subsidiaries generally provide for income taxes on a separate return basis and remit amounts determined to be currently payable to the Parent Company.

**Advertising Costs:** Advertising costs are expensed as incurred.

**Stock-Based Compensation:** On January 1, 2006, the Company adopted SFAS No. 123R, "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock Issued for Employees." SFAS No. 123R establishes accounting requirements for share-based compensation to

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

employees and carries forward prior guidance on accounting for awards to non-employees. Prior to the adoption of SFAS No. 123R, the Company reported no compensation expense on options granted as the exercise price of the options granted always equaled the market price of the underlying stock on the date of grant. SFAS No. 123R requires that such transactions be recognized as compensation expense in the income statement based on their fair values on the measurement date, which is generally the date of the grant, and be expensed over the applicable vesting period.

The Company transitioned to SFAS No. 123R using the modified prospective application method ("modified prospective application"). As permitted under modified prospective application, as it is applicable to the Company, SFAS No. 123R applies to new awards and to awards modified, repurchased, or cancelled after January 1, 2006. Additionally, compensation cost for non-vested awards that were outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered during the period of and/or the periods after the adoption of SFAS No. 123R, adjusted for estimated forfeitures. The recognition of compensation cost for those earlier awards is based on the same method and on the same grant-date fair values previously determined for the pro forma disclosures reported by the Company for periods prior to January 1, 2006. There was no material impact on the Company's income before income taxes and net income from the adoption of SFAS No. 123R. Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Consolidated Statements of Cash Flows. SFAS No. 123R requires the cash flows from the tax benefits resulting from tax deductions in excess of the compensation expense recognized for those options to be classified as financing cash flows. An excess tax benefit totaling \$0.3 million is classified as a financing cash inflow for the year ended December 31, 2006.

SFAS No. 123R requires pro forma disclosures of net income and earnings per share for all periods prior to the adoption of the fair value accounting method for stock-based employee compensation. The pro forma disclosures presented in Note Fourteen — Employee Benefit Plans use the fair value method of SFAS 123R to measure compensation expense for stock-based employee compensation plans for years prior to 2006.

**Basic and Diluted Earnings per Common Share:** Basic earnings per share is computed by dividing net income by the weighted-average number of shares of common stock outstanding. Diluted earnings per share is computed by dividing net income by the weighted-average number of shares outstanding increased by the number of shares of common stock which would be issued assuming the exercise of stock options and other common stock equivalents. The

incremental shares related to stock options were 61,000, 171,000, and 250,000 in 2006, 2005, and 2004, respectively.

**Recent Accounting Pronouncements:** In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3" (SFAS No. 154). The new standard changes the requirements for the accounting for and reporting of a change in accounting principle. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements be termed a "restatement." The new standard was effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this standard had no effect on the Company's financial statements.

In September 2006, the FASB issued Statement No. 157, "Fair Value Measurements" (SFAS No. 157). SFAS No. 157 replaces various definitions of fair value in existing accounting literature with a single definition, establishes a framework for measuring fair value in generally accepted accounting principles, and requires additional disclosures about fair value measurements. SFAS No. 157 does not expand the use of fair value to any new circumstances. SFAS No. 157 is effective for fiscal years ending after November 15, 2007, and early application is encouraged. The Company does not anticipate that the adoption of this statement will have a material effect on its financial statements.

In September 2006, the FASB issued Statement No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS No. 158), an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires recognition of the funded status (the difference between the fair value of the plan assets and the benefit obligation) of a benefit plan as an asset or liability in the employers' financial statements, requires the measurement of benefit plan assets and obligations as of the end of the employer's fiscal year-end, and requires recognition of the funded status of a benefit plan in other comprehensive income in the year in which the changes occur. The Company adopted the recognition and disclosure provisions of SFAS No. 158 on December 31, 2006. The Company had previously recognized the funded status of its defined benefit plan in prior financial statements and the adoption of SFAS No. 158 did not have a material effect on the Company's financial statements. The requirement to measure the plan assets and benefit obligation as of the date of the employers' fiscal year-end

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

financial statements is effective for fiscal years ending after December 15, 2008 and the Company does not anticipate that the adoption of this part of the statement will have a material effect on its financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting and disclosure for uncertain tax positions, as defined. FIN 48 requires that a tax position meet a "probable recognition threshold" for the benefit of the uncertain tax position to be recognized in the financial statements. A tax position that fails to meet the probable recognition threshold will result in either reduction of a current or deferred tax asset or receivable, or recording a current or deferred tax liability. FIN 48 also provides guidance on measurement, derecognition of tax benefits, classification, interim period accounting disclosure, and transition requirements in accounting for uncertain tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company will be required to apply the provisions of FIN 48 to all tax positions upon initial adoption with any cumulative effect adjustment to be recognized as an adjustment to retained earnings. While the ultimate impact of adoption is uncertain, the Company does not anticipate that the adoption of this statement will have a material effect on its financial statements.

**Statements of Cash Flows:** Cash paid for interest, including interest paid on long-term debt and trust preferred securities, was \$53.5 million, \$37.9 million, and \$31.8 million in 2006, 2005, and 2004, respectively. During 2006, 2005 and 2004, the Company paid \$22.9 million, \$20.6 million, and \$19.5 million, respectively, for income taxes.

## NOTE TWO

### RESTRICTIONS ON CASH AND DUE FROM BANKS

City National is required to maintain an average reserve balance with the Federal Reserve Bank of Richmond to compensate for services provided by the Federal Reserve and to meet statutory required reserves for demand deposits. The average amount of the reserve balance for the year ended December 31, 2006 was approximately \$14.0 million.

## NOTE THREE

### INVESTMENTS

The aggregate carrying and approximate market values of securities follow. Fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable financial instruments.

	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
Securities available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 247	\$ -	\$ (3)	\$ 244
Obligations of states and political subdivisions	40,322	330	(204)	40,448
Mortgage-backed securities	325,601	331	(5,126)	320,806
Other debt securities	51,985	485	(153)	52,317
<b>Total Debt Securities</b>	<b>418,155</b>	<b>1,146</b>	<b>(5,486)</b>	<b>413,815</b>
Equity securities and investment funds	58,634	-	(51)	58,583
<b>Total Securities Available-for-Sale</b>	<b>\$ 476,789</b>	<b>\$ 1,146</b>	<b>\$ (5,537)</b>	<b>\$ 472,398</b>
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 5,708	\$ 74	\$ -	\$ 5,782
Other debt securities	41,792	2,453	(72)	44,173
<b>Total Securities Held-to-Maturity</b>	<b>\$ 47,500</b>	<b>\$ 2,527</b>	<b>\$ (72)</b>	<b>\$ 49,955</b>

	December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
Securities available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 246	\$ -	\$ (3)	\$ 243
Obligations of states and political subdivisions	44,180	275	(421)	44,034
Mortgage-backed securities	400,443	226	(8,459)	392,210
Other debt securities	51,088	535	(190)	51,433
<b>Total Debt Securities</b>	<b>495,957</b>	<b>1,036</b>	<b>(9,073)</b>	<b>487,920</b>
Equity securities and investment funds	62,085	-	(39)	62,046
<b>Total Securities Available-for-Sale</b>	<b>\$ 558,042</b>	<b>\$ 1,036</b>	<b>\$ (9,112)</b>	<b>\$ 549,966</b>
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 8,333	\$ 98	\$ -	\$ 8,431
Other debt securities	47,064	3,455	(58)	50,461
<b>Total Securities Held-to-Maturity</b>	<b>\$ 55,397</b>	<b>\$ 3,553</b>	<b>\$ (58)</b>	<b>\$ 58,892</b>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

Certain investment securities owned by the Company were in an unrealized loss position (i.e., amortized cost basis exceeded the estimated fair value of the securities) as of December 31, 2006 and 2005. The following table shows the

gross unrealized losses and fair value of the Company's investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2006 and 2005.

(in thousands)	December 31, 2006					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
<b>Securities available-for-sale:</b>						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ -	\$ -	\$ 244	\$ 3	\$ 244	\$ 3
Obligations of states and political subdivisions	2,790	6	14,673	198	17,643	204
Mortgage-backed securities	28,057	90	245,889	5,036	273,946	5,126
Other debt securities	11,414	64	3,546	89	14,960	153
Equity securities and investment funds	1,449	51	-	-	1,449	51
<b>Total</b>	<b>\$ 43,710</b>	<b>\$ 211</b>	<b>\$ 264,352</b>	<b>\$ 5,326</b>	<b>\$ 308,242</b>	<b>\$ 5,537</b>
<b>Securities held-to-maturity:</b>						
Other debt securities	\$ 2,348	\$ 37	\$ 1,088	\$ 35	\$ 3,436	\$ 72

(in thousands)	December 31, 2005					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
<b>Securities available-for-sale:</b>						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 243	\$ 3	\$ -	\$ -	\$ 243	\$ 3
Obligations of states and political subdivisions	20,195	323	3,822	98	24,017	421
Mortgage-backed securities	184,448	3,167	185,791	5,292	370,239	8,459
Other debt securities	13,624	86	3,480	104	17,104	190
Equity securities and investment funds	-	-	1,461	39	1,461	39
<b>Total</b>	<b>\$ 218,510</b>	<b>\$ 3,579</b>	<b>\$ 194,554</b>	<b>\$ 5,533</b>	<b>\$ 413,064</b>	<b>\$ 9,112</b>
<b>Securities held-to-maturity:</b>						
Other debt securities	\$ 2,344	\$ 5	\$ 1,085	\$ 53	\$ 3,429	\$ 58

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary would be reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Company will receive full value for the securities. Furthermore, as of December 31, 2006, management also had the ability and intent to hold the

securities classified as available for sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of December 31, 2006, management believes the unrealized losses detailed in the table above are temporary and no impairment loss has been recognized in the Company's consolidated income statement.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

The amortized cost and estimated fair value of debt securities at December 31, 2006, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. Mortgage-backed securities have been allocated to their respective maturity groupings based on their contractual maturity.

(in thousands)	Cost	Estimated Fair Value
<b>Securities Available-for-Sale</b>		
Due in one year or less	\$ 2,778	\$ 2,778
Due after one year through five years	12,180	12,104
Due after five years through ten years	30,349	30,396
Due after ten years	372,848	368,537
	<u>\$ 418,155</u>	<u>\$ 413,815</u>

<b>Securities Held-to-Maturity</b>		
Due in one year or less	\$ 1,343	\$ 1,351
Due after one year through five years	4,056	4,119
Due after five years through ten years	309	312
Due after ten years	41,792	44,173
	<u>\$ 47,500</u>	<u>\$ 49,955</u>

Gross gains and gross losses realized by the Company from investment security transactions are summarized in the table below:

(in thousands)	2006	2005	2004
Gross realized gains	\$ 154	\$ 154	\$ 1,173
Gross realized losses	(2,149)	(3)	-
Investment security gains (losses)	<u>\$ (1,995)</u>	<u>\$ 151</u>	<u>\$ 1,173</u>

The carrying value of securities pledged to secure public deposits and for other purposes as required or permitted by law approximated \$167.7 million and \$146.8 million at December 31, 2006 and 2005, respectively.

### NOTE FOUR LOANS

The following summarizes the Company's major classifications for loans:

(in thousands)	2006	2005
Real estate – mortgage	\$ 598,502	\$ 592,521
Home equity	321,708	301,728
Commercial, financial, and agriculture	698,719	629,670
Installment loans to individuals	42,943	58,652
Previously securitized loans	15,597	30,256
Gross Loans	<u>1,677,469</u>	<u>1,612,827</u>
Allowance for loan losses	(15,405)	(16,790)
Net Loans	<u>\$ 1,662,064</u>	<u>\$ 1,596,037</u>

The Company's commercial and residential real estate construction loans are primarily secured by real estate within the Company's principal markets. These loans were originated under the Company's loan policy, which is focused on the risk characteristics of the loan portfolio, including construction loans. Adequate consideration has been given to these loans in establishing the Company's allowance for loan losses.

### NOTE FIVE ALLOWANCE FOR LOAN LOSSES

A summary of changes in the allowance for loan losses follows:

(in thousands)	2006	2005	2004
Balance at January 1	\$ 16,790	\$ 17,815	\$ 21,426
Allowance from acquisition	-	3,265	-
Reduction of allowance for loans sold	(1,368)	-	-
Provision for possible loan losses	3,801	1,400	-
Charge-offs	(6,935)	(8,459)	(7,889)
Recoveries	3,117	2,769	4,278
Balance at December 31	<u>\$ 15,405</u>	<u>\$ 16,790</u>	<u>\$ 17,815</u>

The recorded investment in loans on nonaccrual status and loans past due 90 days or more and still accruing interest is included in the following table:

(in thousands)	2006	2005
Nonaccrual loans	\$ 3,319	\$ 2,785
Accruing loans past due 90 days or more	635	1,124
Previously securitized loans past due 90 days or more	48	268
Total	<u>\$ 4,002</u>	<u>\$ 4,177</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

Information pertaining to impaired loans is included in the following table:

(in thousands)	2006	2005
Impaired loans with a valuation allowance	\$ 3,954	\$ 3,909
Impaired loans with no valuation allowance	48	268
Total impaired loans	\$ 4,002	\$ 4,177
Allowance for loan losses allocated to impaired loans	\$ 1,076	\$ 1,275

The average recorded investment in impaired loans during 2006, 2005, and 2004 was \$3.8 million, \$3.6 million, and \$4.2 million, respectively.

### NOTE SIX

#### PREVIOUSLY SECURITIZED LOANS

Between 1997 and 1999, the Company completed six securitization transactions involving approximately \$759.8 million of fixed rate, junior lien mortgage loans. As described in Note One, the Company retained a financial interest in each of the securitizations until 2004. Principal amounts owed to investors were evidenced by securities ("Notes"). During 2003 and 2004, the Company exercised its early redemption options on each of those securitizations. Once the Notes were redeemed, the Company became the beneficial owner of the mortgage loans and recorded the loans as assets of the Company within the loan portfolio. The table below summarizes information regarding delinquencies, net credit losses, and outstanding collateral balances of previously securitized loans for the dates presented:

	December 31		
(in thousands)	2006	2005	2004
Total principal amount of loans outstanding	\$ 33,334	\$ 48,061	\$ 75,038
Discount	(17,737)	(17,805)	(16,602)
Net book value	\$ 15,597	\$ 30,256	\$ 58,436
Principal amount of loans between 30 and 89 days past due	\$ 1,062	\$ 1,848	\$ 5,091
Principal amount of loans between 90 and 119 days past due	48	268	832
Net credit (recoveries) losses during the year	(4,124)	(3,225)	2,680

Because the book value of the mortgage loans incorporates assumptions for expected cash flows considering prepayment and default rates, the carrying value of the loans is generally less than the actual contractual outstanding balance of the mortgage loans. As of December 31, 2006 and 2005, the Company reported a book value of previously securitized loans of \$15.6 million and \$30.3 million, respectively, while

the actual outstanding balance of previously securitized loans at December 31, 2006 and 2005, was \$33.3 million and \$48.1 million, respectively. The difference ("the discount") between the book value and actual outstanding balance of previously securitized loans is accreted into interest income over the life of the loans. Through December 31, 2004, net credit losses on previously securitized loans were first recorded against this discount and, therefore, impacted the yield earned on these assets. Effective January 1, 2005, the Company adopted the provisions of SOP 03-3 as required. In accordance with SOP 03-3, if the discounted present value of estimated future cash flows declines below the recorded value of previously securitized loans, an impairment charge would be provided through the Company's provision and allowance for loan losses. No such impairment charges were recorded for the years ending December 31, 2006 and 2005.

Key assumptions used in estimating the value of the Company's previously securitized loans as of December 31, 2006 and 2005, were as follows:

	December 31	
	2006	2005
Prepayment speed (CPR):		
From January 2006 – December 2006	–	30%
From January 2007 – September 2007	17%	30%
From September 2007 – December 2007	17%	20%
From January 2008 – December 2008	13%	20%
From January 2009 – December 2009	9%	20%
From January 2010 – December 2010	8%	20%
Thereafter	5%	20%
Weighted-average cumulative defaults	10.19%	10.54%

Prepayment speed, or constant prepayment rate (CPR), represents the annualized monthly prepayment amount as a percentage of the previous month's outstanding loan balance minus the scheduled principal payment. Weighted-average cumulative defaults represent actual loan defaults experienced life-to-date plus forecasted loan defaults projected over the remaining life of the collateral loans, divided by the original collateral balance.

Interest income on previously owned retained interests was recognized over the life of the retained interest using the effective yield method. The Company recognized \$0.8 million of interest income from the retained interests in 2004. The Company received no cash on this asset during 2004. During 2006, 2005, and 2004 the Company recognized \$9.4 million, \$11.4 million, and \$13.7 million, respectively, of interest income on the previously securitized loans and received cash of \$24.2 million, \$39.3 million, and \$61.5 million, respectively, comprised of principal and interest payments received from borrowers.



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

### NOTE SEVEN PREMISES AND EQUIPMENT

A summary of premises and equipment and related accumulated depreciation as of December 31 is summarized as follows:

(in thousands)	Estimated Useful Life	2006	2005
Land		\$ 12,007	\$ 11,015
Buildings and improvements	10 to 30 yrs.	59,330	55,581
Equipment	3 to 7 yrs.	39,615	39,707
		<u>110,952</u>	<u>106,303</u>
Less accumulated depreciation		(66,263)	(63,761)
Net premises and equipment		<u>\$ 44,689</u>	<u>\$ 42,542</u>

### NOTE EIGHT GOODWILL AND INTANGIBLE ASSETS

The carrying amount of goodwill approximated \$54.9 million at both December 31, 2006 and 2005. During the second quarter of 2005, the Company recorded goodwill totaling \$49.4 million in connection with the acquisition of Classic Bancshares. The Company completed its annual assessment of the carrying value of goodwill during 2006 and concluded that its carrying value was not impaired.

During the second quarter of 2005, the Company recorded core deposit intangibles totaling \$4.4 million in connection with the acquisition of Classic Bancshares. The following table summarizes core deposit intangibles as of December 31, 2006 and 2005, which are subject to amortization:

(in thousands)	2006	2005
Gross carrying amount	\$ 6,580	\$ 6,580
Accumulated amortization	(2,646)	(1,923)
Net core deposit intangible	<u>\$ 3,934</u>	<u>\$ 4,657</u>

During 2006, 2005, and 2004, the Company recognized pre-tax amortization expense of \$723,000, \$512,000, and \$204,000, respectively, associated with its core deposit intangible assets. The estimated amortization expense for core deposit intangible assets for each of the next five years is as follows:

(in thousands)	Projected Amortization Expense
2007	\$ 706
2008	637
2009	469
2010	437
2011	409
	<u>\$ 2,658</u>

### NOTE NINE SCHEDULED MATURITIES OF TIME DEPOSITS

Scheduled maturities of time deposits outstanding at December 31, 2006 are summarized as follows:

(in thousands)	
2007	\$ 579,617
2008	229,560
2009	64,965
2010	33,470
2011	12,122
Over five years	445
Total	<u>\$ 920,179</u>

Scheduled maturities of time deposits of \$100,000 or more outstanding at December 31, are summarized as follows:

(in thousands)	2006	2005
Within one year	\$ 143,538	\$ 78,445
Over one through two years	53,849	43,427
Over two through three years	13,945	34,658
Over three through four years	7,798	16,149
Over four through five years	2,623	9,478
Over five years	297	329
Total	<u>\$ 222,050</u>	<u>\$ 182,486</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

### NOTE TEN SHORT-TERM BORROWINGS

A summary of short-term borrowings are as follows:

(dollars in thousands)	2006	2005	2004
Balance at end of year:			
Securities repurchase agreements	\$ 115,675	\$ 76,443	\$ 70,183
Federal funds borrowed	20,895	75,812	75,000
<b>Total</b>	<b>\$ 136,570</b>	<b>\$ 152,255</b>	<b>\$ 145,183</b>
Avg. outstanding during the year:			
Securities repurchase agreements	\$ 98,116	\$ 81,638	\$ 79,385
FHLB advances and Federal funds borrowed	45,589	75,626	41,464
Max. outstanding at any month end:			
Securities repurchase agreements	115,674	105,303	106,171
FHLB advances and Federal funds borrowed	67,334	84,763	75,000
Weighted-average interest rate:			
During the year:			
Securities repurchase agreements	3.95%	1.98%	0.42%
FHLB advances and Federal funds borrowed	2.69%	2.32%	1.81%
End of the year:			
Securities repurchase agreements	4.43%	2.89%	0.79%
FHLB advances and Federal funds borrowed	3.40%	2.83%	2.09%

### NOTE ELEVEN LONG-TERM DEBT

The components of long-term debt are summarized as follows:

(in thousands)	Maturity	Weighted-Average Interest Rate	2006	2005
FHLB Advances	2007	3.38%	\$ -	\$ 23,710
FHLB Advances	2008	3.66%	26,193	38,178
FHLB Advances	2009	5.75%	2,003	2,003
FHLB Advances	2010	6.30%	2,000	2,000
FHLB Advances	2011	4.90%	193	3,698
FHLB Advances	>5 years	5.38%	844	-
Junior subordinated debentures owed to City Holding Capital Trust	2028	9.15%	16,836	28,836
<b>Total Long-term debt</b>			<b>\$ 48,069</b>	<b>\$ 98,425</b>

Through City National, the Company has purchased 51,917 shares of Federal Home Loan Bank ("FHLB") stock at par value as of December 31, 2006. Such purchases entitle the Company to dividends declared by the FHLB and provide an additional source of short-term and long-term funding, in the form of collateralized advances. Financing obtained from the FHLB is based, in part, on the amount of qualifying collateral available, specifically U.S. Treasury and agency securities, mortgage-backed securities, and residential real estate loans.

At December 31, 2006 and 2005, collateral pledged to the FHLB included approximately \$229.7 million and \$629.0 million, respectively, in investment securities and one-to-four-family residential property loans. Therefore, in addition to the short-term (see Note Ten) and long-term financing discussed above, at December 31, 2006 and 2005, City National had an additional \$177.7 million and \$483.8 million, respectively, available from unused portions of lines of credit with the FHLB.

The Company formed a statutory business trust, City Holding Capital Trust, under the laws of the state of Delaware ("the Capital Trust"). The Capital Trust was created for the exclusive purpose of (i) issuing trust preferred capital securities ("Capital Securities"), which represent preferred undivided beneficial interests in the assets of the trusts, (ii) using the proceeds from the sale of the Capital Securities to acquire junior subordinated debentures ("Debentures") issued by the Company, and (iii) engaging in only those activities necessary or incidental thereto. The trust is considered a variable interest entity for which the Company is not the primary beneficiary. Accordingly, the accounts of the trust are not included in the Company's consolidated financial statements (see Note 1).

Distributions on the Debentures are cumulative. The Company has the option to defer payment of the distributions for an extended period up to five years, so long as the Company is not in default as to the terms of the Debentures. The Debentures, which have a stated interest rate of 9.15% and require semi-annual interest payments, mature in April 2028. The Debentures are redeemable prior to maturity at the option of the Company (i) on or after April 1, 2008, in whole at any time or in part from time-to-time, at declining redemption prices ranging from 104.58% to 100.00% on April 1, 2018, and thereafter, or (ii) in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of certain pre-defined events.

Payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities are guaranteed by the Company. The Company also entered into an agreement as to expenses and liabilities with the trust pursuant to which it agreed, on a subordinated basis, to pay any costs, expenses or liabilities of the trust other than those arising under the trust preferred securities. The obligations of the Company under the junior subordinated debentures, the related indentures, the trust agreement establishing the trust, the guarantees and the agreements as to expenses and liabilities, in the aggregate, constitute a full and unconditional guarantee by the Company of the trust's obligations under the trust preferred securities.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

The Capital Securities issued by the statutory business trusts qualify as Tier 1 capital for the Company under the Federal Reserve Board guidelines. In March 2005, the Federal Reserve Board issued a final rule that allows the inclusion of trust preferred securities issued by unconsolidated subsidiary trusts in Tier 1 capital, but with stricter limits. Under the ruling, after a five-year transition period, the aggregate amount of trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill. The amount of trust preferred securities and certain other elements in excess of the limit could be included in Tier 2 capital, subject to restrictions. The Company expects to include all of its \$16.0 million in trust preferred securities in Tier 1 capital after the transition period. The trust preferred securities could be redeemed without penalty if they were no longer permitted to be included in Tier 1 capital.

### NOTE TWELVE DERIVATIVE INSTRUMENTS

The Company utilizes interest rate floors to mitigate exposure to interest rate risk. As of December 31, 2006, the Company has entered into eight interest rate floor contracts with a total notional amount of \$600 million, seven of which (total notional amount of \$500 million) are designated as cash flow hedges. The objective of these interest rate floors is to protect the overall cash flows from the Company's portfolio of \$500 million of variable-rate loans outstanding from the risk of a decrease in those cash flows.

The notional amounts and estimated fair values of interest rate floor derivative positions outstanding at year-end are presented in the following table. The estimated fair values of the interest rate floors on variable-rate loans are based on quoted market prices.

(in thousands)	2006		2005	
	Notional Value	Estimated Fair Value	Notional Value	Estimated Fair Value
Interest rate floors on variable-rate loans	<b>\$500,000</b>	<b>\$4,239</b>	\$400,000	\$1,270

The strike rates for interest rate floors outstanding at December 31, 2006 range from 6.00% to 8.00%.

Interest rate contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. These counterparties must have an investment grade credit rating and be approved by the Company's Asset and Liability Committee.

For cash flow hedges, the effective portion of the gain or loss on the derivative hedging instrument is reported in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is recorded in current earnings as other income or other expense. The Company recognized the decrease in fair value of \$0.2 million, net of taxes, in Other Comprehensive Income for the year ended December 31, 2006 on these derivative instruments. The amount of the market value adjustment reported in earnings and recorded in other expenses in the Consolidated Statement of Income for the year ended December 31, 2005 and in amortization and accretion in the Consolidated Statement of Cash Flows was \$1.4 million.

During the second quarter of 2006, the Company redesignated an interest rate floor contract with a total notional amount of \$100 million that had previously been accounted for as a cash flow hedge as a freestanding derivative. The Company recorded a \$0.1 million charge to expense to reflect changes in fair value of this instrument during the second quarter of 2006. This interest rate floor has no fair value at December 31, 2006, matures in 17 months and has a strike rate of 6.00%.

### NOTE THIRTEEN INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

(in thousands)	December 31	
	2006	2005
Deferred tax assets:		
Previously securitized loans	<b>\$ 10,196</b>	\$ 10,214
Allowance for loan losses	<b>6,015</b>	7,585
Deferred compensation payable	<b>3,231</b>	3,591
Underfunded pension liability	<b>1,780</b>	2,115
Unrealized securities losses	<b>1,766</b>	3,226
Accrued expenses	<b>1,612</b>	1,828
Impaired investments	<b>874</b>	816
Net operating loss carryforward	-	1,926
Other	<b>2,173</b>	1,058
<b>Total Deferred Tax Assets</b>	<b>27,647</b>	32,359
Deferred tax liabilities:		
Intangible assets	<b>1,809</b>	1,778
Deferred loan fees	<b>834</b>	823
Other	<b>1,352</b>	1,829
<b>Total Deferred Tax Liabilities</b>	<b>3,995</b>	4,430
<b>Net Deferred Tax Assets</b>	<b>\$ 23,652</b>	\$ 27,929

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

Significant components of the provision for income taxes are as follows:

(in thousands)	2006	2005	2004
Current:			
Federal	\$ 25,242	\$ 22,895	\$ 20,672
State	571	40	(293)
Total current	25,813	22,935	20,379
Deferred:			
Federal	517	960	1,653
State	1,999	2,475	2,337
Total deferred	2,516	3,435	3,990
<b>Income tax expense</b>	<b>\$ 28,329</b>	<b>\$ 26,370</b>	<b>\$ 24,369</b>
<b>Income tax (benefit) expense attributable to securities transactions</b>	<b>\$ (798)</b>	<b>\$ 60</b>	<b>\$ 469</b>

A reconciliation of the significant differences between the federal statutory income tax rate and the Company's effective income tax rate is as follows:

(in thousands)	2006	2005	2004
Computed federal taxes at statutory rate	\$ 28,519	\$ 26,830	\$ 24,747
State income taxes, net of federal tax benefit	1,671	1,634	1,329
Tax effects of:			
Tax-exempt interest income	(797)	(853)	(633)
Bank-owned life insurance	(823)	(973)	(1,026)
Other items, net	(241)	(268)	(48)
<b>Income tax expense</b>	<b>\$ 28,329</b>	<b>\$ 26,370</b>	<b>\$ 24,369</b>

### NOTE FOURTEEN

### EMPLOYEE BENEFIT PLANS

During 2003, shareholders approved the City Holding Company 2003 Incentive Plan ("the Plan"), replacing the Company's 1993 Stock Incentive Plan that expired on March 8, 2003. Employees, directors, and individuals who provide service to the Company (collectively "Plan Participants") are eligible to participate in the Plan. Pursuant to the terms of the Plan, the Compensation Committee of the Board of Directors, or its delegate, may, from time-to-time, grant stock options, stock appreciation rights ("SARs"), or stock awards to Plan Participants. A maximum of 1,000,000 shares of the Company's common stock may be issued upon the exercise of stock options and SARs and stock awards, but no more than 350,000 shares of common stock may be issued as stock awards. These limitations may be adjusted in the

event of a change in the number of outstanding shares of common stock by reason of a stock dividend, stock split, or other similar event. Specific terms of options and SARs awarded, including vesting periods, exercise prices (stock price date of grant), and expiration dates are determined at the date of grant and are evidenced by agreements between the Company and the awardee. The exercise price of the option grants equals the market price of the Company's stock on the date of grant. All incentive stock options and SARs will be exercisable up to ten years from the date granted and all options and SARs are exercisable for the period specified in the individual agreement. As of December 31, 2006, 251,750 stock options had been awarded pursuant to the terms of the Plan and 16,200 stock awards had been granted.

Each award from the Plan is evidenced by an award agreement that specifies the option price, the duration of the option, the number of shares to which the option pertains, and such other provisions as the Compensation Committee, or its delegate, determines. The option price for each grant is equal to the fair market value of a share of Company's common stock on the date of grant. Options granted expire at such time as the Compensation Committee determines at the date of grant and in no event does the exercise period exceed a maximum of ten years. Upon a change-in-control of the Company, as defined in the plans, all outstanding options immediately vest.

A summary of the Company's stock option activity and related information is presented below for the years ended December 31:

	2006		2005		2004	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at January 1	318,132	\$ 28.56	602,307	\$ 16.51	650,671	\$ 13.19
Granted	-	-	144,250	33.70	107,500	33.62
Exercised	(46,423)	17.20	(367,675)	9.95	(140,730)	12.77
Forfeited	-	-	(60,750)	33.90	(15,134)	30.38
Outstanding at December 31	271,709	\$ 30.51	318,132	\$ 28.56	602,307	\$ 16.51
Exercisable at end of year	200,584	\$ 29.90	232,007	\$ 27.16	512,306	\$ 13.48
Nonvested at beginning of year	86,125	\$ 32.34				
Vested during year	15,000	\$ 32.97				
Nonvested at end of year	71,125	\$ 32.21				

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

Additional information regarding stock options outstanding and exercisable at December 31, 2006, is provided in the following table:

Ranges of Exercise Prices	No. of Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Months)	Intrinsic Value	No. of Options Currently Exercisable	Weighted-Average Exercise Price of Options Currently Exercisable	Weighted-Average Remaining Contractual Life (Months)	Intrinsic Value
\$13.30	21,600	\$ 13.30	61	\$ 573,912	21,600	\$ 13.30	61	\$ 573,912
\$28.00 - \$36.90	250,109	31.99	91	1,970,561	178,984	31.90	89	1,425,766
	<u>271,709</u>			<u>\$ 2,544,473</u>	<u>200,584</u>			<u>\$ 1,999,678</u>

Proceeds from stock option exercises totaled \$0.8 million in 2006, \$3.7 million in 2005 and \$1.8 million in 2004. Shares issued in connection with stock option exercises are issued from available treasury shares. If no treasury shares are available, new shares are issued from available authorized shares. During 2006, 2005 and 2004, all shares issued in connection with stock option exercises and restricted stock awards were issued from available treasury stock.

The total intrinsic value of stock options exercised was \$0.9 million in 2006, \$9.7 million in 2005 and \$2.9 million in 2004.

Stock-based compensation expense totaled \$0.2 million in 2006, while no such compensation expense was recognized in 2005 and in 2004. The total income tax benefit recognized in the accompanying consolidated statements of income related to stock-based compensation was \$0.1 million in 2006. Unrecognized stock-based compensation expense related to stock options totaled \$0.3 million at December 31, 2006. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 1.2 years.

The fair value for the options was estimated at the grant date using a Black-Scholes option-pricing model with the following weighted average assumptions:

	2006	2005	2004
Risk-free interest rate	3.93%	3.93%	3.16%
Expected dividend yield	2.98%	2.98%	2.95%
Volatility factor	0.384	0.384	0.406
Expected life of option	5 years	5 years	5 years

As the Company did not issue any options during the year ended December 31, 2006, the factors for December 31, 2006 are consistent with amounts at December 31, 2005.

The Company records compensation expense with respect to restricted shares in an amount equal to the fair market value of the common stock covered by each award on the date of grant. The restricted shares awarded become fully vested after various periods of continued employment from the respective dates of grant. The Company is entitled to an income tax deduction in an amount equal to the taxable income reported by the holders of the restricted shares when the restrictions are released and the shares are issued. Compensation is being charged to expense over the respective vesting periods.

Restricted shares are forfeited if officers and employees terminate prior to the lapsing of restrictions. The Company records forfeitures of restricted stock as treasury share repurchases and any compensation cost previously recognized is reversed in the period of forfeiture. Recipients of restricted shares do not pay any cash consideration to the Company for the shares, have the right to vote all shares subject to such grant and receive all dividends with respect to such shares, whether or not the shares have vested. The Company recognized \$0.1 million and \$0.2 million of compensation expense for the twelve months ended December 31, 2006 and December 31, 2005, respectively, within salaries and employee benefits in the Company's Consolidated Statements of Income associated with the restricted stock awards issued. Unrecognized stock-based compensation expense related to non-vested restricted shares was \$0.2 million at December 31, 2006. At December 31, 2006, this unrecognized expense is expected to be recognized over 4.0 years based on the weighted average-life of the restricted shares.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(CONTINUED)*

## CITY HOLDING COMPANY AND SUBSIDIARIES

A summary of the Company's restricted shares activity and related information is presented below for the years ended December 31:

	2006		2005	
	Options	Average Market Price At Grant	Options	Average Market Price At Grant
Outstanding at January 1	14,000		-	
Granted	2,200	\$ 36.24	14,000	\$ 30.65
Forfeited/Vested	(600)		-	
Outstanding at December 31	15,600		14,000	

For purposes of pro forma disclosures, the estimated fair value of options is amortized to expense over the options' vesting period. Pro forma net income, basic earnings per share, and diluted earnings per share for the years ended December 31, 2005, and 2004 were:

(in thousands)	2005	2004
Net income, as reported	\$ 50,288	\$ 46,344
Add: restricted stock compensation expense included in reported net income, net of related tax effects	98	-
Less: Total stock-based compensation expense including both restricted stock and stock options, determined under fair value based method, net of related tax effects	(1,182)	(748)
Net income, pro forma	\$ 49,204	\$ 45,596
	2005	2004
Basic earnings per share, as reported	\$ 2.87	\$ 2.79
Basic earnings per share, pro forma	\$ 2.81	\$ 2.74
	2005	2004
Diluted earnings per share, as reported	\$ 2.84	\$ 2.75
Basic earnings per share, pro forma	\$ 2.78	\$ 2.70

Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options at the time of grant.

The Company provides retirement benefits to its employees through the City Holding Company 401(k) Plan and Trust ("the 401(k) Plan"), which is intended to be compliant with Employee Retirement Income Security Act (ERISA) section 404(c). Any employee who has attained age 21 is eligible to participate beginning the first day of the month following employment. Unless specifically chosen otherwise, every employee is automatically enrolled in the 401(k) Plan and may make before-tax contributions of between 1% and 15% of eligible pay up to the dollar limit imposed by Internal Revenue Service regulations. The first 6% of an employee's contribution is matched 50% by the Company. The employer matching contribution is invested according to the investment elections chosen by the employee. Employees are 100% vested in both employee and employer contributions and the earnings generated by such contributions. As of December 31, 2006, there were 15 investment options, including City Holding Company common stock, available under the 401(k) Plan.

The Company's total expense associated with the retirement benefit plan approximated \$574,000, \$542,000, and \$494,000, in 2006, 2005, and 2004, respectively. The total number of shares of the Company's common stock held by the 401(k) Plan as of December 31, 2006 and 2005 is 367,424 and 431,561, respectively. Other than the 401(k) Plan, the Company offers no postretirement benefits.

The Company also maintains a defined benefit pension plan ("the Defined Benefit Plan") that covers approximately 300 current and former employees. The Defined Benefit Plan was frozen in 1999 subsequent to the Company's acquisition of the plan sponsor. The Defined Benefit Plan maintains an October 31 year-end for purposes of computing its benefit obligations.

Primarily as a result of the interest rate environment over the past two years, the benefit obligation exceeded the estimated fair value of plan assets as of October 31, 2006 and 2005. The Company has recorded a minimum pension liability of \$2.6 million and \$3.3 million as of December 31, 2006 and 2005, respectively, included in Other Liabilities within the Consolidated Balance Sheets, and a \$2.7 million and \$3.2 million, net of tax, underfunded pension liability in Accumulated Other Comprehensive Income within Shareholders' Equity at December 31, 2006 and 2005, respectively. The following table summarizes activity within the Defined Benefit Plan in 2006 and 2005:



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

(in thousands)	Pension Benefits	
	2006	2005
Change in fair value of plan assets:		
Fair value at beginning of measurement period	\$ 8,192	\$ 8,044
Actual gain on plan assets	992	698
Contributions	111	76
Benefits paid	(626)	(626)
Fair value at end of measurement period	8,669	8,192
Change in benefit obligation:		
Benefit obligation at beginning of measurement period	(11,501)	(10,133)
Interest cost	(650)	(662)
Actuarial gain (loss)	251	(1,332)
Benefits paid	626	626
Change in estimates	-	-
Benefit obligation at end of measurement period	(11,274)	(11,501)
Funded status	(2,605)	(3,309)
Unrecognized net actuarial gain	4,498	5,366
Unrecognized net obligation	(48)	(77)
Other comprehensive loss	(4,450)	(5,289)
<b>Accrued Benefit Cost</b>	<b>\$ (2,605)</b>	<b>\$ (3,309)</b>

Weighted-average assumptions as of October 31:

Discount rate	6.00%	5.75%
Expected return on plan assets	8.50%	8.50%

The following table presents the components of the net defined benefit pension benefit:

(in thousands)	Pension Benefits		
	2006	2005	2004
Components of net periodic benefit:			
Interest cost	\$ 650	\$ 662	\$ 642
Expected return on plan assets	(718)	(761)	(785)
Net amortization and deferral	314	148	143
<b>Net Periodic Pension Cost</b>	<b>\$ 246</b>	<b>\$ 49</b>	<b>\$ -</b>

The Defined Benefit Plan is administered by the West Virginia Bankers Association ("WVBA") and all investment policies and strategies are established by the WVBA Pension Committee. The policy established by the Pension Committee is to invest assets per target allocations, as detailed in the table below. The assets are reallocated periodically to meet these target allocations. The investment policy is reviewed periodically, under the advisement of a certified investment advisor, to determine if the policy should be revised.

The overall investment return goal is to achieve a return greater than a blended mix of stated indices tailored to the same asset mix of the plan assets by 0.5%, after fees, over a rolling five-year moving average basis. Allowable assets include cash equivalents, fixed income securities, equity securities, exchange-traded index funds and guaranteed investment contracts. Prohibited investments include, but are not limited to, commodities and futures contracts, private

placements, options, limited partnerships, venture capital investments, real estate and interest-only, principal-only, and residual tranche collateralized mortgage obligations. Unless a specific derivative security is allowed per the plan document, permission must be sought from the WVBA Pension Committee to include such investments.

In order to achieve a prudent level of portfolio diversification, the securities of any one company are not to exceed more than 10% of the total plan assets, and no more than 25% of total plan assets are to be invested in any one industry (other than securities of the U.S. government or U.S. government agencies). Additionally, no more than 20% of plan assets shall be invested in foreign securities (both equity and fixed).

The expected long-term rate of return for the plan's assets is based on the expected return of each of the categories, weighted-based on the median of the target allocation for each class, noted in the table below. The allowable, target, and current allocation percentages of plan assets are as follows:

	Target Allocation	Allowable Allocation	Percentage of Plan Assets at October 31	
	2006	Range	2006	2005
Equity securities	75%	40-80%	74%	73%
Debt securities	25%	20-40%	20%	22%
Other	0%	3-10%	6%	5%
<b>Total</b>			<b>100%</b>	<b>100%</b>

The Company anticipates making a contribution to the plan of \$1.7 million for the year ending December 31, 2007. The following table summarizes the expected benefits to be paid in each of the next five years and in the aggregate for the five years thereafter:

Plan Year Ending October 31	Expected Benefits to be Paid (in thousands)
2007	\$ 611
2008	626
2009	644
2010	695
2011	704
2012 through 2016	3,841

In addition, the Company and its subsidiary participate in the Pentegra multi-employer pension plan (the "multi-employer plan"). This non-contributory defined benefit plan covers current and former employees of Classic Bancshares (acquired by the Company during 2005). The multi-employer plan has a June 30 year-end, and it is the policy of the Company to fund the normal cost of the multiemployer plan. No contributions were required for the year ended December 31, 2006. The benefits of the multi-employer plan were frozen prior to the acquisition of Classic Bancshares, and it is

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

the intention of the Company to fund benefit amounts when assets of the plan are sufficient.

The Company has entered into employment contracts with certain of its current and former executive officers. The employment contracts provide for, among other things, the payment of severance compensation in the event an executive officer either voluntarily or involuntarily terminates his employment with the Company for other than "Just Cause." The cost of these benefits was accrued over the five-year service period for each executive and is included in Other Liabilities within the Consolidated Balance Sheets. As of December 31, 2006 and 2005, the liability was \$1.9 million and \$1.8 million, respectively. For the years ended December 31, 2006, 2005, and 2004, \$0.1 million, \$0.5 million, and \$3.3 million, respectively, was charged to operations in connection with these contracts. As of December 31, 2006, two officers had left the Company and are receiving severance compensation in accordance with the terms of each of their respective agreements.

Certain entities previously acquired by the Company had entered into individual deferred compensation and supplemental retirement agreements with certain current and former directors and officers. The Company has assumed the liabilities associated with these agreements, the cost of which is being accrued over the period of active service from the date of the respective agreement. The cost of such agreements approximated \$228,000, \$262,000, and \$256,000, during 2006, 2005, and 2004, respectively. The liability for such agreements approximated \$4.6 million and \$4.7 million at December 31, 2006 and 2005, respectively, and is included in Other Liabilities in the accompanying Consolidated Balance Sheets.

To assist in funding the above liabilities, the acquired entities had insured the lives of certain current and former directors and officers. The Company is the current owner and beneficiary of insurance policies with a cash surrender value approximating \$6.8 million and \$6.4 million at December 31, 2006 and 2005, respectively, which is included in Other Assets in the accompanying Consolidated Balance Sheets.

### NOTE FIFTEEN

#### RELATED PARTY TRANSACTIONS

City National has granted loans to certain non-executive officers and directors of the Company and its subsidiaries, and to their associates. The loans were made in the ordinary course of business and on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with third-party lending arrangements. The Company has no material related party transactions that would warrant disclosure.

### NOTE SIXTEEN

#### COMMITMENTS AND CONTINGENT LIABILITIES

The Company has entered into agreements with certain of its customers to extend credit or provide a conditional commitment to provide payment on drafts presented in accordance with the terms of the underlying credit documents. Conditional commitments generally include standby and commercial letters of credit. Standby letters of credit represent an obligation of the Company to a designated third party contingent upon the failure of a customer of the Company to perform under the terms of the underlying contract between the customer and the third party. Commercial letters of credit are issued specifically to facilitate trade or commerce. Under the terms of a commercial letter of credit, drafts will be drawn when the underlying transaction is consummated, as intended, between the customer and a third party. The table below presents a summary of the contractual obligations of the Company resulting from significant commitments:

(in thousands)	2006	2005
Commitments to extend credit:		
Home equity lines	\$ 140,479	\$ 148,259
Credit card lines	–	39,646
Commercial real estate	48,489	65,966
Other commitments	131,428	145,535
Standby letters of credit	12,735	7,250
Commercial letters of credit	617	312

Loan commitments, standby letters of credit and commercial letters of credit have credit risks essentially the same as that involved in extending loans to customers and are subject to the Company's standard credit policies. Collateral is obtained based on management's credit assessment of the customer. Management does not anticipate any material losses as a result of these commitments.

The Company and City National are involved in various legal actions arising in the ordinary course of business. As these legal actions are resolved, the Company or City National could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately decided. There can be no assurance that current actions will have immaterial results, either positive or negative, or that no material actions will be presented in the future.



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(CONTINUED)*

## CITY HOLDING COMPANY AND SUBSIDIARIES

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### NOTE SEVENTEEN

#### PREFERRED STOCK AND SHAREHOLDER RIGHTS PLAN

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The Company's Board of Directors has the authority to issue preferred stock, and to fix the designation, preferences, rights, dividends, and all other attributes of such preferred stock, without any vote or action by the shareholders. As of December 31, 2006, no such shares are outstanding, nor are any expected to be issued, except as might occur pursuant to the Stock Rights Plan discussed below.

The Company's Stock Rights Plan provides that each share of common stock carries with it one right. The rights would be exercisable only if a person or group, as defined, acquired 15% or more of the Company's common stock, or announces a tender offer for such stock. Under conditions described in the Stock Rights Plan, holders of rights could acquire shares of preferred stock or additional shares of the Company's common stock—or in the event of a 50% or more change in control, shares of common stock of the acquirer. The value of shares acquired under the plan would equal twice the exercise price.

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### NOTE EIGHTEEN

#### REGULATORY REQUIREMENTS AND CAPITAL RATIOS

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The principal source of income and cash for City Holding (the "Parent Company") is dividends from City National. Dividends paid by City National to the Parent Company are subject to certain legal and regulatory limitations. Generally, any dividends in amounts that exceed the earnings retained by City National in the current year plus retained net profits for the preceding two years must be approved by regulatory authorities. Approval is also required if dividends declared would cause City National's regulatory capital to fall below specified minimum levels. During 2005 and 2006 combined, City National received regulatory approval to pay \$144.8 million in cash dividends to the Parent Company, while generating net profits of \$106.6 million. Therefore, City National will be required to obtain regulatory approval prior to declaring any cash dividends to the Parent Company throughout 2007. Although regulatory authorities have approved prior cash dividends, there can be no assurance that future dividend requests will be approved.

During 2006, the Parent Company used cash obtained from the dividends received primarily to: (1) pay common dividends to shareholders, (2) remit interest payments on the Company's junior subordinated debentures, (3) redeem \$12.0 million of the Company's junior subordinated debentures, (4) invest \$40.0 million in a new capital management subsidiary, and (5) fund repurchases of the Company's common shares. As of December 31, 2006, the Parent Company reported a cash balance of approximately \$43.0 million. Management believes that the Parent Company's available cash balance, together with cash dividends from City National is adequate to satisfy its funding and cash needs in 2007.

The Company, including City National, is subject to various regulatory capital requirements administered by the various banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, action by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and City National must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. The Company's and City National's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and City National to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined). Management believes, as of December 31, 2006, that the Company and City National met all capital adequacy requirements to which they were subject.

As of December 31, 2006, the most recent notifications from banking regulatory agencies categorized the Company and City National as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since these notifications that management believes have changed the institutions' categories. The Company's and City National's actual capital amounts and ratios are presented in the following table.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

(dollars in thousands)	2006		2005		Well	Minimum
	Amount	Ratio	Amount	Ratio	Capitalized	Ratio
Total Capital (to Risk-Weighted Assets):						
Consolidated	\$ 280,713	16.2%	\$ 284,313	16.4%	10.0%	8.0%
City National	232,056	13.4	241,294	14.0	10.0	8.0
Tier I Capital (to Risk-Weighted Assets):						
Consolidated	265,308	15.3	267,523	15.4	6.0	4.0
City National	216,651	12.5	224,504	13.0	6.0	4.0
Tier I Capital (to Average Assets):						
Consolidated	265,308	10.8	267,523	11.0	5.0	4.0
City National	216,651	8.8	224,504	9.2	5.0	4.0

### NOTE NINETEEN

#### FAIR VALUES OF FINANCIAL INSTRUMENTS

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following table represents the estimates of fair value of financial instruments:

(in thousands)	Fair Value of Financial Instruments			
	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and cash equivalents	\$ 110,448	\$ 110,448	\$ 86,273	\$ 86,273
Securities available-for-sale	472,398	472,398	549,966	549,966
Securities held-to-maturity	47,500	49,955	55,397	58,892
Net loans	1,662,064	1,679,859	1,596,037	1,626,684
Liabilities:				
Deposits	1,985,217	1,979,161	1,928,420	1,918,853
Short-term borrowings	136,570	135,656	152,255	150,256
Long-term debt	48,069	49,277	98,425	98,985

The following methods and assumptions were used in estimating fair value amounts for financial instruments:

**Cash and cash equivalents:** Due to their short-term nature, the carrying amounts reported in the Consolidated Balance Sheets approximate fair value.

**Securities:** The fair value of securities, both available-for-sale and held-to-maturity, are generally based on quoted market prices.

**Net loans:** The fair value of the loan portfolio is estimated using discounted cash flow analyses at interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying value of accrued interest approximates its fair value.

**Deposits:** The fair values of demand deposits (e.g., interest and noninterest-bearing checking, regular savings, and other money market demand accounts) are, by definition, equal to their carrying values. Fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregate expected monthly maturities of time deposits.

**Short-term borrowings:** Securities sold under agreements to repurchase represent borrowings with original maturities of less than 90 days. The carrying amount of advances from the FHLB and borrowings under repurchase agreements approximate their fair values.

**Long-term debt:** The fair value of long-term borrowings is estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements and market conditions of similar debt instruments.

**Commitments and letters of credit:** The fair values of commitments are estimated based on fees currently charged to enter into similar agreements, taking into consideration the remaining terms of the agreements and the counterparties' credit standing. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The amounts of fees currently charged on commitments and letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values have not been reflected in the table above.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

### NOTE TWENTY

#### CITY HOLDING COMPANY (PARENT COMPANY ONLY) FINANCIAL INFORMATION

##### Condensed Balance Sheets

(in thousands)	December 31	
	2006	2005
<b>Assets</b>		
Cash	\$ 43,042	\$ 38,420
Securities available-for-sale	3,101	3,135
Investment in subsidiaries	281,377	278,967
Deferred tax asset	72	2,232
Fixed assets	75	118
Other assets	1,520	4,103
<b>Total Assets</b>	<b>\$ 329,187</b>	<b>\$ 326,975</b>
<b>Liabilities</b>		
Junior subordinated debentures	\$ 16,836	\$ 28,836
Dividends payable	4,897	4,526
Accrued interest payable	366	641
Other liabilities	1,781	831
<b>Total Liabilities</b>	<b>23,880</b>	<b>34,834</b>
<b>Shareholders' Equity</b>	<b>305,307</b>	<b>292,141</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 329,187</b>	<b>\$ 326,975</b>

Junior subordinated debentures represent the Parent Company's amounts owed to City Holding Capital Trust at December 31, 2006 and 2005.

##### Condensed Statements of Income

(in thousands)	Year Ended December 31		
	2006	2005	2004
<b>Income</b>			
Dividends from bank subsidiaries	\$ 95,200	\$ 49,600	\$ 38,350
Other income	366	339	132
	<b>95,566</b>	<b>49,939</b>	<b>38,482</b>
<b>Expenses</b>			
Interest expense	2,223	2,574	2,627
Loss on early extinguishment of debt	1,368	—	263
Other expenses	639	354	388
	<b>4,230</b>	<b>2,928</b>	<b>3,278</b>
<b>Income Before Income Tax Benefit and (Excess Dividends) Equity in Undistributed Net Income of Subsidiaries</b>	<b>91,336</b>	<b>47,011</b>	<b>35,204</b>
Income tax benefit	(1,828)	(1,183)	(1,395)
<b>Income Before (Excess Dividends) Equity in Undistributed Net Income of Subsidiaries</b>	<b>93,164</b>	<b>48,194</b>	<b>36,599</b>
(Excess dividends) equity in undistributed net income of subsidiaries	(39,977)	2,094	9,745
<b>Net Income</b>	<b>\$ 53,187</b>	<b>\$ 50,288</b>	<b>\$ 46,344</b>

##### Condensed Statements of Cash Flows

(in thousands)	Year Ended December 31		
	2006	2005	2004
<b>Operating Activities</b>			
Net income	\$ 53,187	\$ 50,288	\$ 46,344
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss on early extinguishment of debentures	1,368	—	263
Realized investment securities gains	—	—	(116)
Realized gain on sale of fixed assets	—	(8)	—
Amortization and accretion	25	14	—
Provision for depreciation	43	48	60
Decrease (increase) in other assets	4,322	3,336	(146)
Increase (decrease) in other liabilities	1,159	297	(1,682)
Excess dividends (equity in undistributed net income) of subsidiaries	39,977	(2,094)	(9,745)
<b>Net Cash Provided by Operating Activities</b>	<b>100,081</b>	<b>51,881</b>	<b>34,978</b>
<b>Investing Activities</b>			
Purchases of available for sale securities	(755)	(6,479)	(1,042)
Proceeds from sales of available for sale securities	932	369	217
Investment in subsidiaries	(40,017)	—	—
Acquisition, net cash received	—	(15,385)	—
Proceeds from sale of fixed assets	—	8	—
<b>Net Cash Used in Investing Activities</b>	<b>(39,840)</b>	<b>(21,487)</b>	<b>(825)</b>
<b>Financing Activities</b>			
Repayment of long-term debt	—	—	(2,200)
Redemption of junior subordinated debentures	(13,002)	—	—
Dividends paid	(19,350)	(16,839)	(14,309)
Purchases of treasury stock	(24,334)	(11,912)	(5,858)
Issuance of stock awards	—	147	—
Exercise of stock options	798	3,659	2,048
Excess tax benefits from stock-based compensation arrangements	269	—	—
<b>Net Cash Used in Financing Activities</b>	<b>(55,619)</b>	<b>(24,945)</b>	<b>(20,319)</b>
<b>Increase in Cash and Cash Equivalents</b>	<b>4,622</b>	<b>5,449</b>	<b>13,834</b>
Cash and cash equivalents at beginning of year	38,420	32,971	19,137
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 43,042</b>	<b>\$ 38,420</b>	<b>\$ 32,971</b>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## CITY HOLDING COMPANY AND SUBSIDIARIES

### NOTE TWENTY-ONE SUMMARIZED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

A summary of selected quarterly financial information for 2006 and 2005 follows:

(in thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2006</b>				
Interest income	\$ 37,441	\$ 39,010	\$ 39,747	\$ 39,925
Taxable equivalent adjustment	252	246	236	228
Interest income (FTE)	37,693	39,256	39,983	40,153
Interest expense	11,586	13,085	14,233	14,820
Net interest income	26,107	26,171	25,750	25,333
Provision for loan losses	1,000	675	1,225	901
Investment securities gains (losses)	—	—	(2,067)	72
Noninterest income	12,388	13,463	16,833	13,514
Noninterest expense	17,498	17,555	18,133	18,099
Income before income tax expense	19,997	21,404	21,158	19,919
Income tax expense	6,878	7,397	7,302	6,752
Taxable equivalent adjustment	252	246	236	228
Net income	\$ 12,867	\$ 13,761	\$ 13,620	\$ 12,939
Basic earnings per common share	\$ 0.71	\$ 0.78	\$ 0.78	\$ 0.74
Diluted earnings per common share	0.71	0.77	0.77	0.74
Average common shares outstanding:				
Basic	18,006	17,719	17,557	17,535
Diluted	18,067	17,772	17,619	17,601
<b>2005</b>				
Interest income	\$ 30,293	\$ 32,676	\$ 35,910	\$ 36,639
Taxable equivalent adjustment	233	241	273	269
Interest income (FTE)	30,526	32,917	36,183	36,908
Interest expense	8,030	9,054	10,290	11,064
Net interest income	22,496	23,863	25,893	25,844
Provision for loan losses	—	—	600	800
Investment securities gains (losses)	3	18	5	125
Noninterest income	11,441	12,080	13,007	13,412
Noninterest expense	16,013	16,839	17,922	18,339
Income before income tax expense	17,927	19,122	20,383	20,242
Income tax expense	6,016	6,532	6,938	6,884
Taxable equivalent adjustment	233	241	273	269
Net income	\$ 11,678	\$ 12,349	\$ 13,172	\$ 13,089
Basic earnings per common share	\$ 0.70	\$ 0.72	\$ 0.73	\$ 0.72
Diluted earnings per common share	0.69	0.71	0.72	0.72
Average common shares outstanding:				
Basic	16,605	17,268	18,052	18,127
Diluted	16,812	17,477	18,238	18,211

### NOTE TWENTY-TWO EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

(in thousands, except per share data)	2006	2005	2004
Net income	\$ 53,187	\$ 50,288	\$ 46,344
Average shares outstanding	17,701	17,519	16,632
Effect of dilutive securities:			
Employee stock options	61	171	250
Shares for diluted earnings per share	17,762	17,690	16,882
Basic earnings per share	\$ 3.00	\$ 2.87	\$ 2.79
Diluted earnings per share	\$ 2.99	\$ 2.84	\$ 2.75

Options to purchase 43,750 shares of common stock at exercise prices between \$36.25 and \$36.90 per share were outstanding during 2005 but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares and therefore, the effect would be antidilutive.

### NOTE TWENTY-THREE DISPOSITIONS

On August 4, 2006, the Company sold its credit card portfolio of approximately \$11.5 million to Elan Financial Services (Elan), a wholly owned subsidiary of U.S. Bancorp. As part of this agreement, the Company and Elan have entered into an agent marketing agreement that will enable the Company's customers to continue to receive credit card products, while allowing Elan the exclusive marketing rights to the Company's current and prospective customer base. This transaction was completed during the third quarter of 2006 and resulted in a pre-tax gain of approximately \$3.6 million for the Company.

On February 1, 2007, the Company entered into an alliance and sales agreement with NOVA Information Systems, Inc. (NOVA), a wholly owned subsidiary of U.S. Bancorp. As part of this agreement, NOVA will provide payment processing services to the Company's merchant customers. In addition, the Company sold its existing merchant processing agreements to NOVA and will recognize a pretax gain of approximately \$1.5 million in the first quarter of 2007. The final settlement and conversion of the Company's merchant portfolio to NOVA is expected to be completed in the second quarter of 2007.

