ISABELLA BANK CORP
Form 10-Q
August 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2014
or
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to
Commission File Number: 0-18415

Isabella Bank Corporation
(Exact name of registrant as specified in its charter)

Michigan	38-2830092
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
401 N. Main St, Mt. Pleasant, MI	48858
(Address of principal executive offices)	(Zip code)

(989) 772-9471
(Registrant's telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ý Yes ¨ No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ý Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer ý
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
¨ Yes ý No
The number of shares outstanding of the registrant's Common Stock (no par value) was 7,750,559 as of August 6, 2014.

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Forward Looking Statements

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the FRB, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

The acronyms and abbreviations identified below may be used throughout this Quarterly Report on Form 10-Q, or in our other filings. You may find it helpful to refer back to this page while reading this report.

AFS: Available-for-sale
ALLL: Allowance for loan and lease losses
AOCI: Accumulated other comprehensive income (loss)
ASC: FASB Accounting Standards Codification
ASU: FASB Accounting Standards Update
ATM: Automated Teller Machine
BHC Act: Bank Holding Company Act of 1956
CFPB: Consumer Financial Protection Bureau
CIK: Central Index Key
CRA: Community Reinvestment Act
DIF: Deposit Insurance Fund
DIFS: Department of Insurance and Financial Services
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
ESOP: Employee stock ownership plan
Exchange Act: Securities Exchange Act of 1934
FASB: Financial Accounting Standards Board
FDI Act: Federal Deposit Insurance Act
FDIC: Federal Deposit Insurance Corporation
FFIEC: Federal Financial Institutions Examinations Council
FRB: Federal Reserve Bank
FHLB: Federal Home Loan Bank
Freddie Mac: Federal Home Loan Mortgage Corporation
FTE: Fully taxable equivalent
GAAP: U.S. generally accepted accounting principles
GLB Act: Gramm-Leach-Bliley Act of 1999
IFRS: International Financial Reporting Standards
IRR: Interest rate risk
JOBS Act: Jumpstart our Business Startups Act
LIBOR: London Interbank Offered Rate
N/A: Not applicable
N/M: Not meaningful
NASDAQ: NASDAQ Stock Market Index
NASDAQ Banks: NASDAQ Bank Stock Index
NAV: Net asset value
NOW: Negotiable order of withdrawal
NSF: Non-sufficient funds
OCI: Other comprehensive income (loss)
OMSRs: Originated mortgage servicing rights
OREO: Other real estate owned
OTC: Over-the-Counter
OTTI: Other-than-temporary impairment
PBO: Projected benefit obligation
PCAOB: Public Company Accounting Oversight Board
Rabbi Trust: A trust established to fund the Directors Plan
SEC: U.S. Securities & Exchange Commission
SOX: Sarbanes-Oxley Act of 2002
TDR: Troubled debt restructuring
XBRL: eXtensible Business Reporting Language

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PART I – FINANCIAL INFORMATION
Item 1. Interim Condensed Consolidated Financial Statements (Unaudited)
INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

	June 30 2014	December 31 2013
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$26,484	$21,755
Interest bearing balances due from banks	896	19,803
Total cash and cash equivalents	27,380	41,558
Certificates of deposit held in other financial institutions	580	580
Trading securities	—	525
AFS securities (amortized cost of $546,102 in 2014 and $517,614 in 2013)	550,518	512,062
Mortgage loans AFS	340	1,104
Loans		
Commercial	407,791	392,104
Agricultural	97,661	92,589
Residential real estate	278,545	289,931
Consumer	32,310	33,413
Gross loans	816,307	808,037
Less allowance for loan and lease losses	10,700	11,500
Net loans	805,607	796,537
Premises and equipment	25,701	25,719
Corporate owned life insurance policies	24,775	24,401
Accrued interest receivable	5,448	5,442
Equity securities without readily determinable fair values	19,303	18,293
Goodwill and other intangible assets	46,216	46,311
Other assets	16,267	20,605
TOTAL ASSETS	$1,522,135	$1,493,137
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing	$162,537	$158,428
NOW accounts	186,705	192,089
Certificates of deposit under $100 and other savings	463,497	455,547
Certificates of deposit over $100	248,189	237,702
Total deposits	1,060,928	1,043,766
Borrowed funds	279,457	279,326
Accrued interest payable and other liabilities	10,651	9,436
Total liabilities	1,351,036	1,332,528
Shareholders' equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,735,156 shares (including 6,697 shares held in the Rabbi Trust) in 2014 and 7,723,023 shares (including 12,761 shares held in the Rabbi Trust) in 2013	137,945	137,580
Shares to be issued for deferred compensation obligations	3,984	4,148
Retained earnings	28,702	25,222
Accumulated other comprehensive income (loss)	468	(6,341)
Total shareholders' equity	171,099	160,609
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,522,135	$1,493,137

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands except per share amounts)

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Interest income				
Loans, including fees	$9,799	$10,280	$19,550	$20,610
AFS securities				
Taxable	1,993	1,798	3,991	3,632
Nontaxable	1,486	1,244	2,943	2,478
Trading securities	1	9	6	23
Federal funds sold and other	112	109	265	225
Total interest income	13,391	13,440	26,755	26,968
Interest expense				
Deposits	1,589	1,822	3,205	3,696
Borrowings	879	959	1,763	1,906
Total interest expense	2,468	2,781	4,968	5,602
Net interest income	10,923	10,659	21,787	21,366
Provision for loan losses	(200)	215	(442)	515
Net interest income after provision for loan losses	11,123	10,444	22,229	20,851
Noninterest income				
Service charges and fees	1,360	1,445	2,754	2,726
Net gain on sale of mortgage loans	151	249	266	607
Earnings on corporate owned life insurance policies	190	190	374	359
Net gains (losses) on sale of AFS securities	—	—	—	99
Other	733	852	1,289	1,392
Total noninterest income	2,434	2,736	4,683	5,183
Noninterest expenses				
Compensation and benefits	5,385	5,236	10,871	10,681
Furniture and equipment	1,219	1,192	2,487	2,381
Occupancy	676	641	1,418	1,306
Other	2,020	2,255	4,010	4,147
Total noninterest expenses	9,300	9,324	18,786	18,515
Income before federal income tax expense	4,257	3,856	8,126	7,519
Federal income tax expense	692	643	1,252	1,219
NET INCOME	$3,565	$3,213	$6,874	$6,300
Earnings per common share				
Basic	$0.46	$0.42	$0.89	$0.82
Diluted	$0.45	$0.41	$0.87	$0.80
Cash dividends per common share	$0.22	$0.21	$0.44	$0.42

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Dollars in thousands)

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Net income	$3,565	$3,213	$6,874	$6,300
Unrealized gains (losses) on AFS securities				
Unrealized gains (losses) arising during the period	4,448	(11,997)	9,968	(13,958)
Reclassification adjustment for net realized (gains) losses included in net income	—	—	—	(99)
Net unrealized gains (losses)	4,448	(11,997)	9,968	(14,057)
Tax effect (1)	(1,420)	3,979	(3,159)	4,902
Other comprehensive income (loss), net of tax	3,028	(8,018)	6,809	(9,155)
Comprehensive income (loss)	$6,593	$(4,805)	$13,683	$(2,855)

(1) See “Note 12 – Accumulated Other Comprehensive Income (Loss)” for tax effect reconciliation.

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in thousands except per share amounts)

	Common Stock					
	Shares Outstanding	Amount	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2013	7,671,846	$136,580	$ 3,734	$19,168	$ 5,007	$164,489
Comprehensive income (loss)	—	—	—	6,300	(9,155)	(2,855)
Issuance of common stock	77,568	1,900	—	—	—	1,900
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	121	(121)	—	—	—
Share-based payment awards under equity compensation plan	—	—	258	—	—	258
Common stock purchased for deferred compensation obligations	—	(166)	—	—	—	(166)
Common stock repurchased pursuant to publicly announced repurchase plan	(45,825)	(1,114)	—	—	—	(1,114)
Cash dividends ($0.42 per share)	—	—	—	(3,224)	—	(3,224)
Balance, June 30, 2013	7,703,589	$137,321	$ 3,871	$22,244	$ (4,148)	$159,288
Balance, January 1, 2014	7,723,023	$137,580	$ 4,148	$25,222	$ (6,341)	$160,609
Comprehensive income (loss)	—	—	—	6,874	6,809	13,683
Issuance of common stock	76,341	1,778	—	—	—	1,778
Common stock issued for deferred compensation obligations	6,126	143	(143)	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	258	(258)	—	—	—
Share-based payment awards under equity compensation plan	—	—	237	—	—	237
Common stock purchased for deferred compensation obligations	—	(166)	—	—	—	(166)
Common stock repurchased pursuant to publicly announced repurchase plan	(70,334)	(1,648)	—	—	—	(1,648)
Cash dividends ($0.44 per share)	—	—	—	(3,394)	—	(3,394)

Balance, June 30, 2014	7,735,156	$137,945	$ 3,984	$28,702	$ 468	$171,099

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Six Months Ended June 30	
	2014	2013
OPERATING ACTIVITIES		
Net income	$6,874	$6,300
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	(442)	515
Impairment of foreclosed assets	63	92
Depreciation	1,242	1,249
Amortization of OMSRs	139	210
Amortization of acquisition intangibles	95	114
Net amortization of AFS securities	920	1,131
Net (gains) losses on sale of AFS securities	—	(99)
Net unrealized (gains) losses on trading securities	5	18
Net gain on sale of mortgage loans	(266)	(607)
Increase in cash value of corporate owned life insurance policies	(374)	(359)
Share-based payment awards under equity compensation plan	237	258
Origination of loans held-for-sale	(12,878)	(35,014)
Proceeds from loan sales	13,908	38,511
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	520	605
Accrued interest receivable	(6)	(5)
Other assets	(250)	914
Accrued interest payable and other liabilities	1,215	761
Net cash provided by (used in) operating activities	11,002	14,594
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	—	2,655
Activity in AFS securities		
Sales	—	9,857
Maturities and calls	32,354	46,780
Purchases	(61,762)	(67,140)
Loan principal (originations) collections, net	(9,551)	(32,185)
Proceeds from sales of foreclosed assets	1,140	1,556
Purchases of premises and equipment	(1,224)	(1,314)
Purchases of corporate owned life insurance policies	—	(1,092)
Proceeds from redemption of corporate owned life insurance policies	—	123
Net cash provided by (used in) investing activities	(39,043)	(40,760)

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Dollars in thousands)

	Six Months Ended June 30	
	2014	2013
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	17,162	3,757
Increase (decrease) in borrowed funds	131	21,459
Cash dividends paid on common stock	(3,394)	(3,224)
Proceeds from issuance of common stock	1,778	1,900
Common stock repurchased	(1,648)	(1,114)
Common stock purchased for deferred compensation obligations	(166)	(166)
Net cash provided by (used in) financing activities	13,863	22,612
Increase (decrease) in cash and cash equivalents	(14,178)	(3,554)
Cash and cash equivalents at beginning of period	41,558	24,920
Cash and cash equivalents at end of period	$27,380	$21,366
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	$5,074	$5,667
Federal income taxes paid	715	702
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	$923	$735

See notes to interim condensed consolidated financial statements.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands except per share amounts)

Note 1 – Basis of Presentation

As used in these notes as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to “Isabella,” “we,” “our,” “us,” and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank refers to Isabella Bank Corporation’s subsidiary, Isabella Bank.

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Note 2 – Computation of Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate solely to outstanding shares in the Directors Plan.

Earnings per common share have been computed based on the following:

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Average number of common shares outstanding for basic calculation	7,722,367	7,701,042	7,721,814	7,689,092
Average potential effect of common shares in the Directors Plan (1)	168,715	168,323	170,984	166,800
Average number of common shares outstanding used to calculate diluted earnings per common share	7,891,082	7,869,365	7,892,798	7,855,892
Net income	$3,565	$3,213	$6,874	$6,300
Earnings per common share				
Basic	$0.46	$0.42	$0.89	$0.82
Diluted	$0.45	$0.41	$0.87	$0.80

(1) Exclusive of shares held in the Rabbi Trust

Note 3 – Pending Accounting Standards Updates

ASU No. 2014-01: “Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)”

In January 2014, ASU No. 2014-01 amended ASC Topic 323, “Investments" to allow investors in low income housing tax credits to use the proportional amortization method if the following criteria are met:

- It is probable that the tax credits allocable to the investor will be available.
- The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.
- Substantially all of the projected benefits are from tax credits and other tax benefits (e.g., operating losses).
- The investor’s projected yield is based solely on the cash flows from the tax credits and other tax benefits are positive.
- The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor’s liability is limited to its capital investment.

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Investors that do not meet the above criteria must utilize the cost method or equity method in accordance with previously issued authoritative accounting guidance. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations.

ASU No. 2014-04: "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)"

In January 2014, ASU No. 2014-04 amended ASC Topic 310, "Receivables" to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations.

ASU No. 2014-11: "Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures"

In June 2014, ASU No. 2014-11 amended ASC Topic 860, "Transfers and Servicing" to address concerns that current accounting guidance distinguishes between repurchase agreements that settle at the same time as the maturity of the transferred financial asset and those that settle any time before maturity. The update changes the accounting for repurchase-to-maturity transactions to secured borrowing accounting and, for repurchase financing arrangements, separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to impact our financial statement disclosures.

Note 4 – AFS Securities

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows at:

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$24,706	$5	$607	$24,104
States and political subdivisions	208,564	6,962	1,316	214,210
Auction rate money market preferred	3,200	—	333	2,867
Preferred stocks	6,800	6	592	6,214
Mortgage-backed securities	162,949	1,732	1,689	162,992
Collateralized mortgage obligations	139,883	1,652	1,404	140,131
Total	$546,102	$10,357	$5,941	$550,518

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$24,860	$7	$1,122	$23,745
States and political subdivisions	200,323	5,212	3,547	201,988
Auction rate money market preferred	3,200	—	623	2,577
Preferred stocks	6,800	20	993	5,827
Mortgage-backed securities	147,292	657	3,834	144,115
Collateralized mortgage obligations	135,139	1,016	2,345	133,810
Total	$517,614	$6,912	$12,464	$512,062

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The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2014 are as follows:

	Maturing					
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	Total
Government sponsored enterprises	$—	$9,068	$15,638	$—	$ —	$24,706
States and political subdivisions	10,714	49,186	99,791	48,873	—	208,564
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	6,800	6,800
Mortgage-backed securities	—	—	—	—	162,949	162,949
Collateralized mortgage obligations	—	—	—	—	139,883	139,883
Total amortized cost	$10,714	$58,254	$115,429	$48,873	$ 312,832	$546,102
Fair value	$10,812	$60,195	$118,057	$49,250	$ 312,204	$550,518

Expected maturities for government sponsored enterprises and states and political subdivisions may differ from contractual maturities because issuers may have the right to call or prepay obligations.

As the auction rate money market preferred and preferred stocks have continual call dates, they are not reported by a specific maturity group. Because of their variable monthly payments, mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group.

A summary of the sales activity of AFS securities was as follows for the three and six month periods ended:

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Proceeds from sales of AFS securities	$—	$—	$—	$9,857
Gross realized gains (losses)	$—	$—	$—	$99
Applicable income tax expense (benefit)	$—	$—	$—	$34

The cost basis used to determine the realized gains or losses of AFS securities sold was the amortized cost of the individual investment security as of the trade date.

Information pertaining to AFS securities with gross unrealized losses at June 30, 2014 and December 31, 2013, respectively, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	June 30, 2014				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	$—	$—	$607	$23,389	$607
States and political subdivisions	259	15,190	1,057	27,852	1,316
Auction rate money market preferred	—	—	333	2,167	333
Preferred stocks	—	—	592	3,208	592
Mortgage-backed securities	17	9,268	1,672	65,346	1,689
Collateralized mortgage obligations	82	23,739	1,322	42,518	1,404
Total	$358	$48,197	$5,583	$164,480	$5,941
Number of securities in an unrealized loss position:		123		116	239

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	December 31, 2013				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	$1,122	$22,873	$—	$—	$1,122
States and political subdivisions	2,566	42,593	981	6,115	3,547
Auction rate money market preferred	—	—	623	2,577	623
Preferred stocks	—	—	993	2,807	993
Mortgage-backed securities	2,424	101,816	1,410	21,662	3,834
Collateralized mortgage obligations	2,345	84,478	—	—	2,345
Total	$8,457	$251,760	$4,007	$33,161	$12,464
Number of securities in an unrealized loss position:		182		19	201

As of June 30, 2014 and December 31, 2013, we conducted an analysis to determine whether any securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

- Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable the issuer will be unable to pay the amount when due?
- Is it more likely than not that we will have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended?

Based on our analyses, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell AFS securities in an unrealized loss position before recovery of their cost basis, we do not believe that the values of any AFS securities are other-than-temporarily impaired as of June 30, 2014, or December 31, 2013.

Note 5 – Loans and ALLL

We grant commercial, agricultural, residential real estate, and consumer loans to customers situated primarily in Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The ability of the borrowers to honor their repayment obligations is often dependent upon the real estate, agricultural, light manufacturing, retail, gaming, tourism, higher education, and general economic conditions of this region. Substantially all of our consumer and residential real estate loans are secured by various items of property, while commercial loans are secured primarily by real estate, business assets, and personal guarantees; a portion of loans are unsecured.

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

The accrual of interest on commercial, agricultural, and residential real estate loans is typically discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans are typically returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

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Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and states and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of credit exposure to any one borrower to $15,000. Borrowers with credit needs of more than $15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan-to-value limits of less than 80%. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports as deemed necessary.

We offer adjustable rate mortgages, construction loans, and fixed rate residential real estate loans which typically have amortization periods up to a maximum of 30 years. Fixed rate residential real estate loans with an amortization of greater than 15 years are generally sold upon origination to Freddie Mac. Fixed rate residential real estate loans with an amortization of 15 years or less may be held in our portfolio or sold upon origination. We consider the direction of interest rates, the sensitivity of our balance sheet to changes in interest rates, and overall loan demand to determine whether or not to sell these loans to Freddie Mac.

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 95% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan-to-value ratios in excess of 80%. Substantially all loans upon origination have a loan to value ratio of less than 80%. Underwriting criteria for residential real estate loans include: evaluation of the borrower’s ability to make monthly payments, the value of the property securing the loan, ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower’s gross income, all debt servicing does not exceed 36% of income, acceptable credit reports, verification of employment, income, and financial information. Appraisals are performed by independent appraisers and reviewed internally. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market automated underwriting system; loans in excess of $500 require the approval of our Internal Loan Committee, the Board of Directors’ Loan Committee, or the Board of Directors.

Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 12 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower’s perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectability of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The ALLL is evaluated on a regular basis and is based upon a periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower’s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the net realizable value of the loan’s underlying collateral or the net present value of the projected payment stream and our recorded investment. Historical loss allocations were calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding five years. An unallocated component is maintained to cover uncertainties that we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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A summary of changes in the ALLL and the recorded investment in loans by segments follows:

	Allowance for Loan Losses Three Months Ended June 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2014	$4,814	$425	$4,727	$630	$504	$11,100
Loans charged-off	(79)	—	(264)	(68)	—	(411)
Recoveries	92	—	86	33	—	211
Provision for loan losses	185	(206)	(568)	207	182	(200)
June 30, 2014	$5,012	$219	$3,981	$802	$686	$10,700

	Allowance for Loan Losses Six Months Ended June 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2014	$6,048	$434	$3,845	$639	$534	$11,500
Loans charged-off	(271)	(31)	(377)	(182)	—	(861)
Recoveries	306	—	122	75	—	503
Provision for loan losses	(1,071)	(184)	391	270	152	(442)
June 30, 2014	$5,012	$219	$3,981	$802	$686	$10,700

	Allowance for Loan Losses and Recorded Investment in Loans June 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$1,633	$36	$2,270	$1	$—	$3,940
Collectively evaluated for impairment	3,379	183	1,711	801	686	6,760
Total	$5,012	$219	$3,981	$802	$686	$10,700
Loans						
Individually evaluated for impairment	$13,164	$1,583	$12,906	$74		$27,727
Collectively evaluated for impairment	394,627	96,078	265,639	32,236		788,580
Total	$407,791	$97,661	$278,545	$32,310		$816,307

	Allowance for Loan Losses Three Months Ended June 30, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2013	$6,897	$321	$3,634	$732	$325	$11,909
Loans charged-off	(234)	—	(397)	(88)	—	(719)
Recoveries	166	—	61	68	—	295
Provision for loan losses	(357)	14	378	(65)	245	215
June 30, 2013	$6,472	$335	$3,676	$647	$570	$11,700

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Allowance for Loan Losses
Six Months Ended June 30, 2013

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2013	$6,862	$407	$3,627	$666	$374	$11,936
Loans charged-off	(445)	—	(587)	(209)	—	(1,241)
Recoveries	223	—	114	153	—	490
Provision for loan losses	(168)	(72)	522	37	196	515
June 30, 2013	$6,472	$335	$3,676	$647	$570	$11,700

Allowance for Loan Losses and Recorded Investment in Loans
December 31, 2013

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$2,035	$30	$2,287	$—	$—	$4,352
Collectively evaluated for impairment	4,013	404	1,558	639	534	7,148
Total	$6,048	$434	$3,845	$639	$534	$11,500
Loans						
Individually evaluated for impairment	$13,816	$1,538	$14,302	$119		$29,775
Collectively evaluated for impairment	378,288	91,051	275,629	33,294		778,262
Total	$392,104	$92,589	$289,931	$33,413		$808,037

The following table displays the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit ratings as of:

	June 30, 2014					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$15,038	$16,364	$31,402	$5,619	$3,817	$9,436
3 - High satisfactory	92,014	48,135	140,149	25,840	12,843	38,683
4 - Low satisfactory	166,155	42,561	208,716	29,461	15,804	45,265
5 - Special mention	9,816	1,153	10,969	1,810	318	2,128
6 - Substandard	13,557	145	13,702	1,848	186	2,034
7 - Vulnerable	2,605	234	2,839	115	—	115
8 - Doubtful	—	14	14	—	—	—
Total	$299,185	$108,606	$407,791	$64,693	$32,968	$97,661

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	December 31, 2013					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$18,671	$14,461	$33,132	$3,527	$3,235	$6,762
3 - High satisfactory	91,323	39,403	130,726	26,015	17,000	43,015
4 - Low satisfactory	149,921	43,809	193,730	26,874	10,902	37,776
5 - Special mention	13,747	1,843	15,590	1,609	922	2,531
6 - Substandard	16,974	473	17,447	1,232	1,273	2,505
7 - Vulnerable	1,041	238	1,279	—	—	—
8 - Doubtful	183	17	200	—	—	—
Total	$291,860	$100,244	$392,104	$59,257	$33,332	$92,589

Internally assigned risk ratings are reviewed, at a minimum, when loans are renewed or when management has knowledge of improvements or deterioration of the credit quality of individual credits. Descriptions of the internally assigned risk ratings for commercial and agricultural loans are as follows:

1. EXCELLENT – Substantially Risk Free

Credit has strong financial condition and solid earnings history, characterized by:

- High liquidity, strong cash flow, low leverage.
- Unquestioned ability to meet all obligations when due.
- Experienced management, with management succession in place.
- Secured by cash.

2. HIGH QUALITY – Limited Risk

Credit with sound financial condition and has a positive trend in earnings supplemented by:

- Favorable liquidity and leverage ratios.
- Ability to meet all obligations when due.
- Management with successful track record.
- Steady and satisfactory earnings history.
- If loan is secured, collateral is of high quality and readily marketable.
- Access to alternative financing.
- Well defined primary and secondary source of repayment.
- If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.

3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

- Working capital adequate to support operations.
- Cash flow sufficient to pay debts as scheduled.
- Management experience and depth appear favorable.
- Loan performing according to terms.
- If loan is secured, collateral is acceptable and loan is fully protected.

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4. LOW SATISFACTORY – Acceptable Risk
Credit with bankable risks, although some signs of weaknesses are shown:
- Would include most start-up businesses.
- Occasional instances of trade slowness or repayment delinquency – may have been 10-30 days slow within the past year.
- Management's abilities are apparent, yet unproven.
- Weakness in primary source of repayment with adequate secondary source of repayment.
- Loan structure generally in accordance with policy.
- If secured, loan collateral coverage is marginal.
- Adequate cash flow to service debt, but coverage is low.

To be classified as less than satisfactory, only one of the following criteria must be met.
5. SPECIAL MENTION – Criticized
Credit constitutes an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific loan:
- Downward trend in sales, profit levels, and margins.
- Impaired working capital position.
- Cash flow is strained in order to meet debt repayment.
- Loan delinquency (30-60 days) and overdrafts may occur.
- Shrinking equity cushion.
- Diminishing primary source of repayment and questionable secondary source.
- Management abilities are questionable.
- Weak industry conditions.
- Litigation pending against the borrower.
- Collateral or guaranty offers limited protection.
- Negative debt service coverage, however the credit is well collateralized and payments are current.

6. SUBSTANDARD – Classified
Credit where the borrower's current net worth, paying capacity, and value of the collateral pledged is inadequate. There is a distinct possibility that we will implement collection procedures if the loan deficiencies are not corrected. In addition, the following characteristics may apply:
- Sustained losses have severely eroded the equity and cash flow.
- Deteriorating liquidity.
- Serious management problems or internal fraud.
- Original repayment terms liberalized.
- Likelihood of bankruptcy.
- Inability to access other funding sources.
- Reliance on secondary source of repayment.
- Litigation filed against borrower.
- Collateral provides little or no value.
- Requires excessive attention of the loan officer.
- Borrower is uncooperative with loan officer.

7. VULNERABLE – Classified
Credit is considered "Substandard" and warrants placing on nonaccrual. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:
- Insufficient cash flow to service debt.
- Minimal or no payments being received.
- Limited options available to avoid the collection process.

- Transition status, expect action will take place to collect loan without immediate progress being made.

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8. DOUBTFUL – Workout
Credit has all the weaknesses inherent in a "Substandard" loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:

- Normal operations are severely diminished or have ceased.
- Seriously impaired cash flow.
- Original repayment terms materially altered.
- Secondary source of repayment is inadequate.
- Survivability as a "going concern" is impossible.
- Collection process has begun.
- Bankruptcy petition has been filed.
- Judgments have been filed.
- Portion of the loan balance has been charged-off.

Our primary credit quality indicator for residential real estate and consumer loans is the individual loan's past due aging. The following tables summarize the past due and current loans as of:

	June 30, 2014						
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual	Current	Total
Commercial							
Commercial real estate	$857	$332	$—	$2,605	$3,794	$295,391	$299,185
Commercial other	257	13	28	234	532	108,074	108,606
Total commercial	1,114	345	28	2,839	4,326	403,465	407,791
Agricultural							
Agricultural real estate	208	—	—	115	323	64,370	64,693
Agricultural other	312	84	—	—	396	32,572	32,968
Total agricultural	520	84	—	115	719	96,942	97,661
Residential real estate							
Senior liens	1,558	766	91	1,239	3,654	222,355	226,009
Junior liens	311	18	—	23	352	11,984	12,336
Home equity lines of credit	246	—	—	361	607	39,593	40,200
Total residential real estate	2,115	784	91	1,623	4,613	273,932	278,545
Consumer							
Secured	46	—	—	10	56	27,827	27,883
Unsecured	38	4	—	—	42	4,385	4,427
Total consumer	84	4	—	10	98	32,212	32,310
Total	$3,833	$1,217	$119	$4,587	$9,756	$806,551	$816,307

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	December 31, 2013						
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual	Current	Total
Commercial							
Commercial real estate	$1,226	$296	$—	$1,136	$2,658	$289,202	$291,860
Commercial other	368	15	13	238	634	99,610	100,244
Total commercial	1,594	311	13	1,374	3,292	388,812	392,104
Agricultural							
Agricultural real estate	34	295	—	—	329	58,928	59,257
Agricultural other	—	—	—	—	—	33,332	33,332
Total agricultural	34	295	—	—	329	92,260	92,589
Residential real estate							
Senior liens	3,441	986	129	1,765	6,321	229,865	236,186
Junior liens	408	44	—	29	481	13,074	13,555
Home equity lines of credit	181	—	—	25	206	39,984	40,190
Total residential real estate	4,030	1,030	129	1,819	7,008	282,923	289,931
Consumer							
Secured	167	11	—	50	228	28,444	28,672
Unsecured	25	5	—	1	31	4,710	4,741
Total consumer	192	16	—	51	259	33,154	33,413
Total	$5,850	$1,652	$142	$3,244	$10,888	$797,149	$808,037

Impaired Loans

Loans may be classified as impaired if they meet one or more of the following criteria:

1. There has been a charge-off of its principal balance (in whole or in part),
2. The loan has been classified as a TDR, or
3. The loan is in nonaccrual status.

Impairment is measured on a loan-by-loan basis for commercial and agricultural loans by comparing the loan’s outstanding balance to the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair value of the collateral, less cost to sell, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Impairment is measured on a loan-by-loan basis for residential real estate and consumer loans by comparing the loan’s outstanding balance to the present value of expected future cash flows discounted at the loan’s effective interest rate.

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We do not recognize interest income on impaired loans in nonaccrual status. For impaired loans not in nonaccrual status, interest income is recognized daily, as earned, according to the terms of the loan agreement. The following is a summary of information pertaining to impaired loans as of:

	June 30, 2014			December 31, 2013		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	$6,512	$6,720	$1,621	$6,748	$6,888	$1,915
Commercial other	629	848	12	521	521	120
Agricultural real estate	204	204	36	90	90	30
Residential real estate senior liens	12,454	13,727	2,242	14,061	15,315	2,278
Residential real estate junior liens	92	102	19	48	64	9
Home equity lines of credit	360	660	9	—	—	—
Consumer secured	64	64	1	—	—	—
Total impaired loans with a valuation allowance	20,315	22,325	3,940	21,468	22,878	4,352
Impaired loans without a valuation allowance						
Commercial real estate	5,708	6,326		5,622	6,499	
Commercial other	315	356		925	1,035	
Agricultural real estate	1,361	1,361		1,370	1,370	
Agricultural other	18	138		78	198	
Home equity lines of credit	—	—		193	493	
Consumer secured	10	10		119	148	
Total impaired loans without a valuation allowance	7,412	8,191		8,307	9,743	
Impaired loans						
Commercial	13,164	14,250	1,633	13,816	14,943	2,035
Agricultural	1,583	1,703	36	1,538	1,658	30
Residential real estate	12,906	14,489	2,270	14,302	15,872	2,287
Consumer	74	74	1	119	148	—
Total impaired loans	$27,727	$30,516	$3,940	$29,775	$32,621	$4,352

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The following is a summary of information pertaining to impaired loans for the three and six month periods ended:

	Three Months Ended June 30, 2014		Six Months Ended June 30, 2014	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	$6,644	$91	$6,701	$185
Commercial other	852	11	825	29
Agricultural real estate	147	(1)	118	—
Agricultural other	—	—	—	—
Residential real estate senior liens	12,786	126	13,188	264
Residential real estate junior liens	68	1	57	1
Home equity lines of credit	265	10	175	11
Consumer secured	63	1	77	2
Total impaired loans with a valuation allowance	20,825	239	21,141	492
Impaired loans without a valuation allowance				
Commercial real estate	5,819	91	5,797	193
Commercial other	286	1	438	7
Agricultural real estate	1,405	21	1,407	37
Agricultural other	131	—	146	28
Home equity lines of credit	—	—		