

ISABELLA BANK CORP  
Form 10-Q  
August 08, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended June 30, 2013

or  
 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 (I.R.S. Employer  
incorporation or organization) 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.  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).  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 "accelerated filer", "large accelerated filer", and "smaller reporting company", in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer  Accelerated filer

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  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock no par value, 7,711,460 as of 7/25/2013



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



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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<br>2013    | December 31<br>2012 |
|--|--------------------|---------------------|
| <b>ASSETS</b>  |                    |                     |
| Cash and cash equivalents  |                    |                     |
| Cash and demand deposits due from banks  | \$21,289           | \$22,634            |
| Interest bearing balances due from banks   | 77                 | 2,286               |
| Total cash and cash equivalents  | 21,366             | 24,920              |
| Certificates of deposit held in other financial institutions   | 1,810              | 4,465               |
| Trading securities   | 950                | 1,573               |
| AFS securities (amortized cost of \$499,891 in 2013 and \$490,420 in 2012)   | 499,424            | 504,010             |
| Mortgage loans AFS   | 743                | 3,633               |
| Loans  |                    |                     |
| Commercial   | 389,044            | 371,505             |
| Agricultural   | 87,516             | 83,606              |
| Residential real estate  | 293,158            | 284,148             |
| Consumer   | 33,734             | 33,494              |
| Total loans  | 803,452            | 772,753             |
| Less allowance for loan and lease losses   | 11,700             | 11,936              |
| Net loans  | 791,752            | 760,817             |
| Premises and equipment   | 25,852             | 25,787              |
| Corporate owned life insurance policies  | 24,101             | 22,773              |
| Accrued interest receivable  | 5,232              | 5,227               |
| Equity securities without readily determinable fair values   | 18,242             | 18,118              |
| Goodwill and other intangible assets   | 46,418             | 46,532              |
| Other assets   | 15,525             | 12,784              |
| <b>TOTAL ASSETS</b>  | <b>\$1,451,415</b> | <b>\$1,430,639</b>  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                    |                     |
| Deposits   |                    |                     |
| Noninterest bearing  | \$139,942          | \$143,735           |
| NOW accounts   | 173,184            | 181,259             |
| Certificates of deposit under \$100 and other savings  | 468,094            | 455,546             |
| Certificates of deposit over \$100   | 240,204            | 237,127             |
| Total deposits   | 1,021,424          | 1,017,667           |
| Borrowed funds   | 262,460            | 241,001             |
| Accrued interest payable and other liabilities   | 8,243              | 7,482               |
| Total liabilities  | 1,292,127          | 1,266,150           |
| Shareholders' equity   |                    |                     |
| Common stock — no par value 15,000,000 shares authorized; issued and outstanding<br>7,703,589 shares (including 4,742 shares held in the Rabbi Trust) in 2013 and<br>7,671,846 shares (including 5,130 shares held in the Rabbi Trust) in 2012 | 137,321            | 136,580             |
| Shares to be issued for deferred compensation obligations  | 3,871              | 3,734               |
| Retained earnings  | 22,244             | 19,168              |
| Accumulated other comprehensive income (loss)  | (4,148             | ) 5,007             |
| Total shareholders' equity   | 159,288            | 164,489             |

|  |             |             |
|--|-------------|-------------|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$1,451,415 | \$1,430,639 |
|--|-------------|-------------|

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 |          | Six Months Ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30            |          | June 30          |          |
|   | 2013               | 2012     | 2013             | 2012     |
| Interest income   |                    |          |                  |          |
| Loans, including fees   | \$10,280           | \$10,849 | \$20,610         | \$21,789 |
| AFS securities  |                    |          |                  |          |
| Taxable   | 1,798              | 1,988    | 3,632            | 3,877    |
| Nontaxable  | 1,244              | 1,216    | 2,478            | 2,420    |
| Trading securities  | 9                  | 22       | 23               | 64       |
| Federal funds sold and other                                  | 109                | 113      | 225              | 242      |
| Total interest income   | 13,440             | 14,188   | 26,968           | 28,392   |
| Interest expense  |                    |          |                  |          |
| Deposits  | 1,822              | 2,368    | 3,696            | 4,880    |
| Borrowings  | 959                | 1,061    | 1,906            | 2,253    |
| Total interest expense  | 2,781              | 3,429    | 5,602            | 7,133    |
| Net interest income   | 10,659             | 10,759   | 21,366           | 21,259   |
| Provision for loan losses                                     | 215                | 439      | 515              | 900      |
| Net interest income after provision for loan losses           | 10,444             | 10,320   | 20,851           | 20,359   |
| Noninterest income  |                    |          |                  |          |
| Service charges and fees                                      | 1,747              | 1,628    | 3,291            | 3,257    |
| Gain (loss) on sale of mortgage loans                         | 249                | 279      | 607              | 658      |
| Earnings on corporate owned life insurance policies           | 190                | 177      | 359              | 348      |
| Gain (loss) on sale of AFS securities                         | —                  | —        | 99               | 1,003    |
| Other   | 550                | 460      | 827              | 819      |
| Total noninterest income                                      | 2,736              | 2,544    | 5,183            | 6,085    |
| Noninterest expenses  |                    |          |                  |          |
| Compensation and benefits                                     | 5,236              | 5,232    | 10,681           | 10,533   |
| Furniture and equipment                                       | 1,192              | 1,170    | 2,381            | 2,260    |
| Occupancy   | 641                | 599      | 1,306            | 1,240    |
| AFS security impairment loss                                  |                    |          |                  |          |
| Total other-than-temporary impairment loss                    | —                  | —        | —                | 486      |
| Portion of loss reported in other comprehensive income (loss) | —                  | —        | —                | (204)    |
| Net AFS security impairment loss                              | —                  | —        | —                | 282      |
| Other   | 2,255              | 2,187    | 4,147            | 4,446    |
| Total noninterest expenses                                    | 9,324              | 9,188    | 18,515           | 18,761   |
| Income before federal income tax expense                      | 3,856              | 3,676    | 7,519            | 7,683    |
| Federal income tax expense                                    | 643                | 672      | 1,219            | 1,445    |
| NET INCOME  | \$3,213            | \$3,004  | \$6,300          | \$6,238  |
| Earnings per share  |                    |          |                  |          |
| Basic   | \$0.42             | \$0.40   | \$0.82           | \$0.82   |
| Diluted   | \$0.41             | \$0.39   | \$0.80           | \$0.80   |
| Cash dividends per basic share                                | \$0.21             | \$0.20   | \$0.42           | \$0.40   |

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 |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | June 30            |           | June 30          |           |
|  | 2013               | 2012      | 2013             | 2012      |
| Net income   | \$3,213            | \$3,004   | \$6,300          | \$6,238   |
| Unrealized gains (losses) on AFS securities:                                       |                    |           |                  |           |
| Unrealized gains (losses) arising during the period                                | (11,997            | ) 1,420   | (13,958          | ) 2,219   |
| Reclassification adjustment for net realized (gains) losses included in net income | —                  | —         | (99              | ) (1,003  |
| Reclassification adjustment for impairment loss included in net income             | —                  | —         | —                | 282       |
| Net unrealized gains (losses)  | (11,997            | ) 1,420   | (14,057          | ) 1,498   |
| Tax effect (1)   | 3,979              | (546      | ) 4,902          | (27       |
| Other comprehensive income (loss)  | (8,018             | ) 874     | (9,155           | ) 1,471   |
| Comprehensive income (loss)  | \$(4,805           | ) \$3,878 | \$(2,855         | ) \$7,709 |

(1) See "Note 10 – Federal Income Taxes" for tax effect reconciliation.

See notes to interim condensed consolidated financial statements.

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(Dollars in thousands except per share amounts)

|   | Common<br>Stock<br>Shares<br>Outstanding | Common<br>Stock | Shares to be<br>Issued for<br>Deferred<br>Compensation<br>Obligations | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Totals     |
|---|--|-----------------|---|----------------------|--|------------|
| Balance, January 1, 2012  | 7,589,226                                | \$ 134,734      | \$ 4,524  | \$ 13,036            | \$ 2,489   | \$ 154,783 |
| Comprehensive income (loss)   | —  | —               | —   | 6,238                | 1,471  | 7,709      |
| Issuance of common stock  | 54,900                                   | 1,322           | —   | —                    | —  | 1,322      |
| Common stock transferred from<br>the Rabbi Trust to satisfy<br>deferred compensation<br>obligations | —  | 95              | (95 )   | —                    | —  | —          |
| Share-based payment awards<br>under equity compensation plan  | —  | —               | 295   | —                    | —  | 295        |
| Common stock purchased for<br>deferred compensation<br>obligations                                  | —  | (225 )          | —   | —                    | —  | (225 )     |
| Common stock repurchased<br>pursuant to publicly announced<br>repurchase plan                       | (41,581 )                                | (995 )          | —   | —                    | —  | (995 )     |
| Cash dividends (\$0.40 per<br>share)  | —  | —               | —   | (3,034 )             | —  | (3,034 )   |
| Balance, June 30, 2012  | 7,602,545                                | \$ 134,931      | \$ 4,724  | \$ 16,240            | \$ 3,960   | \$ 159,855 |
| 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 transferred from<br>the Rabbi Trust to satisfy<br>deferred compensation<br>obligations | —  | 121             | (121 )  | —                    | —  | —          |
| Share-based payment awards<br>under equity compensation plan  | —  | —               | 258   | —                    | —  | 258        |
| Common stock purchased for<br>deferred compensation<br>obligations                                  | —  | (166 )          | —   | —                    | —  | (166 )     |
| Common stock repurchased<br>pursuant to publicly announced<br>repurchase plan                       | (45,825 )                                | (1,114 )        | —   | —                    | —  | (1,114 )   |
| Cash dividends (\$0.42 per<br>share)  | —  | —               | —   | (3,224 )             | —  | (3,224 )   |
| Balance, June 30, 2013  | 7,703,589                                | \$ 137,321      | \$ 3,871  | \$ 22,244            | \$ (4,148 )  | \$ 159,288 |

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          |            |
|   | 2013             | 2012       |
| <b>OPERATING ACTIVITIES</b>   |                  |            |
| Net income  | \$6,300          | \$6,238    |
| Reconciliation of net income to net cash provided by operations:            |                  |            |
| Provision for loan losses   | 515              | 900        |
| Impairment of foreclosed assets   | 92               | 17         |
| Depreciation  | 1,249            | 1,195      |
| Amortization and impairment of OMSRs  | 210              | 287        |
| Amortization of acquisition intangibles                                     | 114              | 133        |
| Net amortization of AFS securities  | 1,131            | 1,076      |
| AFS security impairment loss  | —                | 282        |
| (Gain) loss on sale of AFS securities                                       | (99              | ) (1,003   |
| Net unrealized (gains) losses on trading securities                         | 18               | 32         |
| Net gain on sale of mortgage loans  | (607             | ) (658     |
| Net unrealized (gains) losses on borrowings measured at fair value          | —                | (33        |
| Increase in cash value of corporate owned life insurance policies           | (359             | ) (348     |
| Share-based payment awards under equity compensation plan                   | 258              | 295        |
| Origination of loans held-for-sale  | (35,014          | ) (46,386  |
| Proceeds from loan sales  | 38,511           | 47,902     |
| Net changes in operating assets and liabilities which provided (used) cash: |                  |            |
| Trading securities  | 605              | 2,680      |
| Accrued interest receivable   | (5               | ) 631      |
| Other assets  | 914              | (1,132     |
| Accrued interest payable and other liabilities                              | 761              | (161       |
| Net cash provided by (used in) operating activities                         | 14,594           | 11,947     |
| <b>INVESTING ACTIVITIES</b>   |                  |            |
| Net change in certificates of deposit held in other financial institutions  | 2,655            | 2,044      |
| Activity in AFS securities  |                  |            |
| Sales   | 9,857            | 24,241     |
| Maturities and calls  | 46,780           | 37,922     |
| Purchases   | (67,140          | ) (112,835 |
| Loan principal originations, net  | (32,185          | ) (6,768   |
| Proceeds from sales of foreclosed assets                                    | 1,556            | 647        |
| Purchases of premises and equipment   | (1,314           | ) (1,298   |
| 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                         | (40,760          | ) (56,047  |

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

|  | Six Months Ended |          |
|--|------------------|----------|
|  | June 30          |          |
|  | 2013             | 2012     |
| <b>FINANCING ACTIVITIES</b>                                      |                  |          |
| Acceptances and withdrawals of deposits, net                     | 3,757            | 20,664   |
| Increase (decrease) in borrowed funds                            | 21,459           | 18,029   |
| Cash dividends paid on common stock                              | (3,224           | ) (3,034 |
| Proceeds from issuance of common stock                           | 1,900            | 1,322    |
| Common stock repurchased   | (1,114           | ) (995   |
| Common stock purchased for deferred compensation obligations     | (166             | ) (225   |
| Net cash provided by (used in) financing activities              | 22,612           | 35,761   |
| Increase (decrease) in cash and cash equivalents                 | (3,554           | ) (8,339 |
| Cash and cash equivalents at beginning of period                 | 24,920           | 28,590   |
| Cash and cash equivalents at end of period                       | \$21,366         | \$20,251 |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                      |                  |          |
| Interest paid  | \$5,667          | \$7,291  |
| Federal income taxes paid  | 702              | 836      |
| <b>SUPPLEMENTAL NONCASH INVESTING AND FINANCING INFORMATION:</b> |                  |          |
| Transfers of loans to foreclosed assets                          | \$735            | \$1,150  |

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, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. For further information, refer to the consolidated financial statements and footnotes thereto included in our annual report for the year ended December 31, 2012.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our annual report for the year ended December 31, 2012.

## Note 2 – Computation of Earnings Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per 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 |           | Six Months Ended |           |
|---|--------------------|-----------|------------------|-----------|
|   | June 30            |           | June 30          |           |
|   | 2013               | 2012      | 2013             | 2012      |
| Average number of common shares outstanding for basic calculation                               | 7,701,042          | 7,592,668 | 7,689,092        | 7,593,462 |
| Average potential effect of shares in the Directors Plan (1)                                    | 168,323            | 203,603   | 166,800          | 201,743   |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 7,869,365          | 7,796,271 | 7,855,892        | 7,795,205 |
| Net income  | \$3,213            | \$3,004   | \$6,300          | \$6,238   |
| Earnings per share  |                    |           |                  |           |
| Basic   | \$0.42             | \$0.40    | \$0.82           | \$0.82    |
| Diluted   | \$0.41             | \$0.39    | \$0.80           | \$0.80    |

(1) Exclusive of shares held in the Rabbi Trust

## Note 3 – Recently Adopted Accounting Standards Update

ASU No. 2013-02: "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income"

In February 2013, ASU No. 2013-02 amended ASC Topic 220, "Comprehensive Income" to require disclosures related to reclassifications out of AOCI in one place. The ASU also requires the disclosure of reclassifications out of AOCI by component. The new authoritative guidance was effective for interim and annual periods beginning after December 15, 2012 and did not have a financial impact on the Corporation, but increased the level of disclosures related to AOCI (see "Note 13 – Accumulated Other Comprehensive Income (Loss)").

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## Note 4 – Trading Securities

Trading securities, at fair value, consist of the following investments at:

|                                   | June 30<br>2013 | December 31<br>2012 |
|-----------------------------------|-----------------|---------------------|
| States and political subdivisions | \$950           | \$1,573             |

Included in net trading losses of \$18 during the first six months of 2013 were \$4 of net unrealized trading losses on securities that were held in our trading portfolio as of June 30, 2013. Included in net trading losses of \$32 during the first six months of 2012 were \$10 of net unrealized trading losses on securities that were held in our trading portfolio as of June 30, 2012.

## Note 5 – AFS Securities

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

|                                     | June 30, 2013     |                              |                               |               |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Government sponsored enterprises    | \$25,184          | \$16                         | \$951                         | \$24,249      |
| States and political subdivisions   | 184,157           | 5,567                        | 2,422                         | 187,302       |
| Auction rate money market preferred | 3,200             | —                            | 257                           | 2,943         |
| Preferred stocks                    | 6,800             | 66                           | 307                           | 6,559         |
| Mortgage-backed securities          | 151,530           | 862                          | 2,985                         | 149,407       |
| Collateralized mortgage obligations | 129,020           | 1,445                        | 1,501                         | 128,964       |
| Total                               | \$499,891         | \$7,956                      | \$8,423                       | \$499,424     |
|                                     | December 31, 2012 |                              |                               |               |
|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Government sponsored enterprises    | \$25,668          | \$108                        | \$—                           | \$25,776      |
| States and political subdivisions   | 174,118           | 9,190                        | 565                           | 182,743       |
| Auction rate money market preferred | 3,200             | —                            | 422                           | 2,778         |
| Preferred stocks                    | 6,800             | —                            | 437                           | 6,363         |
| Mortgage-backed securities          | 152,256           | 3,199                        | 110                           | 155,345       |
| Collateralized mortgage obligations | 128,378           | 2,627                        | —                             | 131,005       |
| Total                               | \$490,420         | \$15,124                     | \$1,534                       | \$504,010     |

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The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2013 are as follows:

|                                     | Maturing                      |   |  |                    | Securities with<br>Variable<br>Monthly<br>Payments or<br>Noncontractual<br>Maturities | Total     |
|-------------------------------------|-------------------------------|---|--|--------------------|---|-----------|
|                                     | Due in<br>One Year<br>or Less | After One<br>Year But<br>Within<br>Five Years | After Five<br>Years But<br>Within<br>Ten Years | After<br>Ten Years |   |           |
| Government sponsored enterprises    | \$—                           | \$72  | \$25,112                                       | \$—                | \$—   | \$25,184  |
| States and political subdivisions   | 9,925                         | 35,019  | 92,688   | 46,525             | —   | 184,157   |
| Auction rate money market preferred | —                             | —   | —  | —                  | 3,200   | 3,200     |
| Preferred stocks                    | —                             | —   | —  | —                  | 6,800   | 6,800     |
| Mortgage-backed securities          | —                             | —   | —  | —                  | 151,530   | 151,530   |
| Collateralized mortgage obligations | —                             | —   | —  | —                  | 129,020   | 129,020   |
| Total amortized cost                | \$9,925                       | \$35,091                                      | \$117,800                                      | \$46,525           | \$290,550   | \$499,891 |
| Fair value                          | \$9,998                       | \$36,221                                      | \$119,783                                      | \$45,549           | \$287,873   | \$499,424 |

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

|   | Three Months Ended |      | Six Months Ended |          |
|---|--------------------|------|------------------|----------|
|   | June 30            |      | June 30          |          |
|   | 2013               | 2012 | 2013             | 2012     |
| Proceeds from sales of AFS securities   | \$—                | \$—  | \$9,857          | \$24,241 |
| Gross realized gains (losses)           | \$—                | \$—  | \$99             | \$1,003  |
| Applicable income tax expense (benefit) | \$—                | \$—  | \$34             | \$341    |

The cost basis used to determine the realized gains or losses of 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, 2013 and December 31, 2012 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|  | June 30, 2013                 |               |                               |               |                               |
|--|-------------------------------|---------------|-------------------------------|---------------|-------------------------------|
|  | Less Than Twelve Months       |               | Twelve Months or More         |               | Total<br>Unrealized<br>Losses |
|  | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                               |
| Government sponsored enterprises                     | \$951                         | \$23,043      | \$—                           | \$—           | \$951                         |
| States and political subdivisions                    | 1,901                         | 39,297        | 521                           | 2,090         | 2,422                         |
| Auction rate money market preferred                  | —                             | —             | 257                           | 2,943         | 257                           |
| Preferred stocks                                     | —                             | —             | 307                           | 3,493         | 307                           |
| Mortgage-backed securities                           | 2,985                         | 93,842        | —                             | —             | 2,985                         |
| Collateralized mortgage obligations                  | 1,501                         | 54,368        | —                             | —             | 1,501                         |
| Total  | \$7,338                       | \$210,550     | \$1,085                       | \$8,526       | \$8,423                       |
| Number of securities in an unrealized loss position: |                               | 155           |                               | 6             | 161                           |





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|  | December 31, 2012             |               |                         |                       | Total<br>Unrealized<br>Losses |
|--|-------------------------------|---------------|-------------------------|-----------------------|-------------------------------|
|  | Gross<br>Unrealized<br>Losses | Fair<br>Value | Less Than Twelve Months | Twelve Months or More |                               |
| States and political subdivisions                    | \$80                          | \$5,019       | \$485                   | \$2,352               | \$565                         |
| Auction rate money market preferred                  | —                             | —             | 422                     | 2,778                 | 422                           |
| Preferred stocks                                     | —                             | —             | 437                     | 3,363                 | 437                           |
| Mortgage-backed securities                           | 110                           | 25,499        | —                       | —                     | 110                           |
| Total  | \$190                         | \$30,518      | \$1,344                 | \$8,493               | \$1,534                       |
| Number of securities in an unrealized loss position: |                               | 15            |                         | 6                     | 21                            |

As of June 30, 2013 and December 31, 2012, 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 not have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended?

During the three month period ended March 31, 2012, we had one state issued student loan auction rate AFS investment security (which is included in states and political subdivisions) that was downgraded by Moody's from A3 to Caa3. As a result of this downgrade, we engaged the services of an independent investment valuation firm to estimate the amount of credit losses (if any) related to this particular issue as of March 31, 2012. The evaluation calculated a range of estimated credit losses utilizing two different bifurcation methods:

- 1) Discounted Cash Flow Method.
- 2) Credit Yield Analysis Method.

The two methods were then weighted, with a higher weighting applied to the Discounted Cash Flow Method, to determine the estimated credit related impairment. As a result of this analysis we recognized an OTTI of \$282 in earnings in the quarter ended March 31, 2012.

A summary of key valuation assumptions used in the aforementioned analysis as of March 31, 2012, follows:

|   |                                 |
|---|---------------------------------|
| Ratings   | Discounted<br>Cash Flow Method  |
| Fitch   | Not Rated                       |
| Moody's   | Caa3                            |
| S&P   | A                               |
| Seniority   | Senior                          |
| Discount rate   | LIBOR + 6.35%                   |
| Credit discount rate                                    | Credit Yield<br>Analysis Method |
| Average observed discounts based on closed transactions | LIBOR + 4.00%                   |
|   | 14.00%                          |

To test for additional impairment of this security during the three and six months ended June 30, 2013, we obtained another investment valuation (from the same firm engaged to perform the initial valuation as of March 31, 2012) as of June 30, 2013. Based on our analysis, no additional OTTI was indicated as of June 30, 2013.



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The following table provides a roll-forward of credit related impairment recognized in earnings for the:

|  | Three Months Ended June 30 |       | Six Months Ended June 30 |       |
|--|----------------------------|-------|--------------------------|-------|
|  | 2013                       | 2012  | 2013                     | 2012  |
| Balance at beginning of period                                       | \$282                      | \$282 | \$282                    | \$—   |
| Additions to credit losses for which no previous OTTI was recognized | —                          | —     | —                        | 282   |
| Balance at end of period   | \$282                      | \$282 | \$282                    | \$282 |

Based on our analysis using the above criteria, the fact that we have asserted that we do not have the intent to sell these securities in an unrealized loss position, and considering it is unlikely that we will have to sell the securities before recovery of their cost basis, we do not believe that the values of any other securities are other-than-temporarily impaired as of June 30, 2013, or December 31, 2012.

#### Note 6 – 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 on loans 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. The interest on these loans is accounted for on the cash basis, until qualifying for return to accrual status. 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.

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 \$12,500. Borrowers with credit needs of more than \$12,500 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, fixed rate balloon mortgages, construction loans, and fixed rate mortgage loans which typically have amortization periods up to a maximum of 30 years. Fixed rate 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, held for future sale, 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,

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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 \$400 require the approval of our Internal Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors. Consumer loans include automobile loans, secured and unsecured personal loans, and overdraft protection related loans. Loans are amortized generally for a period of up to 6 years. 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. 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, 2013 |              |                            |          |             |          |
|                           | Commercial                       | Agricultural | Residential<br>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 |
|                           | Allowance for Loan Losses        |              |                            |          |             |          |
|                           | Six Months Ended June 30, 2013   |              |                            |          |             |          |
|                           | Commercial                       | Agricultural | Residential<br>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 |

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| Allowance for Loan Losses and Recorded Investment in Loans<br>June 30, 2013     |            |              |                            |          |             |           |
|---|------------|--------------|----------------------------|----------|-------------|-----------|
|   | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total     |
| ALLL  |            |              |                            |          |             |           |
| Individually evaluated for impairment   | \$1,642    | \$31         | \$1,744                    | \$—      | \$—         | \$3,417   |
| Collectively evaluated for impairment   | 4,830      | 304          | 1,932                      | 647      | 570         | 8,283     |
| Total   | \$6,472    | \$335        | \$3,676                    | \$647    | \$570       | \$11,700  |
| Loans   |            |              |                            |          |             |           |
| Individually evaluated for impairment   | \$13,639   | \$576        | \$10,720                   | \$54     |             | \$24,989  |
| Collectively evaluated for impairment   | 375,405    | 86,940       | 282,438                    | 33,680   |             | 778,463   |
| Total   | \$389,044  | \$87,516     | \$293,158                  | \$33,734 |             | \$803,452 |
| Allowance for Loan Losses<br>Three Months Ended June 30, 2012                   |            |              |                            |          |             |           |
|   | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total     |
| April 1, 2012   | \$5,728    | \$859        | \$3,702                    | \$625    | \$1,461     | \$12,375  |
| Loans charged-off   | (237 )     | —            | (238 )                     | (146 )   | —           | (621 )    |
| Recoveries  | 42         | —            | 20                         | 63       | —           | 125       |
| Provision for loan losses   | 475        | (426 )       | 185                        | 125      | 80          | 439       |
| June 30, 2012   | \$6,008    | \$433        | \$3,669                    | \$667    | \$1,541     | \$12,318  |
| Allowance for Loan Losses<br>Six Months Ended June 30, 2012                     |            |              |                            |          |             |           |
|   | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total     |
| January 1, 2012   | \$6,284    | \$1,003      | \$2,980                    | \$633    | \$1,475     | \$12,375  |
| Loans charged-off   | (686 )     | —            | (353 )                     | (237 )   | —           | (1,276 )  |
| Recoveries  | 128        | —            | 61                         | 130      | —           | 319       |
| Provision for loan losses   | 282        | (570 )       | 981                        | 141      | 66          | 900       |
| June 30, 2012   | \$6,008    | \$433        | \$3,669                    | \$667    | \$1,541     | \$12,318  |
| Allowance for Loan Losses and Recorded Investment in Loans<br>December 31, 2012 |            |              |                            |          |             |           |
|   | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total     |
| ALLL  |            |              |                            |          |             |           |
| Individually evaluated for impairment   | \$2,050    | \$91         | \$1,796                    | \$—      | \$—         | \$3,937   |
| Collectively evaluated for impairment   | 4,812      | 316          | 1,831                      | 666      | 374         | 7,999     |
| Total   | \$6,862    | \$407        | \$3,627                    | \$666    | \$374       | \$11,936  |
| Loans   |            |              |                            |          |             |           |
| Individually evaluated for impairment   | \$14,456   | \$723        | \$10,704                   | \$75     |             | \$25,958  |
| Collectively evaluated for impairment   | 357,049    | 82,883       | 273,444                    | 33,419   |             | 746,795   |

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|       |           |          |           |          |           |
|-------|-----------|----------|-----------|----------|-----------|
| Total | \$371,505 | \$83,606 | \$284,148 | \$33,494 | \$772,753 |
|-------|-----------|----------|-----------|----------|-----------|

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

| Rating                | June 30, 2013 |           |           |              |          |          |
|-----------------------|---------------|-----------|-----------|--------------|----------|----------|
|                       | Commercial    |           |           | Agricultural |          |          |
|                       | Real Estate   | Other     | Total     | Real Estate  | Other    | Total    |
| 2 - High quality      | \$21,836      | \$16,358  | \$38,194  | \$3,523      | \$3,273  | \$6,796  |
| 3 - High satisfactory | 94,390        | 40,835    | 135,225   | 24,305       | 14,758   | 39,063   |
| 4 - Low satisfactory  | 133,379       | 44,636    | 178,015   | 24,782       | 13,248   | 38,030   |
| 5 - Special mention   | 14,315        | 1,314     | 15,629    | 803          | 201      | 1,004    |
| 6 - Substandard       | 17,350        | 2,138     | 19,488    | 958          | 1,268    | 2,226    |
| 7 - Vulnerable        | 1,068         | 78        | 1,146     | —            | 248      | 248      |
| 8 - Doubtful          | 1,327         | 20        | 1,347     | —            | 149      | 149      |
| Total                 | \$283,665     | \$105,379 | \$389,044 | \$54,371     | \$33,145 | \$87,516 |

  

| Rating                | December 31, 2012 |          |           |              |          |          |
|-----------------------|-------------------|----------|-----------|--------------|----------|----------|
|                       | Commercial        |          |           | Agricultural |          |          |
|                       | Real Estate       | Other    | Total     | Real Estate  | Other    | Total    |
| 2 - High quality      | \$25,209          | \$15,536 | \$40,745  | \$2,955      | \$2,313  | \$5,268  |
| 3 - High satisfactory | 83,805            | 28,974   | 112,779   | 16,972       | 11,886   | 28,858   |
| 4 - Low satisfactory  | 127,423           | 45,143   | 172,566   | 27,291       | 15,437   | 42,728   |
| 5 - Special mention   | 16,046            | 1,692    | 17,738    | 1,008        | 3,191    | 4,199    |
| 6 - Substandard       | 20,029            | 2,224    | 22,253    | 1,167        | 1,217    | 2,384    |
| 7 - Vulnerable        | 1,512             | 2,294    | 3,806     | —            | —        | —        |
| 8 - Doubtful          | 1,596             | 22       | 1,618     | —            | 169      | 169      |
| Total                 | \$275,620         | \$95,885 | \$371,505 | \$49,393     | \$34,213 | \$83,606 |

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.



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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.

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.

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## 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.

## 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 indicators 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, 2013                      |               |                    |            | Total<br>Past Due<br>and<br>Nonaccrual | Current    | Total      |
|-------------------------------|------------------------------------|---------------|--------------------|------------|--|------------|------------|
|                               | Accruing Interest<br>and Past Due: |               | 90 Days<br>or More | Nonaccrual |  |            |            |
|                               | 30-59<br>Days                      | 60-89<br>Days |                    |            |  |            |            |
| Commercial                    |                                    |               |                    |            |  |            |            |
| Commercial real estate        | \$ 1,224                           | \$ 490        | \$—                | \$ 1,806   | \$ 3,520                               | \$ 280,145 | \$ 283,665 |
| Commercial other              | 403                                | 113           | 192                | 78         | 786                                    | 104,593    | 105,379    |
| Total commercial              | 1,627                              | 603           | 192                | 1,884      | 4,306                                  | 384,738    | 389,044    |
| Agricultural                  |                                    |               |                    |            |  |            |            |
| Agricultural real estate      | 377                                | 19            | —                  | —          | 396                                    | 53,975     | 54,371     |
| Agricultural other            | —                                  | 12            | —                  | 248        | 260                                    | 32,885     | 33,145     |
| Total agricultural            | 377                                | 31            | —                  | 248        | 656                                    | 86,860     | 87,516     |
| Residential real estate       |                                    |               |                    |            |  |            |            |
| Senior liens                  | 2,461                              | 462           | 316                | 1,427      | 4,666                                  | 234,597    | 239,263    |
| Junior liens                  | 199                                | 29            | —                  | 71         | 299                                    | 14,220     | 14,519     |
| Home equity lines of credit   | 90                                 | 25            | —                  | —          | 115                                    | 39,261     | 39,376     |
| Total residential real estate | 2,750                              | 516           | 316                | 1,498      | 5,080                                  | 288,078    | 293,158    |
| Consumer                      |                                    |               |                    |            |  |            |            |
| Secured                       | 46                                 | —             | 12                 | 21         | 79                                     | 28,984     | 29,063     |
| Unsecured                     | 19                                 | 6             | —                  | —          | 25                                     | 4,646      | 4,671      |
| Total consumer                | 65                                 | 6             | 12                 | 21         | 104                                    | 33,630     | 33,734     |
| Total                         | \$ 4,819                           | \$ 1,156      | \$ 520             | \$ 3,651   | \$ 10,146                              | \$ 793,306 | \$ 803,452 |

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|                               | December 31, 2012                  |               |                    |            | Total<br>Past Due<br>and<br>Nonaccrual | Current   | Total     |
|-------------------------------|------------------------------------|---------------|--------------------|------------|--|-----------|-----------|
|                               | Accruing Interest<br>and Past Due: |               |                    |            |  |           |           |
|                               | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or More | Nonaccrual |  |           |           |
| Commercial                    |                                    |               |                    |            |  |           |           |
| Commercial real estate        | \$1,304                            | \$161         | \$63               | \$2,544    | \$4,072                                | \$271,548 | \$275,620 |
| Commercial other              | 606                                | —             | 40                 | 2,294      | 2,940                                  | 92,945    | 95,885    |
| Total commercial              | 1,910                              | 161           | 103                | 4,838      | 7,012                                  | 364,493   | 371,505   |
| Agricultural                  |                                    |               |                    |            |  |           |           |
| Agricultural real estate      | —                                  | —             | —                  | —          | —                                      | 49,393    | 49,393    |
| Agricultural other            | 90                                 | —             | —                  | 169        | 259                                    | 33,954    | 34,213    |
| Total agricultural            | 90                                 | —             | —                  | 169        | 259                                    | 83,347    | 83,606    |
| Residential real estate       |                                    |               |                    |            |  |           |           |
| Senior liens                  | 2,000                              | 346           | 320                | 2,064      | 4,730                                  | 223,532   | 228,262   |
| Junior liens                  | 232                                | —             | —                  | 50         | 282                                    | 16,207    | 16,489    |
| Home equity lines of credit   | 237                                | —             | —                  | 182        | 419                                    | 38,978    | 39,397    |
| Total residential real estate | 2,469                              | 346           | 320                | 2,296      | 5,431                                  | 278,717   | 284,148   |
| Consumer                      |                                    |               |                    |            |  |           |           |
| Secured                       | 127                                | 33            | 4                  | —          | 164                                    | 28,118    | 28,282    |
| Unsecured                     | 31                                 | 3             | 1                  | —          | 35                                     | 5,177     | 5,212     |
| Total consumer                | 158                                | 36            | 5                  | —          | 199                                    | 33,295    | 33,494    |
| Total                         | \$4,627                            | \$543         | \$428              | \$7,303    | \$12,901                               | \$759,852 | \$772,753 |

## 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, and for the periods ended:

|  | June 30, 2013          |                                |                        | December 31, 2012      |                                |                        |
|--|------------------------|--------------------------------|------------------------|------------------------|--------------------------------|------------------------|
|  | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| Impaired loans with a valuation allowance          |                        |                                |                        |                        |                                |                        |
| Commercial real estate                             | \$6,919                | \$7,420                        | \$1,578                | \$7,295                | \$7,536                        | \$1,653                |
| Commercial other                                   | 1,468                  | 1,468                          | 64                     | 2,140                  | 2,140                          | 397                    |
| Agricultural real estate                           | 91                     | 91                             | 31                     | 91                     | 91                             | 32                     |
| Agricultural other                                 | —                      | —                              | —                      | 420                    | 420                            | 59                     |
| Residential real estate senior liens               | 10,475                 | 11,675                         | 1,731                  | 10,450                 | 11,672                         | 1,783                  |
| Residential real estate junior liens               | 71                     | 109                            | 13                     | 72                     | 118                            | 13                     |
| Total impaired loans with a valuation allowance    | \$19,024               | \$20,763                       | \$3,417                | \$20,468               | \$21,977                       | \$3,937                |
| Impaired loans without a valuation allowance       |                        |                                |                        |                        |                                |                        |
| Commercial real estate                             | \$4,405                | \$5,139                        |                        | \$3,749                | \$4,408                        |                        |
| Commercial other                                   | 847                    | 958                            |                        | 1,272                  | 1,433                          |                        |
| Agricultural real estate                           | 132                    | 132                            |                        | —                      | —                              |                        |
| Agricultural other                                 | 353                    | 473                            |                        | 212                    | 332                            |                        |
| Home equity lines of credit                        | 174                    | 474                            |                        | 182                    | 482                            |                        |
| Consumer secured                                   | 54                     | 54                             |                        | 75                     | 84                             |                        |
| Total impaired loans without a valuation allowance | \$5,965                | \$7,230                        |                        | \$5,490                | \$6,739                        |                        |
| Impaired loans                                     |                        |                                |                        |                        |                                |                        |
| Commercial   | \$13,639               | \$14,985                       | \$1,642                | \$14,456               | \$15,517                       | \$2,050                |
| Agricultural                                       | 576                    | 696                            | 31                     | 723                    | 843                            | 91                     |
| Residential real estate                            | 10,720                 | 12,258                         | 1,744                  | 10,704                 | 12,272                         | 1,796                  |
| Consumer   | 54                     | 54                             | —                      | 75                     | 84                             | —                      |
| Total impaired loans                               | \$24,989               | \$27,993                       | \$3,417                | \$25,958               | \$28,716                       | \$3,937                |

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|  | Three Months Ended<br>June 30, 2013 |                                  | Six Months Ended<br>June 30, 2013 |                                  |   |
|--|-------------------------------------|----------------------------------|-----------------------------------|----------------------------------|---|
|  | Average<br>Outstanding<br>Balance   | Interest<br>Income<br>Recognized | Average<br>Outstanding<br>Balance | Interest<br>Income<br>Recognized |   |
| Impaired loans with a valuation allowance          |                                     |                                  |                                   |                                  |   |
| Commercial real estate                             | \$7,990                             | \$102                            | \$8,084                           | \$221                            |   |
| Commercial other                                   | 764                                 | 37                               | 932                               | 38                               |   |
| Agricultural real estate                           | 91                                  | 1                                | 124                               | 4                                |   |
| Agricultural other                                 | —                                   | —                                | 105                               | —                                |   |
| Residential real estate senior liens               | 10,466                              | 110                              | 10,460                            | 209                              |   |
| Residential real estate junior liens               | 85                                  | 1                                | 85                                | 1                                |   |
| Total impaired loans with a valuation allowance    | \$19,396                            | \$251                            | \$19,790                          | \$473                            |   |
| Impaired loans without a valuation allowance       |                                     |                                  |                                   |                                  |   |
| Commercial real estate                             | \$3,954                             | \$85                             | \$3,790                           | \$158                            |   |
| Commercial other                                   | 1,020                               | 19                               | 1,126                             | 59                               |   |
| Agricultural real estate                           | 133                                 | 2                                | 67                                | 2                                |   |
| Agricultural other                                 | 458                                 | (11                              | ) 423                             | (4                               | ) |
| Home equity lines of credit                        | 179                                 | 5                                | 181                               | 9                                |   |
| Consumer secured                                   | 63                                  | 1                                | 68                                | 2                                |   |
| Total impaired loans without a valuation allowance | \$5,807                             | \$101                            | \$5,655                           | \$226                            |   |
| Impaired loans                                     |                                     |                                  |                                   |                                  |   |
| Commercial   | \$13,728                            | \$243                            | \$13,932                          | \$476                            |   |
| Agricultural                                       | 682                                 | (8                               | ) 719                             | 2                                |   |
| Residential real estate                            | 10,730                              | 116                              | 10,726                            | 219                              |   |
| Consumer   | 63                                  | 1                                | 68                                | 2                                |   |
| Total impaired loans                               | \$25,203                            | \$352                            | \$25,445                          | \$699                            |   |



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|  | Three Months Ended<br>June 30, 2012 |                                  | Six Months Ended<br>June 30, 2012 |                                  |
|--|-------------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | Average<br>Outstanding<br>Balance   | Interest<br>Income<br>Recognized | Average<br>Outstanding<br>Balance | Interest<br>Income<br>Recognized |
| Impaired loans with a valuation allowance          |                                     |                                  |                                   |                                  |
| Commercial real estate                             | \$6,444                             | \$83                             | \$6,165                           | \$181                            |
| Commercial other                                   | 829                                 | 16                               | 777                               | 28                               |
| Agricultural real estate                           | —                                   | —                                | —                                 | —                                |
| Agricultural other                                 | 2,145                               | 36                               | 2,306                             | 73                               |
| Residential real estate senior liens               | 7,862                               | 92                               | 7,706                             | 175                              |
| Residential real estate junior liens               | 175                                 | 2                                | 183                               | 4                                |
| Total impaired loans with a valuation allowance    | \$17,455                            | \$229                            | \$17,137                          | \$461                            |
| Impaired loans without a valuation allowance       |                                     |                                  |                                   |                                  |
| Commercial real estate                             | \$6,789                             | \$112                            | \$7,299                           | \$179                            |
| Commercial other                                   | 2,249                               | 34                               | 1,777                             | 65                               |
| Agricultural real estate                           | 274                                 | —                                | 232                               | —                                |
| Agricultural other                                 | 607                                 | 3                                | 595                               | 7                                |
| Home equity lines of credit                        | 195                                 | 4                                | 197                               | 8                                |
| Consumer secured                                   | 89                                  | 1                                | 95                                | 3                                |
| Total impaired loans without a valuation allowance | \$10,203                            | \$154                            | \$10,195                          | \$262                            |
| Impaired loans                                     |                                     |                                  |                                   |                                  |
| Commercial   | \$16,311                            | \$245                            | \$16,018                          | \$453                            |
| Agricultural                                       | 3,026                               | 39                               | 3,133                             | 80                               |
| Residential real estate                            | 8,232                               | 98                               | 8,086                             | 187                              |
| Consumer   | 89                                  | 1                                | 95                                | 3                                |
| Total impaired loans                               | \$27,658                            | \$383                            | \$27,332                          | \$723                            |

As of June 30, 2013 and December 31, 2012, we had committed to advance \$61 and \$9, respectively, in connection with impaired loans, which include TDRs.

**Troubled Debt Restructurings**

Loan modifications are considered to be TDRs when the modification includes terms outside of normal lending practices to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

1. Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
2. Extending the amortization period beyond typical lending guidelines for debt with similar risk characteristics.
3. Forbearance of principal.
4. Forbearance of accrued interest.

To determine if a borrower is experiencing financial difficulties, we consider if:

1. The borrower is currently in default on any of their debt.
2. The borrower would likely default on any of their debt if the concession was not granted.
3. The borrower's cash flow was insufficient to service all of their debt if the concession was not granted.
4. The borrower has declared, or is in the process of declaring, bankruptcy.
5. The borrower is unlikely to continue as a going concern (if the entity is a business).

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The following is a summary of information pertaining to TDRs granted in the periods ended:

|                                      | Three Months Ended June 30, 2013 |                                      |   | Six Months Ended June 30, 2013       |                                      |                                       |   |                                      |
|--------------------------------------|----------------------------------|--------------------------------------|---|--------------------------------------|--------------------------------------|---------------------------------------|---|--------------------------------------|
|                                      | Number of Loans                  | Pre-Modification Recorded Investment | Post-Modification Recorded Investment                           | Number of Loans                      | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |   |                                      |
| Commercial other                     | 7                                | \$ 3,153                             | \$ 2,957  | 7                                    | \$ 3,153                             | \$ 2,957                              |   |                                      |
| Agricultural other                   | —                                | —                                    | —   | 1                                    | 134                                  | 134                                   |   |                                      |
| Residential real estate senior liens | 7                                | 635                                  | 635   | 15                                   | 1,435                                | 1,418                                 |   |                                      |
| <b>Total</b>                         | <b>14</b>                        | <b>\$ 3,788</b>                      | <b>\$ 3,592</b>   | <b>23</b>                            | <b>\$ 4,722</b>                      | <b>\$ 4,509</b>                       |   |                                      |
|                                      | Three Months Ended June 30, 2012 |                                      |   | Six Months Ended June 30, 2012       |                                      |                                       |   |                                      |
|                                      | Number of Loans                  | Pre-Modification Recorded Investment | Post-Modification Recorded Investment                           | Number of Loans                      | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |   |                                      |
| Commercial other                     | 5                                | \$ 305                               | \$ 305  | 26                                   | \$ 4,891                             | \$ 4,891                              |   |                                      |
| Agricultural other                   | —                                | —                                    | —   | 6                                    | 561                                  | 561                                   |   |                                      |
| Residential real estate senior liens | 7                                | 684                                  | 684   | 12                                   | 1,405                                | 1,405                                 |   |                                      |
| <b>Total</b>                         | <b>12</b>                        | <b>\$ 989</b>                        | <b>\$ 989</b>   | <b>44</b>                            | <b>\$ 6,857</b>                      | <b>\$ 6,857</b>                       |   |                                      |
|                                      | Three Months Ended June 30, 2013 |                                      |   |                                      | Six Months Ended June 30, 2013       |                                       |   |                                      |
|                                      | Below Market Interest Rate       |                                      | Below Market Interest Rate and Extension of Amortization Period |                                      | Below Market Interest Rate           |                                       | Below Market Interest Rate and Extension of Amortization Period |                                      |
|                                      | Number of Loans                  | Pre-Modification Recorded Investment | Number of Loans   | Pre-Modification Recorded Investment | Number of Loans                      | Pre-Modification Recorded Investment  | Number of Loans   | Pre-Modification Recorded Investment |
| Commercial other                     | 3                                | \$ 1,357                             | 4   | \$ 1,796                             | 3                                    | \$ 1,357                              | 4   | \$ 1,796                             |
| Agricultural other                   | —                                | —                                    | —   | —                                    | 1                                    | 134                                   | —   | —                                    |
| Residential real estate senior liens | 4                                | 414                                  | 3   | 221                                  | 7                                    | 625                                   | 8   | 810                                  |
| <b>Total</b>                         | <b>7</b>                         | <b>\$ 1,771</b>                      | <b>7</b>  | <b>\$ 2,017</b>                      | <b>11</b>                            | <b>\$ 2,116</b>                       | <b>12</b>   | <b>\$ 2,606</b>                      |
|                                      | Three Months Ended June 30, 2012 |                                      |   |                                      | Six Months Ended June 30, 2012       |                                       |   |                                      |
|                                      | Below Market Interest Rate       |                                      | Below Market Interest Rate and Extension of Amortization Period |                                      | Below Market Interest Rate           |                                       | Below Market Interest Rate and Extension of Amortization Period |                                      |
|                                      | Number of Loans                  | Pre-Modification Recorded Investment | Number of Loans   | Pre-Modification Recorded Investment | Number of Loans                      | Pre-Modification Recorded Investment  | Number of Loans   | Pre-Modification Recorded Investment |
| Commercial other                     | 3                                | \$ 160                               | 2   | \$ 145                               | 24                                   | \$ 4,746                              | 2   | \$ 145                               |
| Agricultural other                   | —                                | —                                    | —   | —                                    | 6                                    | 561                                   | —   | —                                    |
| Residential real estate senior liens | 4                                | 324                                  | 3   | 360                                  | 4                                    | 324                                   | 8   | 1,081                                |
| <b>Total</b>                         | <b>7</b>                         | <b>\$ 484</b>                        | <b>5</b>  | <b>\$ 505</b>                        | <b>34</b>                            | <b>\$ 5,631</b>                       | <b>10</b>   | <b>\$ 1,226</b>                      |

We did not restructure any loans through the forbearance of principal or accrued interest in the three and six month periods ended June 30, 2013 or 2012.

Based on our historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs, including TDRs that have been modified in the past 12 months that subsequently defaulted, are analyzed in the same manner as other impaired loans within their respective loan segment.

We had no loans that defaulted in the three and six month periods ended June 30, 2013, which were modified within 12 months prior to the default date.

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Following is a summary of loans that defaulted in the three and six month periods ended June 30, 2012, which were modified within 12 months prior to the default date:

|                                      | Three Months Ended June 30, 2012 |                                      |                                  |                                       | Six Months Ended June 30, 2012 |                                      |                                  |                                       |
|--------------------------------------|----------------------------------|--------------------------------------|----------------------------------|---------------------------------------|--------------------------------|--------------------------------------|----------------------------------|---------------------------------------|
|                                      | Number of Loans                  | Pre-Default Recorded Upon Investment | Charge-Off Recorded Upon Default | Post-Default Recorded Upon Investment | Number of Loans                | Pre-Default Recorded Upon Investment | Charge-Off Recorded Upon Default | Post-Default Recorded Upon Investment |
| Commercial other                     | 2                                | \$ 50                                | \$ 25                            | \$ 25                                 | 3                              | \$ 132                               | \$ 67                            | \$ 65                                 |
| Residential real estate senior liens | —                                | —                                    | —                                | —                                     | 1                              | 47                                   | 43                               | 4                                     |
| Consumer secured                     | 1                                | 8                                    | 8                                | —                                     | 1                              | 8                                    | 8                                | —                                     |
| Total                                | 3                                | \$ 58                                | \$ 33                            | \$ 25                                 | 5                              | \$ 187                               | \$ 118                           | \$ 69                                 |

The following is a summary of TDR loan balances as of:

|      | June 30<br>2013 | December 31<br>2012 |
|------|-----------------|---------------------|
| TDRs | \$20,857        | \$19,355            |

#### Note 7 – Equity Securities Without Readily Determinable Fair Values

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost, and investments in unconsolidated entities accounted for under the equity method of accounting.

Equity securities without readily determinable fair values consist of the following as of:

|                                     | June 30<br>2013 | December 31<br>2012 |
|-------------------------------------|-----------------|---------------------|
| FHLB Stock                          | \$8,100         | \$7,850             |
| Corporate Settlement Solutions, LLC | 6,919           | 7,040               |
| FRB Stock                           | 1,879           | 1,879               |
| Valley Financial Corporation        | 1,000           | 1,000               |
| Other                               | 344             | 349                 |
| Total                               | \$18,242        | \$18,118            |

#### Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

|  | June 30<br>2013 | December 31<br>2012 |
|--|-----------------|---------------------|
| FHLB advances  | \$162,000       | \$152,000           |
| Securities sold under agreements to repurchase without stated maturity dates | 71,668          | 66,147              |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,292          | 16,284              |
| Federal funds purchased  | 12,500          | 6,570               |
| Total  | \$262,460       | \$241,001           |

The FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans and certain mortgage-backed securities and collateralized mortgage obligations. Advances are also secured by our holdings of FHLB stock. As of June 30, 2013, we had the ability to borrow up to an additional \$91,951, based on assets pledged as collateral. During the first quarter of 2013 and 2012, we reduced funding costs by modifying the term of \$30,000 and \$60,000, respectively, of FHLB advances.

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The following table lists the maturity and weighted average interest rates of FHLB advances as of:

|                              | June 30, 2013 |      | December 31, 2012 |      |   |
|------------------------------|---------------|------|-------------------|------|---|
|                              | Amount        | Rate | Amount            | Rate |   |
| Fixed rate advances due 2013 | \$10,000      | 0.33 | % \$—             | —    | % |
| Fixed rate advances due 2014 | 10,000        | 0.48 | % 10,000          | 0.48 | % |
| Fixed rate advances due 2015 | 32,000        | 0.84 | % 42,000          | 1.12 | % |
| Fixed rate advances due 2016 | 10,000        | 2.15 | % 10,000          | 2.15 | % |
| Fixed rate advances due 2017 | 30,000        | 1.95 | % 40,000          | 2.15 | % |
| Fixed rate advances due 2018 | 30,000        | 2.49 | % 20,000          | 2.86 | % |
| Fixed rate advances due 2019 | 20,000        | 3.11 | % 20,000          | 3.73 | % |
| Fixed rate advances due 2020 | 10,000        | 1.98 | % 10,000          | 1.98 | % |
| Fixed rate advances due 2023 | 10,000        | 3.90 | % —               | —    | % |
| Total                        | \$162,000     | 1.92 | % \$152,000       | 2.05 | % |

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date.

Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$122,362 and \$143,322 at June 30, 2013 and December 31, 2012, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

The following table provides a summary of short-term borrowings for the three and six month periods ended:

|  | Three Months Ended June 30, 2013 |                 |  | Three Months Ended June 30, 2012 |                 |  |  |
|--|----------------------------------|-----------------|--|----------------------------------|-----------------|--|--|
|  | Maximum Month End Balance        | Average Balance | Weighted Average Interest Rate During the Period | Maximum Month End Balance        | Average Balance | Weighted Average Interest Rate During the Period |  |
| Securities sold under agreements to repurchase without stated maturity dates | \$71,668                         | \$69,692        | 0.15 %   | \$58,584                         | \$58,045        | 0.20 %   |  |
| Federal funds purchased  | 13,700                           | 6,022           | 0.57 %   | 17,900                           | 7,025           | 0.47 %   |  |
|  | Six Months Ended June 30, 2013   |                 |  | Six Months Ended June 30, 2012   |                 |  |  |
|  | Maximum Month End Balance        | Average Balance | Weighted Average Interest Rate During the Period | Maximum Month End Balance        | Average Balance | Weighted Average Interest Rate During the Period |  |
| Securities sold under agreements to repurchase without stated maturity dates | \$71,668                         | \$65,363        | 0.15 %   | \$58,584                         | \$55,436        | 0.11 %   |  |
| Federal funds purchased  | 13,700                           | 3,646           | 0.56 %   | 17,900                           | 3,552           | 0.23 %   |  |

We had pledged certificates of deposit held in other financial institutions, trading securities, AFS securities, and 1-4 family residential real estate loans in the following amounts at:

|   | June 30 2013 | December 31 2012 |
|---|--------------|------------------|
| Pledged to secure borrowed funds  | \$307,647    | \$308,628        |
| Pledged to secure repurchase agreements   | 122,362      | 143,322          |
| Pledged for public deposits and for other purposes necessary or required by law | 22,331       | 22,955           |
| Total   | \$452,340    | \$474,905        |

We had no investment securities that are restricted to be pledged for specific purposes.



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## Note 9 – Other Noninterest Expenses

A summary of expenses included in other noninterest expenses are as follows for the:

|                                   | Three Months Ended |         | Six Months Ended |         |
|-----------------------------------|--------------------|---------|------------------|---------|
|                                   | June 30            |         | June 30          |         |
|                                   | 2013               | 2012    | 2013             | 2012    |
| Marketing and community relations | \$432              | \$535   | \$674            | \$1,029 |
| FDIC insurance premiums           | 273                | 213     | 545              | 428     |
| Directors fees                    | 205                | 209     | 404              | 419     |
| Audit and related fees            | 162                | 154     | 301              | 330     |
| Education and travel              | 116                | 139     | 238              | 266     |
| Postage and freight               | 94                 | 94      | 193              | 195     |
| Printing and supplies             | 99                 | 110     | 185              | 219     |
| Legal fees                        | 120                | 81      | 180              | 143     |
| Consulting fees                   | 83                 | 71      | 155              | 258     |
| Other                             | 671                | 581     | 1,272            | 1,159   |
| Total other                       | \$2,255            | \$2,187 | \$4,147          | \$4,446 |

## Note 10 – Federal Income Taxes

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the:

|   | Three Months Ended |         | Six Months Ended |         |
|---|--------------------|---------|------------------|---------|
|   | June 30            |         | June 30          |         |
|   | 2013               | 2012    | 2013             | 2012    |
| Income taxes at 34% statutory rate                  | \$1,311            | \$1,250 | \$2,556          | \$2,612 |
| Effect of nontaxable income                         |                    |         |                  |         |
| Interest income on tax exempt municipal securities  | (400)              | (388)   | (801)            | (779)   |
| Earnings on corporate owned life insurance policies | (65)               | (60)    | (122)            | (118)   |
| Other   | (222)              | (141)   | (450)            | (292)   |
| Total effect of nontaxable income                   | (687)              | (589)   | (1,373)          | (1,189) |
| Effect of nondeductible expenses                    | 19                 | 11      | 36               | 22      |
| Federal income tax expense                          | \$643              | \$672   | \$1,219          | \$1,445 |

Included in OCI for the three and six month periods ended June 30, 2013 and 2012 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

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A summary of OCI follows for the:

|  | Three Months Ended June 30 |             |             | 2012          |            |         |
|--|----------------------------|-------------|-------------|---------------|------------|---------|
|  | 2013                       |             |             | Auction Rate  | All Other  | Total   |
|  | Money                      | All Other   | Total       | Money         | All Other  | Total   |
|  | Market                     | AFS         |             | Market        | AFS        |         |
|  | Preferred and              | Securities  |             | Preferred and | Securities |         |
|  | Preferred                  |             |             | Preferred     |            |         |
|  | Stocks                     |             |             | Stocks        |            |         |
| Unrealized gains (losses) arising during the period                                | \$(363 )                   | \$(11,634 ) | \$(11,997 ) | \$(185 )      | \$1,605    | \$1,420 |
| Reclassification adjustment for net realized (gains) losses included in net income | —                          | —           | —           | —             | —          | —       |
| Reclassification adjustment for impairment loss included in net income             | —                          | —           | —           | —             | —          | —       |
| Net unrealized gains (losses)  | (363 )                     | (11,634 )   | (11,997 )   | (185 )        | 1,605      | 1,420   |
| Tax effect   | —                          | 3,979       | 3,979       | —             | (546 )     | (546 )  |
| Unrealized gains (losses), net of tax  | \$(363 )                   | \$(7,655 )  | \$(8,018 )  | \$(185 )      | \$1,059    | \$874   |

|  | Six Months Ended June 30 |             |             | 2012          |            |          |
|--|--------------------------|-------------|-------------|---------------|------------|----------|
|  | 2013                     |             |             | Auction Rate  | All Other  | Total    |
|  | Money                    | All Other   | Total       | Money         | All Other  | Total    |
|  | Market                   | AFS         |             | Market        | AFS        |          |
|  | Preferred and            | Securities  |             | Preferred and | Securities |          |
|  | Preferred                |             |             | Preferred     |            |          |
|  | Stocks                   |             |             | Stocks        |            |          |
| Unrealized gains (losses) arising during the period                                | \$295                    | \$(14,253 ) | \$(13,958 ) | \$1,419       | \$800      | \$2,219  |
| Reclassification adjustment for net realized (gains) losses included in net income | —                        | (99 )       | (99 )       | —             | (1,003 )   | (1,003 ) |
| Reclassification adjustment for impairment loss included in net income             | —                        | —           | —           | —             | 282        | 282      |
| Net unrealized gains (losses)  | 295                      | (14,352 )   | (14,057 )   | 1,419         | 79         | 1,498    |
| Tax effect   | —                        | 4,902       | 4,902       | —             | (27 )      | (27 )    |
| Unrealized gains (losses), net of tax  | \$295                    | \$(9,450 )  | \$(9,155 )  | \$1,419       | \$52       | \$1,471  |

Note 11 – Defined Benefit Pension Plan



We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. As a result of the curtailment, future salary increases are no longer considered and plan benefits are based on years of service and the individual employee's five highest consecutive years of compensation out of the last ten years of service through March 1, 2007. We contributed \$215 and \$709 to the plan during the six month periods ended June 30, 2013 and 2012, respectively. We do not anticipate any further contributions to the plan in 2013.

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Following are the components of net periodic benefit cost for the three and six month periods ended:

|   | Three Months Ended |        | Six Months Ended |        |
|---|--------------------|--------|------------------|--------|
|   | June 30            |        | June 30          |        |
|   | 2013               | 2012   | 2013             | 2012   |
| Interest cost on PBO                            | \$112              | \$117  | \$225            | \$235  |
| Expected return on plan assets                  | (144               | ) (127 | ) (287           | ) (254 |
| Amortization of unrecognized actuarial net loss | 82                 | 73     | 165              | 146    |
| Net periodic benefit cost                       | \$50               | \$63   | \$103            | \$127  |

## Note 12 – Fair Value

Following is a description of the valuation methodologies, key inputs, and an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

**Cash and cash equivalents:** The carrying amounts of cash and short term investments, including Federal funds sold, approximate fair values. As such, we classify cash and demand deposits due from banks as Level 1.

**Certificates of deposit held in other financial institutions:** Interest bearing balances held in unaffiliated financial institutions include certificates of deposit and other short term interest bearing balances that mature within 3 years. Fair value is determined using prices for similar assets with similar characteristics. As such, we classify certificates of deposits held in other financial institutions as Level 2.

**AFS and trading securities:** AFS and trading securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

**Mortgage loans AFS:** Mortgage loans AFS are carried at the lower of cost or fair value. The fair value of Mortgage loans AFS are based on what price secondary markets are currently offering for portfolios with similar characteristics. As such, we classify Mortgage loans AFS subject to nonrecurring fair value adjustments as Level 2.

**Loans:** For variable rate loans with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated. As such, we classify loans as Level 3 assets.

We do not record loans at fair value on a recurring basis. However, from time-to-time, loans are classified as impaired and a specific allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will be significantly different than the contractual terms of the original loan agreement are considered impaired. Once a loan is identified as impaired, we measure the estimated impairment. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value, or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, we utilize independent appraisals, broker price opinions, or internal evaluations. We review these valuations to determine whether an additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to carry and sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any charge-offs or specific reserves are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated. Due to the inherent level of estimation in the valuation process, we record impaired loans as nonrecurring Level 3.



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The table below lists the quantitative information about impaired loans measured utilizing Level 3 fair value measurements as of:

|                            |            | June 30, 2013  |               |
|----------------------------|------------|--|---------------|
| Valuation Techniques       | Fair Value | Unobservable Input                                   | Range         |
| Discounted cash flow       | \$8,802    | Duration of cash flows:                              | 8-120 Months  |
|                            |            | Reduction in interest rate from original loan terms: | 5.00% - 6.63% |
| Discounted appraisal value | \$12,770   | Discount applied to collateral appraisal:            |               |
|                            |            | Real Estate  | 20% - 30%     |
|                            |            | Equipment  | 50%           |
|                            |            | Livestock  | 50%           |
|                            |            | Cash crop inventory                                  | 50%           |
|                            |            | Other inventory                                      | 75%           |
|                            |            | Accounts receivable                                  | 75%           |
|                            |            | December 31, 2012                                    |               |
| Valuation Techniques       | Fair Value | Unobservable Input                                   | Range         |
| Discounted cash flow       | \$8,726    | Duration of cash flows:                              | 14-120 Months |
|                            |            | Reduction in interest rate from original loan terms: | 5.00% - 6.25% |
| Discounted appraisal value | \$13,295   | Discount applied to collateral appraisal:            |               |
|                            |            | Real Estate  | 20% - 30%     |
|                            |            | Equipment  | 50%           |
|                            |            | Livestock  | 50%           |
|                            |            | Cash crop inventory                                  | 50%           |
|                            |            | Other inventory                                      | 75%           |
|                            |            | Accounts receivable                                  | 75%           |

Accrued interest receivable: The carrying amounts of accrued interest receivable approximate fair value. As such, we classify accrued interest receivable as Level 1.

Equity securities without readily determinable fair values: Included in equity securities without readily determinable fair values are FHLB Stock and FRB Stock as well as our ownership interests in Corporate Settlement Solutions, LLC and Valley Financial Corporation. The investment in Corporate Settlement Solutions, LLC, a title insurance company, was made in the first quarter 2007. We are not the managing entity of Corporate Settlement Solutions, LLC, and therefore, we account for our investment under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a de novo bank that opened in 2005. We made investments in Valley Financial Corporation in 2004 and in 2007.

The lack of an active market, or other independent sources to validate fair value estimates coupled with the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. As the fair values of these investments are not readily determinable, they are not disclosed under a specific fair value hierarchy; however, they are reviewed quarterly for impairment. If we were to record an impairment adjustment related to these securities, it would be classified as a nonrecurring Level 3 fair value adjustment. During 2013 and 2012, there were no impairments recorded on equity securities without readily determinable fair values.

Foreclosed assets: Upon transfer from the loan portfolio, foreclosed assets (which are included in other assets) are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. Due to the inherent level of estimation in the valuation process, we record foreclosed assets as nonrecurring Level 3.



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The table below lists the quantitative information related to foreclosed assets measured utilizing Level 3 fair value measurements as of:

| Valuation Techniques       | June 30, 2013     |  |           |
|----------------------------|-------------------|--|-----------|
|                            | Fair Value        | Unobservable Input<br>Discount applied to<br>collateral appraisal: | Range     |
| Discounted appraisal value | \$1,105           | Real Estate  | 20% - 30% |
| Valuation Techniques       | December 31, 2012 |  |           |
|                            | Fair Value        | Unobservable Input<br>Discount applied to<br>collateral appraisal: | Range     |
| Discounted appraisal value | \$2,018           | Real Estate  | 20% - 30% |

Goodwill and other intangible assets: Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Acquisition intangibles and goodwill are typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of acquisition intangibles or goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2013 and 2012, there were no impairments recorded on goodwill and other acquisition intangibles.

OMSRs: OMSRs (which are included in other assets) are subject to impairment testing. To test for impairment, we utilize a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and discount rates. If the valuation model reflects a value less than the carrying value, OMSRs are adjusted to fair value through a valuation allowance as determined by the model. As such, we classify OMSRs subject to nonrecurring fair value adjustments as Level 2.

Deposits: The fair value of demand, savings, and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts), and are classified as Level 1. Fair values for variable rate certificates of deposit approximate their recorded carrying value. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. As such, fixed rate certificates of deposit are classified as Level 2.

Borrowed funds: The carrying amounts of federal funds purchased, borrowings under overnight repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. The fair values of other borrowed funds are estimated using discounted cash flow analyses based on current incremental borrowing arrangements. As such, borrowed funds are classified as Level 2.

Accrued interest payable: The carrying amounts of accrued interest payable approximate fair value. As such, we classify accrued interest payable as Level 1.

Commitments to extend credit, standby letters of credit, and undisbursed loans: Our commitments to extend credit, standby letters of credit, and undisbursed funds have no carrying amount and are estimated to have no realizable fair value. Historically, a majority of the unused commitments to extend credit have not been drawn upon and, generally, we do not receive fees in connection with these commitments other than standby letter of credit fees, which are not significant.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement.

Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis  
Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation

methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

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The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis on our consolidated balance sheets are as follows as of:

|  | June 30, 2013     |                      |           |           |           |
|--|-------------------|----------------------|-----------|-----------|-----------|
|  | Carrying Value    | Estimated Fair Value | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                   |                      |           |           |           |
| Cash and cash equivalents                                      | \$21,366          | \$21,366             | \$21,366  | \$—       | \$—       |
| Certificates of deposit held in other financial institutions   | 1,810             | 1,813                | —         | 1,813     | —         |
| Mortgage loans AFS   | 743               | 768                  | —         | 768       | —         |
| Total loans  | 803,452           | 808,902              | —         | —         | 808,902   |
| Less allowance for loan and lease losses                       | (11,700 )         | (11,700 )            | —         | —         | (11,700 ) |
| Net loans  | 791,752           | 797,202              | —         | —         | 797,202   |
| Accrued interest receivable                                    | 5,232             | 5,232                | 5,232     | —         | —         |
| Equity securities without readily determinable fair values (1) | 18,242            | 18,242               | —         | —         | —         |
| OMSRs  | 2,381             | 2,381                | —         | 2,381     | —         |
| <b>LIABILITIES</b>   |                   |                      |           |           |           |
| Deposits without stated maturities                             | 561,224           | 561,224              | 561,224   | —         | —         |
| Deposits with stated maturities                                | 460,200           | 464,148              | —         | 464,148   | —         |
| Borrowed funds   | 262,460           | 266,633              | —         | 266,633   | —         |
| Accrued interest payable                                       | 686               | 686                  | 686       | —         | —         |
|  | December 31, 2012 |                      |           |           |           |
|  | Carrying Value    | Estimated Fair Value | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                   |                      |           |           |           |
| Cash and cash equivalents                                      | \$24,920          | \$24,920             | \$24,920  | \$—       | \$—       |
| Certificates of deposit held in other financial institutions   | 4,465             | 4,475                | —         | 4,475     | —         |
| Mortgage loans AFS   | 3,633             | 3,680                | —         | 3,680     | —         |
| Total loans  | 772,753           | 784,964              | —         | —         | 784,964   |
| Less allowance for loan and lease losses                       | (11,936 )         | (11,936 )            | —         | —         | (11,936 ) |
| Net loans  | 760,817           | 773,028              | —         | —         | 773,028   |
| Accrued interest receivable                                    | 5,227             | 5,227                | 5,227     | —         | —         |
| Equity securities without readily determinable fair values (1) | 18,118            | 18,118               | —         | —         | —         |
| OMSRs  | 2,285             | 2,285                | —         | 2,285     | —         |
| <b>LIABILITIES</b>   |                   |                      |           |           |           |
| Deposits without stated maturities                             | 553,332           | 553,332              | 553,332   | —         | —         |
| Deposits with stated maturities                                | 464,335           | 472,630              | —         | 472,630   | —         |
| Borrowed funds   | 241,001           | 248,822              | —         | 248,822   | —         |
| Accrued interest payable                                       | 751               | 751                  | 751       | —         | —         |

Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under (1) a specific fair value hierarchy. If we were to record an impairment adjustment related to these securities, such amount would be classified as a nonrecurring Level 3 fair value adjustment.



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## Financial Instruments Recorded at Fair Value

The table below presents the recorded amount of assets and liabilities measured at fair value on:

|  | June 30, 2013 |           |           |           | December 31, 2012 |           |           |           |
|--|---------------|-----------|-----------|-----------|-------------------|-----------|-----------|-----------|
|  | Total         | (Level 1) | (Level 2) | (Level 3) | Total             | (Level 1) | (Level 2) | (Level 3) |
| Recurring items  |               |           |           |           |                   |           |           |           |
| Trading securities                                       |               |           |           |           |                   |           |           |           |
| States and political subdivisions                        | \$950         | \$—       | \$950     | \$—       | \$1,573           | \$—       | \$1,573   | \$—       |
| AFS Securities   |               |           |           |           |                   |           |           |           |
| Government-sponsored enterprises                         | 24,249        | —         | 24,249    | —         | 25,776            | —         | 25,776    | —         |
| States and political subdivisions                        | 187,302       | —         | 187,302   | —         | 182,743           | —         | 182,743   | —         |
| Auction rate money market preferred                      | 2,943         | —         | 2,943     | —         | 2,778             | —         | 2,778     | —         |
| Preferred stocks   | 6,559         | 6,559     | —         | —         | 6,363             | 6,363     | —         | —         |
| Mortgage-backed securities                               | 149,407       | —         | 149,407   | —         | 155,345           | —         | 155,345   | —         |
| Collateralized mortgage obligations                      | 128,964       | —         | 128,964   | —         | 131,005           | —         | 131,005   | —         |
| Total AFS Securities                                     | 499,424       | 6,559     | 492,865   | —         | 504,010           | 6,363     | 497,647   | —         |
| Nonrecurring items                                       |               |           |           |           |                   |           |           |           |
| Impaired loans (net of the ALLL)                         | 21,572        | —         | —         | 21,572    | 22,021            | —         | —         | 22,021    |
| OMSRs  | 2,381         | —         | 2,381     | —         | 2,285             | —         | 2,285     | —         |
| Foreclosed assets  | 1,105         | —         | —         | 1,105     | 2,018             | —         | —         | 2,018     |
|  | \$525,432     | \$6,559   | \$496,196 | \$22,677  | \$531,907         | \$6,363   | \$501,505 | \$24,039  |
| Percent of assets and liabilities measured at fair value |               | 1.25 %    | 94.44 %   | 4.31 %    |                   | 1.20 %    | 94.28 %   | 4.52 %    |

The following table provides a summary of the changes in fair value of assets and liabilities recorded at fair value through earnings on a recurring basis and changes in assets and liabilities recorded at fair value on a nonrecurring basis, for which an impairment, or reduction of an impairment, was recognized in the three and six month periods ended:

|                    | Three Months Ended June 30 |                      |        | 2012           |                      |         |
|--------------------|----------------------------|----------------------|--------|----------------|----------------------|---------|
|                    | Trading Losses             | Other Gains (Losses) | Total  | Trading Losses | Other Gains (Losses) | Total   |
| Recurring items    |                            |                      |        |                |                      |         |
| Trading securities | \$(8 )                     | \$—                  | \$(8 ) | \$(16 )        | \$—                  | \$(16 ) |
| Borrowed funds     | —                          | —                    | —      | —              | —                    | —       |
| Nonrecurring items |                            |                      |        |                |                      |         |
| Foreclosed assets  | —                          | (68 )                | (68 )  | —              | —                    | —       |
| OMSRs              | —                          | 135                  | 135    | —              | (32 )                | (32 )   |
| Total              | \$(8 )                     | \$67                 | \$59   | \$(16 )        | \$(32 )              | \$(48 ) |

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|                    | Six Months Ended June 30 |             |         | 2012    |             |         |
|--------------------|--------------------------|-------------|---------|---------|-------------|---------|
|                    | 2013                     |             |         |         |             |         |
|                    | Trading                  | Other Gains | Total   | Trading | Other Gains | Total   |
|                    | Losses                   | (Losses)    |         | Losses  | (Losses)    |         |
| Recurring items    |                          |             |         |         |             |         |
| Trading securities | \$(18 )                  | \$—         | \$(18 ) | \$(32 ) | \$—         | \$(32 ) |
| Borrowed funds     | —                        | —           | —       | —       | 33          | 33      |
| Nonrecurring items |                          |             |         |         |             |         |
| Foreclosed assets  | —                        | (92 )       | (92 )   | —       | (17 )       | (17 )   |
| OMSRs              | —                        | 152         | 152     | —       | 42          | (16 )   |
| Total              | \$(18 )                  | \$60        | \$42    | \$(32 ) | \$58        | \$(32 ) |

## Note 13 – Accumulated Other Comprehensive Income (Loss)

The following table summarizes the changes in AOCI by component for the:

|                                | Three Months Ended June 30 |              |            | 2012          |              |         |
|--------------------------------|----------------------------|--------------|------------|---------------|--------------|---------|
|                                | 2013                       |              |            |               |              |         |
|                                | Unrealized                 |              |            | Unrealized    |              |         |
|                                | Holding Gains              | Defined      | Total      | Holding Gains | Defined      | Total   |
|                                | (Losses) on                | Benefit      |            | (Losses) on   | Benefit      |         |
|                                | AFS                        | Pension Plan |            | AFS           | Pension Plan |         |
|                                | Securities                 |              |            | Securities    |              |         |
| April 1, 2013                  | \$7,541                    | \$(3,671 )   | \$3,870    | \$6,539       | \$(3,453 )   | \$3,086 |
| OCI before reclassifications   | (11,997 )                  | —            | (11,997 )  | 1,420         | —            | 1,420   |
| Amounts reclassified from AOCI | —                          | —            | —          | —             | —            | —       |
| Subtotal                       | (11,997 )                  | —            | (11,997 )  | 1,420         | —            | 1,420   |
| Tax effect                     | 3,979                      | —            | 3,979      | (546 )        | —            | (546 )  |
| OCI, net of tax                | (8,018 )                   | —            | (8,018 )   | 874           | —            | 874     |
| June 30, 2013                  | \$(477 )                   | \$(3,671 )   | \$(4,148 ) | \$7,413       | \$(3,453 )   | \$3,960 |
|                                | Six Months Ended June 30   |              |            | 2012          |              |         |
|                                | 2013                       |              |            |               |              |         |
|                                | Unrealized                 |              |            | Unrealized    |              |         |
|                                | Holding Gains              | Defined      | Total      | Holding Gains | Defined      | Total   |
|                                | (Losses) on                | Benefit      |            | (Losses) on   | Benefit      |         |
|                                | AFS                        | Pension Plan |            | AFS           | Pension Plan |         |
|                                | Securities                 |              |            | Securities    |              |         |
| January 1, 2013                | \$8,678                    | \$(3,671 )   | \$5,007    | \$5,942       | \$(3,453 )   | \$2,489 |
| OCI before reclassifications   | (13,958 )                  | —            | (13,958 )  | 2,219         | —            | 2,219   |
| Amounts reclassified from AOCI | (99 )                      | —            | (99 )      | (721 )        | —            | (721 )  |
| Subtotal                       | (14,057 )                  | —            | (14,057 )  | 1,498         | —            | 1,498   |
| Tax effect                     | 4,902                      | —            | 4,902      | (27 )         | —            | (27 )   |
| OCI, net of tax                | (9,155 )                   | —            | (9,155 )   | 1,471         | —            | 1,471   |
| June 30, 2013                  | \$(477 )                   | \$(3,671 )   | \$(4,148 ) | \$7,413       | \$(3,453 )   | \$3,960 |

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The following table details reclassification adjustments and the related affected line items on our interim condensed consolidated statements of income for the noted periods:

| Details about AOCI components                       | Amount Reclassified from AOCI |      |                          |         | Affected Line Item in the Interim Condensed Consolidated Statements of Income |
|---|-------------------------------|------|--------------------------|---------|---|
|   | Three Months Ended June 30    |      | Six Months Ended June 30 |         |   |
|   | 2013                          | 2012 | 2013                     | 2012    |   |
| Unrealized holding gains (losses) on AFS securities | \$—                           | \$—  | \$99                     | \$1,003 | Gain (loss) on sale of AFS securities   |
|   | —                             | —    | —                        | (282    | ) Net AFS impairment loss   |
|   | —                             | —    | 99                       | 721     | Income before federal income tax expense                                      |
|   | —                             | —    | 34                       | 245     | Federal income tax expense  |
|   | \$—                           | \$—  | \$65                     | \$476   | Net income  |

Note 14 – Parent Company Only Financial Information  
Interim Condensed Balance Sheets

|   | June 30<br>2013  | December 31<br>2012 |
|---|------------------|---------------------|
| <b>ASSETS</b>                                     |                  |                     |
| Cash on deposit at the Bank                       | \$812            | \$332               |
| AFS Securities                                    | 3,595            | 3,939               |
| Investments in subsidiaries                       | 110,500          | 115,781             |
| Premises and equipment                            | 2,091            | 2,041               |
| Other assets                                      | 52,303           | 52,398              |
| <b>TOTAL ASSETS</b>                               | <b>\$169,301</b> | <b>\$174,491</b>    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                  |                     |
| Other liabilities                                 | \$10,013         | \$10,002            |
| Shareholders' equity                              | 159,288          | 164,489             |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$169,301</b> | <b>\$174,491</b>    |

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## Interim Condensed Statements of Income

|   | Three Months Ended |         | Six Months Ended |         |
|---|--------------------|---------|------------------|---------|
|   | June 30            |         | June 30          |         |
|   | 2013               | 2012    | 2013             | 2012    |
| Income  |                    |         |                  |         |
| Dividends from subsidiaries   | \$1,500            | \$1,500 | \$3,000          | \$3,125 |
| Interest income   | 41                 | 43      | 84               | 89      |
| Management fee and other  | 559                | 551     | 1,067            | 966     |
| Total income  | 2,100              | 2,094   | 4,151            | 4,180   |
| Expenses  |                    |         |                  |         |
| Compensation and benefits   | 669                | 604     | 1,381            | 1,214   |
| Occupancy and equipment   | 119                | 97      | 230              | 182     |
| Audit and related fees  | 93                 | 81      | 158              | 175     |
| Other   | 297                | 265     | 501              | 497     |
| Total expenses  | 1,178              | 1,047   | 2,270            | 2,068   |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 922                | 1,047   | 1,881            | 2,112   |
| Federal income tax benefit  | 199                | 160     | 388              | 357     |
|   | 1,121              | 1,207   | 2,269            | 2,469   |
| Undistributed earnings of subsidiaries  | 2,092              | 1,797   | 4,031            | 3,769   |
| Net income  | \$3,213            | \$3,004 | \$6,300          | \$6,238 |

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## Interim Condensed Statements of Cash Flows

|  | Six Months Ended |                 |
|--|------------------|-----------------|
|  | June 30          |                 |
|  | 2013             | 2012            |
| <b>OPERATING ACTIVITIES</b>  |                  |                 |
| Net income   | \$6,300          | \$6,238         |
| Adjustments to reconcile net income to cash provided by operations                   |                  |                 |
| Undistributed earnings of subsidiaries   | (4,031           | ) (3,769        |
| Undistributed earnings of equity securities without readily determinable fair values | 125              | —               |
| Share-based payment awards   | 258              | 295             |
| Depreciation   | 77               | 54              |
| Net amortization of AFS securities   | 1                | 2               |
| Changes in operating assets and liabilities which used cash                          |                  |                 |
| Other assets   | (26              | ) (278          |
| Accrued interest and other liabilities   | 211              | (69             |
| <b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>                           | <b>2,915</b>     | <b>2,473</b>    |
| <b>INVESTING ACTIVITIES</b>  |                  |                 |
| Maturities, calls, and sales of AFS securities                                       | 395              | 370             |
| Purchases of equipment and premises  | (127             | ) (81           |
| Repayment of advances to subsidiaries  | 101              | —               |
| <b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>                           | <b>369</b>       | <b>289</b>      |
| <b>FINANCING ACTIVITIES</b>  |                  |                 |
| Net increase (decrease) in borrowed funds  | (200             | ) (597          |
| Cash dividends paid on common stock  | (3,224           | ) (3,034        |
| Proceeds from the issuance of common stock   | 1,900            | 1,322           |
| Common stock repurchased   | (1,114           | ) (995          |
| Common stock purchased for deferred compensation obligations                         | (166             | ) (225          |
| <b>NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>                           | <b>(2,804</b>    | <b>) (3,529</b> |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                              | <b>480</b>       | <b>(767</b>     |
| Cash and cash equivalents at beginning of period                                     | 332              | 1,474           |
| Cash and cash equivalents at end of period   | \$812            | \$707           |

## Note 15 – Operating Segments

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of June 30, 2013 and 2012 and each of the three and six month periods then ended, represented 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(Dollars in thousands except per share amounts)

This section reviews our financial condition and results of our operations for the three and six month periods ended June 30, 2013 and 2012. This analysis should be read in conjunction with our 2012 annual report and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

Executive Summary

Despite compressed margins, we surpassed 2012 earnings on a quarterly and year-to-date basis due to continued improvement in credit quality, a reduction in the provision for loan losses, and loan growth of \$30.70 million in the first six months of 2013. Our continued success throughout these challenging times is a direct result of our unwavering focus on community banking principles, prudent underwriting standards, and long term sustainable growth. This focus has enabled us to continue to meet the needs of the communities we serve, which translates into increased shareholder value.

As we continue to provide superior customer service, we are excited to see the construction progress on our latest branch located in Big Rapids, Michigan, which is expected to open in the third quarter. The new location will complement our existing Big Rapids office and provide additional shareholder value for years to come.

Recent Legislation

The Health Care and Education Act of 2010, the Patient Protection and Affordable Care Act, the Dodd-Frank Act, and the JOBS Act, have already had, and are expected to continue to have, a significant negative impact on our operating results. Of these three acts, the Dodd-Frank Act has had, and is likely to have, the most significant impact, along with its establishment of the Consumer Financial Protection Bureau. This particular act made sweeping changes in the regulation of financial institutions aimed at strengthening the oversight of the federal government over the operation of the financial services sector and increasing the protection of consumers within the financial services sector. As a result of the implementation of some of the provisions, we have had increases in compensation costs and this trend is expected to continue.

The CFPB has begun to issue substantial proposed and final rules regarding consumer lending, including residential mortgage lending. These rules will likely further increase our compensation and outside advisor costs to ensure our compliance with the new regulations.

On July 3, 2013, the FRB published revised BASEL III Capital standards for Banks. The rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital cushion buffer. The rules take effect for us on January 1, 2015 and are not expected to have a material impact on the Corporation.

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## RESULTS OF OPERATIONS

## Selected Financial Data

The following table outlines our quarterly results of operations and provides certain performance measures for:

|   | Three Months Ended |           | Six Months Ended |           |   |
|---|--------------------|-----------|------------------|-----------|---|
|   | June 30            |           | June 30          |           |   |
|   | 2013               | 2012      | 2013             | 2012      |   |
| <b>INCOME STATEMENT DATA</b>                        |                    |           |                  |           |   |
| Interest income                                     | \$13,440           | \$14,188  | \$26,968         | \$28,392  |   |
| Interest expense                                    | 2,781              | 3,429     | 5,602            | 7,133     |   |
| Net interest income                                 | 10,659             | 10,759    | 21,366           | 21,259    |   |
| Provision for loan losses                           | 215                | 439       | 515              | 900       |   |
| Noninterest income                                  | 2,736              | 2,544     | 5,183            | 6,085     |   |
| Noninterest expenses                                | 9,324              | 9,188     | 18,515           | 18,761    |   |
| Federal income tax expense                          | 643                | 672       | 1,219            | 1,445     |   |
| Net Income  | \$3,213            | \$3,004   | \$6,300          | \$6,238   |   |
| <b>PER SHARE</b>                                    |                    |           |                  |           |   |
| Basic earnings                                      | 0.42               | 0.40      | 0.82             | 0.82      |   |
| Diluted earnings                                    | 0.41               | 0.39      | 0.80             | 0.80      |   |
| Dividends   | 0.21               | 0.20      | 0.42             | 0.40      |   |
| Market value*                                       | 24.75              | 24.85     | 24.75            | 24.85     |   |
| Tangible book value*                                | 15.19              | 14.37     | 15.19            | 14.37     |   |
| <b>BALANCE SHEET DATA</b>                           |                    |           |                  |           |   |
| At end of period                                    |                    |           |                  |           |   |
| Loans   | \$803,452          | \$754,952 | \$803,452        | \$754,952 |   |
| Total assets  | 1,451,415          | 1,381,496 | 1,451,415        | 1,381,496 |   |
| Deposits  | 1,021,424          | 978,828   | 1,021,424        | 978,828   |   |
| Shareholders' equity                                | 159,288            | 159,855   | 159,288          | 159,855   |   |
| Average balance                                     |                    |           |                  |           |   |
| Loans   | \$780,909          | \$748,223 | \$773,825        | \$746,072 |   |
| Total assets  | 1,440,370          | 1,369,240 | 1,436,287        | 1,362,675 |   |
| Deposits  | 1,022,153          | 972,953   | 1,024,924        | 975,835   |   |
| Shareholders' equity                                | 165,710            | 154,627   | 165,112          | 155,374   |   |
| <b>PERFORMANCE RATIOS</b>                           |                    |           |                  |           |   |
| Return on average total assets (annualized)         | 0.89               | % 0.88    | % 0.88           | % 0.92    | % |
| Return on average shareholders' equity (annualized) | 7.76               | % 7.77    | % 7.63           | % 8.03    | % |
| Return on average tangible equity (annualized)      | 11.10              | % 11.11   | % 10.98          | % 11.66   | % |
| Net interest margin yield (FTE annualized)          | 3.50               | % 3.73    | % 3.52           | % 3.71    | % |
| Loan to deposit*                                    | 78.66              | % 77.13   | % 78.66          | % 77.13   | % |
| Nonperforming loans to total loans*                 | 0.52               | % 0.86    | % 0.52           | % 0.86    | % |
| Nonperforming assets to total assets*               | 0.36               | % 0.64    | % 0.36           | % 0.64    | % |
| ALLL to nonperforming loans*                        | 280.51             | % 188.67  | % 280.51         | % 188.67  | % |
| <b>CAPITAL RATIOS</b>                               |                    |           |                  |           |   |
| Shareholders' equity to assets*                     | 10.97              | % 11.57   | % 10.97          | % 11.57   | % |
| Tier 1 capital to average assets*                   | 8.38               | % 8.24    | % 8.38           | % 8.24    | % |
| Tier 1 risk-based capital*                          | 13.59              | % 13.19   | % 13.59          | % 13.19   | % |
| Total risk-based capital*                           | 14.84              | % 14.44   | % 14.84          | % 14.44   | % |

\* At end of period





Table of Contents**AVERAGE BALANCES, INTEREST RATE, AND NET INTEREST INCOME**

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities. This schedule also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a 34% tax rate. Nonaccruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

The following table displays the results for the three month periods ended June 30:

|  | 2013               |                               |                            | 2012 |                    |                               |                            |   |
|--|--------------------|-------------------------------|----------------------------|------|--------------------|-------------------------------|----------------------------|---|
|  | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |      | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |   |
| <b>INTEREST EARNING ASSETS</b>             |                    |                               |                            |      |                    |                               |                            |   |
| Loans                                      | \$780,909          | \$10,280                      | 5.27                       | %    | \$748,223          | \$10,849                      | 5.80                       | % |
| Taxable investment securities              | 341,232            | 1,798                         | 2.11                       | %    | 316,237            | 1,988                         | 2.51                       | % |
| Nontaxable investment securities           | 162,626            | 2,024                         | 4.98                       | %    | 144,492            | 1,983                         | 5.49                       | % |
| Trading account securities                 | 1,156              | 14                            | 4.84                       | %    | 2,496              | 33                            | 5.29                       | % |
| Other                                      | 23,533             | 109                           | 1.85                       | %    | 25,911             | 113                           | 1.74                       | % |
| Total earning assets                       | 1,309,456          | 14,225                        | 4.35                       | %    | 1,237,359          | 14,966                        | 4.84                       | % |
| <b>NONEARNING ASSETS</b>                   |                    |                               |                            |      |                    |                               |                            |   |
| ALLL                                       | (11,889            | )                             |                            |      | (12,586            | )                             |                            |   |
| Cash and demand deposits due from banks    | 17,157             |                               |                            |      | 18,572             |                               |                            |   |
| Premises and equipment                     | 25,917             |                               |                            |      | 24,948             |                               |                            |   |
| Accrued income and other assets            | 99,729             |                               |                            |      | 100,947            |                               |                            |   |
| Total assets                               | \$1,440,370        |                               |                            |      | \$1,369,240        |                               |                            |   |
| <b>INTEREST BEARING LIABILITIES</b>        |                    |                               |                            |      |                    |                               |                            |   |
| Interest bearing demand deposits           | \$181,044          | 40                            | 0.09                       | %    | \$167,399          | 50                            | 0.12                       | % |
| Savings deposits                           | 242,247            | 90                            | 0.15                       | %    | 210,872            | 109                           | 0.21                       | % |
| Time deposits                              | 460,379            | 1,692                         | 1.47                       | %    | 475,996            | 2,209                         | 1.86                       | % |
| Borrowed funds                             | 243,936            | 959                           | 1.57                       | %    | 227,360            | 1,061                         | 1.87                       | % |
| Total interest bearing liabilities         | 1,127,606          | 2,781                         | 0.99                       | %    | 1,081,627          | 3,429                         | 1.27                       | % |
| <b>NONINTEREST BEARING LIABILITIES</b>     |                    |                               |                            |      |                    |                               |                            |   |
| Demand deposits                            | 138,483            |                               |                            |      | 118,686            |                               |                            |   |
| Other                                      | 8,571              |                               |                            |      | 14,300             |                               |                            |   |
| Shareholders' equity                       | 165,710            |                               |                            |      | 154,627            |                               |                            |   |
| Total liabilities and shareholders' equity | \$1,440,370        |                               |                            |      | \$1,369,240        |                               |                            |   |
| Net interest income (FTE)                  |                    | \$11,444                      |                            |      |                    | \$11,537                      |                            |   |
| Net yield on interest earning assets (FTE) |                    |                               | 3.50                       | %    |                    |                               | 3.73                       | % |

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The following table displays the results for the six month periods ended June 30:

|  | 2013               |                               |                            | 2012 |                    |                               |                            |   |
|--|--------------------|-------------------------------|----------------------------|------|--------------------|-------------------------------|----------------------------|---|
|  | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |      | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |   |
| <b>INTEREST EARNING ASSETS</b>             |                    |                               |                            |      |                    |                               |                            |   |
| Loans                                      | \$773,825          | \$20,610                      | 5.33                       | %    | \$746,072          | \$21,789                      | 5.84                       | % |
| Taxable investment securities              | 342,375            | 3,632                         | 2.12                       | %    | 300,689            | 3,877                         | 2.58                       | % |
| Nontaxable investment securities           | 159,147            | 4,035                         | 5.07                       | %    | 141,560            | 3,948                         | 5.58                       | % |
| Trading account securities                 | 1,363              | 35                            | 5.14                       | %    | 3,457              | 97                            | 5.61                       | % |
| Other                                      | 26,955             | 225                           | 1.67                       | %    | 37,246             | 242                           | 1.30                       | % |
| Total earning assets                       | 1,303,665          | 28,537                        | 4.38                       | %    | 1,229,024          | 29,953                        | 4.87                       | % |
| <b>NON-EARNING ASSETS</b>                  |                    |                               |                            |      |                    |                               |                            |   |
| ALLL                                       | (11,987            | )                             |                            |      | (12,597            | )                             |                            |   |
| Cash and demand deposits due from banks    | 17,909             |                               |                            |      | 19,442             |                               |                            |   |
| Premises and equipment                     | 25,927             |                               |                            |      | 24,974             |                               |                            |   |
| Accrued income and other assets            | 100,773            |                               |                            |      | 101,832            |                               |                            |   |
| Total assets                               | \$1,436,287        |                               |                            |      | \$1,362,675        |                               |                            |   |
| <b>INTEREST BEARING LIABILITIES</b>        |                    |                               |                            |      |                    |                               |                            |   |
| Interest bearing demand deposits           | \$183,921          | 81                            | 0.09                       | %    | \$170,153          | 104                           | 0.12                       | % |
| Savings deposits                           | 241,824            | 181                           | 0.15                       | %    | 209,047            | 231                           | 0.22                       | % |
| Time deposits                              | 460,958            | 3,434                         | 1.49                       | %    | 477,843            | 4,545                         | 1.90                       | % |
| Borrowed funds                             | 237,863            | 1,906                         | 1.60                       | %    | 219,386            | 2,253                         | 2.05                       | % |
| Total interest bearing liabilities         | 1,124,566          | 5,602                         | 1.00                       | %    | 1,076,429          | 7,133                         | 1.33                       | % |
| <b>NON-INTEREST BEARING LIABILITIES</b>    |                    |                               |                            |      |                    |                               |                            |   |
| Demand deposits                            | 138,221            |                               |                            |      | 118,792            |                               |                            |   |
| Other                                      | 8,388              |                               |                            |      | 12,080             |                               |                            |   |
| Shareholders' equity                       | 165,112            |                               |                            |      | 155,374            |                               |                            |   |
| Total liabilities and shareholders' equity | \$1,436,287        |                               |                            |      | \$1,362,675        |                               |                            |   |
| Net interest income (FTE)                  |                    | \$22,935                      |                            |      |                    | \$22,820                      |                            |   |
| Net yield on interest earning assets (FTE) |                    |                               | 3.52                       | %    |                    |                               | 3.71                       | % |
| <b>Net Interest Income</b>                 |                    |                               |                            |      |                    |                               |                            |   |

Net interest income is our primary source of income. Interest income includes loan fees of \$862 and \$1,683 for the three and six month periods ended June 30, 2013, respectively, as compared to \$809 and \$1,456 during the same periods in 2012. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

Table of Contents**VOLUME AND RATE VARIANCE ANALYSIS**

The following table sets forth the effect of volume and rate changes on interest income and expense for the periods indicated. For the purpose of this table, changes in interest due to volume and rate were determined as follows:

Volume Variance—change in volume multiplied by the previous year's rate.

Rate Variance—change in the FTE rate multiplied by the previous year's volume.

The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

|                                     | Three Months Ended                         |           |         | Six Months Ended                           |           |           |
|-------------------------------------|--|-----------|---------|--|-----------|-----------|
|                                     | June 30, 2013 Compared to<br>June 30, 2012 |           |         | June 30, 2013 Compared to<br>June 30, 2012 |           |           |
|                                     | Increase (Decrease) Due to                 |           |         | Increase (Decrease) Due to                 |           |           |
|                                     | Volume                                     | Rate      | Net     | Volume                                     | Rate      | Net       |
| <b>CHANGES IN INTEREST INCOME</b>   |  |           |         |  |           |           |
| Loans                               | \$460                                      | \$(1,029) | \$(569) | \$789                                      | \$(1,968) | \$(1,179) |
| Taxable AFS securities              | 149  | (339)     | (190)   | 496  | (741)     | (245)     |
| Nontaxable AFS securities           | 236  | (195)     | 41      | 465  | (378)     | 87        |
| Trading securities                  | (16)                                       | (3)       | (19)    | (54)                                       | (8)       | (62)      |
| Other                               | (11)                                       | 7         | (4)     | (76)                                       | 59        | (17)      |
| Total changes in interest income    | 818  | (1,559)   | (741)   | 1,620                                      | (3,036)   | (1,416)   |
| <b>CHANGES IN INTEREST EXPENSE</b>  |  |           |         |  |           |           |
| Interest bearing demand deposits    | 4  | (14)      | (10)    | 8  | (31)      | (23)      |
| Savings deposits                    | 15   | (34)      | (19)    | 32   | (82)      | (50)      |
| Time deposits                       | (70)                                       | (447)     | (517)   | (156)                                      | (955)     | (1,111)   |
| Borrowed funds                      | 73   | (175)     | (102)   | 178  | (525)     | (347)     |
| Total changes in interest expense   | 22   | (670)     | (648)   | 62   | (1,593)   | (1,531)   |
| Net change in interest margin (FTE) | \$796                                      | \$(889)   | \$(93)  | \$1,558                                    | \$(1,443) | \$115     |

As shown in the following table, we continue to experience downward pressure on our net yield on interest earning assets. This pressure is a direct result of FRB monetary policy which has reduced yields on interest earning assets more than rates on interest bearing liabilities. The persistent low interest rate environment coupled with an increase in the concentration of AFS securities and trading securities as a percentage of earnings assets has also placed downward pressure on net interest margin yield.

|  | Average Yield / Rate For The Three Month Periods Ended: |                  |                     |                      |                 |
|--|---|------------------|---------------------|----------------------|-----------------|
|  | June 30<br>2013   | March 31<br>2013 | December 31<br>2012 | September 30<br>2012 | June 30<br>2012 |
| Total earning assets                       | 4.35  | % 4.41           | % 4.61              | % 4.76               | % 4.84          |
| Total interest bearing liabilities         | 0.99  | % 1.01           | % 1.12              | % 1.18               | % 1.27          |
| Net yield on interest earning assets (FTE) | 3.50  | % 3.54           | % 3.65              | % 3.73               | % 3.73          |

While there have recently been noticeable increases in long term interest rates, short and medium term rates continue to be at historically low levels, and therefore the net yield on interest earning assets is not likely to increase in the near future. We anticipate that the continued reduction in rates earned on loans without a proportionate decline in funding rate will continue to cause downward pressure in net interest margin yield.

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## Allowance for Loan and Lease Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans outstanding represent our single largest concentration of risk. The ALLL is our estimation of probable losses inherent in the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment allocations, historical charge-offs, internally assigned credit ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a reflection of other qualitative risks within the loan portfolio.

The following tables summarize our charge-off and recovery activity for the:

|  | Three Months Ended |           | Six Months Ended |           |   |
|--|--------------------|-----------|------------------|-----------|---|
|  | June 30            |           | June 30          |           |   |
|  | 2013               | 2012      | 2013             | 2012      |   |
| ALLL at beginning of period                        | \$11,909           | \$12,375  | \$11,936         | \$12,375  |   |
| Loans charged-off                                  |                    |           |                  |           |   |
| Commercial and agricultural                        | 234                | 237       | 445              | 686       |   |
| Residential real estate                            | 397                | 238       | 587              | 353       |   |
| Consumer   | 88                 | 146       | 209              | 237       |   |
| Total Loans charged-off                            | 719                | 621       | 1,241            | 1,276     |   |
| Recoveries   |                    |           |                  |           |   |
| Commercial and agricultural                        | 166                | 42        | 223              | 128       |   |
| Residential real estate                            | 61                 | 20        | 114              | 61        |   |
| Consumer   | 68                 | 63        | 153              | 130       |   |
| Total Recoveries                                   | 295                | 125       | 490              | 319       |   |
| Provision for loan losses                          | 215                | 439       | 515              | 900       |   |
| ALLL at end of period                              | \$11,700           | \$12,318  | \$11,700         | \$12,318  |   |
| Net loans charged-off                              | \$424              | \$496     | \$751            | \$957     |   |
| Year-to-date average loans outstanding             | 780,909            | 748,223   | 773,825          | 746,072   |   |
| Net loans charged-off to average loans outstanding | 0.05               | % 0.07    | % 0.10           | % 0.13    | % |
| Total loans at end of period                       | \$803,452          | \$754,952 | \$803,452        | \$754,952 |   |
| ALLL as a% of loans at end of period               | 1.46               | % 1.63    | % 1.46           | % 1.63    | % |

As shown in the preceding table, the level of net charge-offs continues to decline. This trend has allowed us to reduce the provision for loan losses, leading to a decline in the ALLL in both amount and as a percentage of loans. We do not expect any significant increases in net loans charged-off throughout the remainder of 2013 and, as such, we anticipate the provision for loan losses to approximate current levels. For further discussion of the allocation of the ALLL, see “Note 6 – Loans and ALLL” of the interim condensed consolidated financial statements.

## Loans Past Due and Loans in Nonaccrual Status

Increases in past due and nonaccrual loans can have a significant impact on the ALLL. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due greater than 30 days and nonaccrual loans. We monitor all loans that are past due and in nonaccrual status for indicators of additional deterioration.

|                             | Total Past Due and Nonaccrual |                  |                     |                      |                 |
|-----------------------------|-------------------------------|------------------|---------------------|----------------------|-----------------|
|                             | June 30<br>2013               | March 31<br>2013 | December 31<br>2012 | September 30<br>2012 | June 30<br>2012 |
| Commercial and agricultural | \$4,962                       | \$8,713          | \$7,271             | \$11,004             | \$9,459         |
| Residential real estate     | 5,080                         | 4,077            | 5,431               | 4,879                | 4,496           |
| Consumer                    | 104                           | 212              | 199                 | 284                  | 179             |
| Total                       | \$10,146                      | \$13,002         | \$12,901            | \$16,167             | \$14,134        |



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A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual loans by type, is included in “Note 6 – Loans and ALLL” of our interim condensed consolidated financial statements.

Troubled Debt Restructurings

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has allowed certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDRs. The implementation of ASU No. 2011-02 “A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring” has also contributed to the increased level of TDRs. The modifications have been successful for us and our customers as very few of the modified loans have resulted in foreclosures. At the time of the TDR, the loan is reviewed to determine whether or not to classify the loan as accrual or nonaccrual. The majority of new modifications result in terms that satisfy our criteria for continued interest accrual. TDRs that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance.

We restructure debt with borrowers who due to temporary financial difficulties are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, forgive principal, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There were no TDRs that were Government sponsored as of June 30, 2013 or December 31, 2012.

Losses associated with TDRs, if any, are included in the estimation of the ALLL in the quarter in which a loan is identified as a TDR, and we review the ALLL estimation each reporting period to ensure its continued appropriateness.

The following tables provide a roll-forward of TDRs for the:

|                                | Three Months Ended June 30, 2013 |          |            |         |        |          |
|--------------------------------|----------------------------------|----------|------------|---------|--------|----------|
|                                | Accruing Interest                |          | Nonaccrual |         | Total  |          |
|                                | Number                           | Balance  | Number     | Balance | Number | Balance  |
|                                | of                               |          | of         |         | of     |          |
|                                | Loans                            |          | Loans      |         | Loans  |          |
| April 1, 2013                  | 119                              | \$16,900 | 19         | \$2,502 | 138    | \$19,402 |
| New modifications              | 14                               | 3,592    | —          | —       | 14     | 3,592    |
| Principal payments             | —                                | (198 )   | —          | (206 )  | —      | (404 )   |
| Loans paid-off                 | (7 )                             | (1,089 ) | (4 )       | (497 )  | (11 )  | (1,586 ) |
| Partial charge-off             | —                                | —        | —          | —       | —      | —        |
| Balances charged-off           | (3 )                             | (147 )   | —          | —       | (3 )   | (147 )   |
| Transfers to OREO              | —                                | —        | —          | —       | —      | —        |
| Transfers to accrual status    | 1                                | 105      | (1 )       | (105 )  | —      | —        |
| Transfers to nonaccrual status | (1 )                             | (29 )    | 1          | 29      | —      | —        |
| June 30, 2013                  | 123                              | \$19,134 | 15         | \$1,723 | 138    | \$20,857 |

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|                                | Six Months Ended June 30, 2013   |          |            |         |        |          |
|--------------------------------|----------------------------------|----------|------------|---------|--------|----------|
|                                | Accruing Interest                |          | Nonaccrual |         | Total  |          |
|                                | Number                           | Balance  | Number     | Balance | Number | Balance  |
|                                | of                               |          | of         |         | of     |          |
|                                | Loans                            |          | Loans      |         | Loans  |          |
| January 1, 2013                | 115                              | \$16,531 | 19         | \$2,824 | 134    | \$19,355 |
| New modifications              | 22                               | 4,411    | 1          | 98      | 23     | 4,509    |
| Principal payments             | —                                | (463)    | ) —        | (243)   | ) —    | (706)    |
| Loans paid-off                 | (10)                             | (1,219)  | ) (5)      | (697)   | ) (15) | (1,916)  |
| Partial charge-off             | —                                | (15)     | ) —        | (211)   | ) —    | (226)    |
| Balances charged-off           | (3)                              | (147)    | ) —        | —       | (3)    | (147)    |
| Transfers to OREO              | —                                | —        | (1)        | (12)    | (1)    | (12)     |
| Transfers to accrual status    | 1                                | 105      | (1)        | (105)   | ) —    | —        |
| Transfers to nonaccrual status | (2)                              | (69)     | ) 2        | 69      | —      | —        |
| June 30, 2013                  | 123                              | \$19,134 | 15         | \$1,723 | 138    | \$20,857 |
|                                | Three Months Ended June 30, 2012 |          |            |         |        |          |
|                                | Accruing Interest                |          | Nonaccrual |         | Total  |          |
|                                | Number                           | Balance  | Number     | Balance | Number | Balance  |
|                                | of                               |          | of         |         | of     |          |
|                                | Loans                            |          | Loans      |         | Loans  |          |
| April 1, 2012                  | 127                              | \$20,964 | 17         | \$2,138 | 144    | \$23,102 |
| New modifications              | 12                               | 989      | 1          | —       | 13     | 989      |
| Principal payments             | —                                | (423)    | ) —        | (30)    | ) —    | (453)    |
| Loans paid-off                 | (5)                              | (550)    | ) —        | —       | (5)    | (550)    |
| Partial charge-off             | —                                | (152)    | ) —        | —       | —      | (152)    |
| Balances charged-off           | (1)                              | (8)      | ) (1)      | (25)    | ) (2)  | (33)     |
| Transfers to OREO              | —                                | —        | (4)        | (360)   | (4)    | (360)    |
| Transfers to accrual status    | —                                | —        | —          | —       | —      | —        |
| Transfers to nonaccrual status | (7)                              | (1,186)  | ) 7        | 1,186   | —      | —        |
| June 30, 2012                  | 126                              | \$19,634 | 20         | \$2,909 | 146    | \$22,543 |
|                                | Six Months Ended June 30, 2012   |          |            |         |        |          |
|                                | Accruing Interest                |          | Nonaccrual |         | Total  |          |
|                                | Number                           | Balance  | Number     | Balance | Number | Balance  |
|                                | of                               |          | of         |         | of     |          |
|                                | Loans                            |          | Loans      |         | Loans  |          |
| January 1, 2012                | 112                              | \$17,738 | 12         | \$1,018 | 124    | \$18,756 |
| New modifications              | 36                               | 5,640    | 9          | 1,217   | 45     | 6,857    |
| Principal payments             | —                                | (778)    | ) —        | (91)    | ) —    | (869)    |
| Loans paid-off                 | (14)                             | (1,591)  | ) —        | —       | (14)   | (1,591)  |
| Partial charge-off             | —                                | (152)    | ) —        | —       | —      | (152)    |
| Balances charged-off           | (1)                              | (8)      | ) (4)      | (90)    | ) (5)  | (98)     |
| Transfers to OREO              | —                                | —        | (4)        | (360)   | (4)    | (360)    |
| Transfers to accrual status    | 1                                | 21       | (1)        | (21)    | ) —    | —        |
| Transfers to nonaccrual status | (8)                              | (1,236)  | ) 8        | 1,236   | —      | —        |
| June 30, 2012                  | 126                              | \$19,634 | 20         | \$2,909 | 146    | \$22,543 |

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The following table summarizes our TDRs as of:

|                          | June 30, 2013        |            |          | December 31, 2012    |            |          | Total<br>Change |
|--------------------------|----------------------|------------|----------|----------------------|------------|----------|-----------------|
|                          | Accruing<br>Interest | Nonaccrual | Total    | Accruing<br>Interest | Nonaccrual | Total    |                 |
| Current                  | \$18,264             | \$874      | \$19,138 | \$16,301             | \$941      | \$17,242 | \$1,896         |
| Past due 30-59 days      | 870                  | 34         | 904      | 158                  | 561        | 719      | 185             |
| Past due 60-89 days      | —                    | —          | —        | 72                   | 41         | 113      | (113 )          |
| Past due 90 days or more | —                    | 815        | 815      | —                    | 1,281      | 1,281    | (466 )          |
| Total                    | \$19,134             | \$1,723    | \$20,857 | \$16,531             | \$2,824    | \$19,355 | \$1,502         |

Additional disclosures about TDRs are included in “Note 6 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Impaired Loans**

The following is a summary of information pertaining to impaired loans as of:

|   | June 30, 2013          |                                |                        | December 31, 2012      |                                |                        |
|---|------------------------|--------------------------------|------------------------|------------------------|--------------------------------|------------------------|
|   | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| <b>TDRs</b>                             |                        |                                |                        |                        |                                |                        |
| Commercial real estate                  | \$9,411                | \$10,085                       | \$1,269                | \$9,227                | \$9,640                        | \$1,333                |
| Commercial other                        | 2,286                  | 2,316                          | 64                     | 1,167                  | 1,197                          | 38                     |
| Agricultural real estate                | 223                    | 223                            | 31                     | 91                     | 91                             | 32                     |
| Agricultural other                      | 105                    | 225                            | —                      | 569                    | 689                            | 59                     |
| Residential real estate senior<br>liens | 8,798                  | 9,197                          | 1,489                  | 8,224                  | 8,670                          | 1,429                  |
| Residential real estate junior<br>liens | —                      | —                              | —                      | 21                     | 57                             | 4                      |
| Consumer secured                        | 34                     | 34                             | —                      | 56                     | 56                             | —                      |
| Total TDRs                              | 20,857                 | 22,080                         | 2,853                  | 19,355                 | 20,400                         | 2,895                  |
| <b>Other impaired loans</b>             |                        |                                |                        |                        |                                |                        |
| Commercial real estate                  | 1,913                  | 2,474                          | 309                    | 1,817                  | 2,304                          | 320                    |
| Commercial other                        | 29                     | 110                            | —                      | 2,245                  | 2,376                          | 359                    |
| Agricultural other                      | 248                    | 248                            | —                      | 63                     | 63                             | —                      |
| Residential real estate senior<br>liens | 1,677                  | 2,478                          | 242                    | 2,226                  | 3,002                          | 354                    |
| Residential real estate junior<br>liens | 71                     | 109                            | 13                     | 51                     | 61                             | 9                      |
| Home equity lines of credit             | 174                    | 474                            | —                      | 182                    | 482                            | —                      |
| Consumer secured                        | 20                     | 20                             | —                      | 19                     | 28                             | —                      |
| Total other impaired loans              | 4,132                  | 5,913                          | 564                    | 6,603                  | 8,316                          | 1,042                  |
| Total impaired loans                    | \$24,989               | \$27,993                       | \$3,417                | \$25,958               | \$28,716                       | \$3,937                |

Additional disclosure related to impaired loans is included in “Note 6 – Loans and ALLL” of our interim condensed consolidated financial statements.



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## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

|   | June 30<br>2013 | December 31<br>2012 |  |   |
|---|-----------------|---------------------|--|---|
| Nonaccrual loans                            | \$3,651         | \$7,303             |  |   |
| Accruing loans past due 90 days or more     | 520             | 428                 |  |   |
| Total nonperforming loans                   | 4,171           | 7,731               |  |   |
| Foreclosed assets                           | 1,105           | 2,018               |  |   |
| Total nonperforming assets                  | \$5,276         | \$9,749             |  |   |
| Nonperforming loans as a % of total loans   | 0.52            | % 1.00              |  | % |
| Nonperforming assets as a % of total assets | 0.36            | % 0.68              |  | % |

Loans are placed in nonaccrual status when the foreclosure process has begun, generally after a loan is 90 days past due, unless they are well secured. Upon transferring the loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Loans may be placed back on accrual status after six months of continued performance.

Included in the nonaccrual loan balances above were loans currently classified as TDRs as of:

|                             | June 30<br>2013 | December 31<br>2012 |
|-----------------------------|-----------------|---------------------|
| Commercial and agricultural | \$1,317         | \$2,325             |
| Residential real estate     | 406             | 499                 |
| Total                       | \$1,723         | \$2,824             |

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of June 30, 2013 and December 31, 2012. To be classified as individually significant, the recorded investment in nonaccrual loans to each borrower must have exceeded \$1,000 as of the end of either period.

|                                     | June 30, 2013          |                        | December 31, 2012      |                        |
|-------------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                     | Outstanding<br>Balance | Specific<br>Allocation | Outstanding<br>Balance | Specific<br>Allocation |
| Borrower 1                          | \$—                    | \$—                    | \$2,077                | \$359                  |
| Others not individually significant | 3,651                  |                        | 5,226                  |                        |
| Total                               | \$3,651                |                        | \$7,303                |                        |

The reduction in the outstanding balance for Borrower 1 was the result of the loan being placed back on accrual status due to continued performance. There were no other individually significant credits included in nonaccrual loans as of June 30, 2013 or December 31, 2012.

Additional disclosures about nonaccrual loans are included in “Note 6 – Loans and ALLL” of our interim condensed consolidated financial statements.

We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge-off. We believe that all loans deemed to be impaired have been identified.

We believe that the level of the ALLL is appropriate as of June 30, 2013 and we will continue to closely monitor overall credit quality and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains appropriate.

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## NONINTEREST INCOME AND EXPENSES

## Noninterest Income

Noninterest income consists of service charges and fee income, gains from the sale of mortgage loans, gains and losses on trading securities and borrowings measured at fair value, gains from the sale of investment securities, and other. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

|   | Three Months Ended June 30 |         | Change |         |    |
|---|----------------------------|---------|--------|---------|----|
|   | 2013                       | 2012    | \$     | %       |    |
| Service charges and fees                            |                            |         |        |         |    |
| NSF and overdraft fees                              | \$558                      | \$597   | \$(39) | (6.53)  | )% |
| ATM and debit card fees                             | 489                        | 477     | 12     | 2.52    | %  |
| Trust fees  | 302                        | 266     | 36     | 13.53   | %  |
| Freddie Mac servicing fee                           | 187                        | 187     | —      | —       | %  |
| Service charges on deposit accounts                 | 95                         | 84      | 11     | 13.10   | %  |
| Net OMSRs income (loss)                             | 88                         | (13)    | ) 101  | N/M     |    |
| All other   | 28                         | 30      | (2)    | (6.67)  | )% |
| Total service charges and fees                      | 1,747                      | 1,628   | 119    | 7.31    | %  |
| Gain on sale of mortgage loans                      | 249                        | 279     | (30)   | (10.75) | )% |
| Earnings on corporate owned life insurance policies | 190                        | 177     | 13     | 7.34    | %  |
| Gain (loss) on sale of AFS securities               | —                          | —       | —      | —       | %  |
| Other   |                            |         |        |         |    |
| Brokerage and advisory fees                         | 181                        | 137     | 44     | 32.12   | %  |
| Other   | 369                        | 323     | 46     | 14.24   | %  |
| Total other   | 550                        | 460     | 90     | 19.57   | %  |
| Total noninterest income                            | \$2,736                    | \$2,544 | \$192  | 7.55    | %  |

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|   | Six Months Ended June 30 |         | Change  |         |    |
|---|--------------------------|---------|---------|---------|----|
|   | 2013                     | 2012    | \$      | %       |    |
| Service charges and fees                            |                          |         |         |         |    |
| NSF and overdraft fees                              | \$1,074                  | \$1,155 | \$(81)  | (7.01)  | )% |
| ATM and debit card fees                             | 944                      | 934     | 10      | 1.07    | %  |
| Trust fees  | 565                      | 516     | 49      | 9.50    | %  |
| Freddie Mac servicing fee                           | 371                      | 378     | (7)     | (1.85)  | )% |
| Service charges on deposit accounts                 | 185                      | 158     | 27      | 17.09   | %  |
| Net OMSRs income (loss)                             | 96                       | 50      | 46      | 92.00   | %  |
| All other   | 56                       | 66      | (10)    | (15.15) | )% |
| Total service charges and fees                      | 3,291                    | 3,257   | 34      | 1.04    | %  |
| Gain on sale of mortgage loans                      | 607                      | 658     | (51)    | (7.75)  | )% |
| Earnings on corporate owned life insurance policies | 359                      | 348     | 11      | 3.16    | %  |
| Gain (loss) on sale of AFS securities               | 99                       | 1,003   | (904)   | (90.13) | )% |
| Other   |                          |         |         |         |    |
| Brokerage and advisory fees                         | 328                      | 267     | 61      | 22.85   | %  |
| Other   | 499                      | 552     | (53)    | (9.60)  | )% |
| Total other   | 827                      | 819     | 8       | 0.98    | %  |
| Total noninterest income                            | \$5,183                  | \$6,085 | \$(902) | (14.82) | )% |

Significant changes in noninterest income are detailed below:

We continuously analyze various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, we make any necessary adjustments to ensure that our fee structure is within the range of our competitors, while at the same time making sure that the fees remain fair to deposit customers. NSF and overdraft fees represent the largest single component of service charges and fees. While we have experienced significant increases in deposit accounts, NSF and overdraft fees continue to decline. This decline has been the result of reduced overdraft activity by our customers. We expect this trend to continue.

In recent periods, we have invested considerable efforts to increase our market share in trust and brokerage and advisory services. These efforts have translated into increases in trust fees and brokerage and advisory fees. We expect this trend to continue.

Residential loan refinancing activity declined in 2013, resulting in a decline in the gain on sale of mortgage loans. The decline in refinancing activity was the result of a decline in demand as well as an increase in offering rates. Offsetting the decline in the gain on sale of mortgage loans was an increase in net OMSRs income. We expect mortgage origination volumes and the related income to continue to decline when compared to 2012.

- We are continually analyzing our AFS securities for potential sale opportunities. These analyses identified several mortgage-backed securities pools in 2013 and 2012 that made economic sense to sell. We do not anticipate any significant investment sales during the remainder of 2013.

The fluctuations in all other income is spread throughout various categories, none of which are individually significant. We do not anticipate any significant fluctuations from current levels for the remainder of 2013.

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## Noninterest Expenses

Noninterest expenses include compensation and benefits, furniture and equipment, occupancy, net AFS security impairment loss, and other expenses. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

|                                   | Three Months Ended June 30 |         |              |         |    |
|-----------------------------------|----------------------------|---------|--------------|---------|----|
|                                   | 2013                       | 2012    | Change<br>\$ | %       |    |
| Compensation and benefits         |                            |         |              |         |    |
| Employee salaries                 | \$3,844                    | \$3,820 | \$24         | 0.63    | %  |
| Employee benefits                 | 1,392                      | 1,412   | (20)         | (1.42)  | )% |
| Total compensation and benefits   | 5,236                      | 5,232   | 4            | 0.08    | %  |
| Furniture and equipment           |                            |         |              |         |    |
| Service contracts                 | 534                        | 534     | —            | —       | %  |
| Depreciation                      | 459                        | 443     | 16           | 3.61    | %  |
| ATM and debit card fees           | 185                        | 179     | 6            | 3.35    | %  |
| All other                         | 14                         | 14      | —            | —       | %  |
| Total furniture and equipment     | 1,192                      | 1,170   | 22           | 1.88    | %  |
| Occupancy                         |                            |         |              |         |    |
| Depreciation                      | 165                        | 155     | 10           | 6.45    | %  |
| Outside services                  | 151                        | 153     | (2)          | (1.31)  | )% |
| Property taxes                    | 134                        | 130     | 4            | 3.08    | %  |
| Utilities                         | 119                        | 98      | 21           | 21.43   | %  |
| All other                         | 72                         | 63      | 9            | 14.29   | %  |
| Total occupancy                   | 641                        | 599     | 42           | 7.01    | %  |
| Net AFS security impairment loss  | —                          | —       | —            | N/M     |    |
| Other                             |                            |         |              |         |    |
| Marketing and community relations | 432                        | 535     | (103)        | (19.25) | )% |
| FDIC insurance premiums           | 273                        | 213     | 60           | 28.17   | %  |
| Directors fees                    | 205                        | 209     | (4)          | (1.91)  | )% |
| Audit and related fees            | 162                        | 154     | 8            | 5.19    | %  |
| Education and travel              | 116                        | 139     | (23)         | (16.55) | )% |
| Postage and freight               | 94                         | 94      | —            | —       | %  |
| Printing and supplies             | 99                         | 110     | (11)         | (10.00) | )% |
| Legal fees                        | 120                        | 81      | 39           | 48.15   | %  |
| Consulting fees                   | 83                         | 71      | 12           | 16.90   | %  |
| Other                             | 671                        | 581     | 90           | 15.49   | %  |
| Total other                       | 2,255                      | 2,187   | 68           | 3.11    | %  |
| Total noninterest expenses        | \$9,324                    | \$9,188 | \$136        | 1.48    | %  |

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|                                   | Six Months Ended June 30 |          | Change  |         |    |
|-----------------------------------|--------------------------|----------|---------|---------|----|
|                                   | 2013                     | 2012     | \$      | %       |    |
| Compensation and benefits         |                          |          |         |         |    |
| Employee salaries                 | \$7,720                  | \$7,648  | \$72    | 0.94    | %  |
| Employee benefits                 | 2,961                    | 2,885    | 76      | 2.63    | %  |
| Total compensation and benefits   | 10,681                   | 10,533   | 148     | 1.41    | %  |
| Furniture and equipment           |                          |          |         |         |    |
| Service contracts                 | 1,070                    | 1,014    | 56      | 5.52    | %  |
| Depreciation                      | 923                      | 886      | 37      | 4.18    | %  |
| ATM and debit card fees           | 353                      | 330      | 23      | 6.97    | %  |
| All other                         | 35                       | 30       | 5       | 16.67   | %  |
| Total furniture and equipment     | 2,381                    | 2,260    | 121     | 5.35    | %  |
| Occupancy                         |                          |          |         |         |    |
| Depreciation                      | 326                      | 309      | 17      | 5.50    | %  |
| Outside services                  | 321                      | 300      | 21      | 7.00    | %  |
| Property taxes                    | 269                      | 259      | 10      | 3.86    | %  |
| Utilities                         | 255                      | 224      | 31      | 13.84   | %  |
| All other                         | 135                      | 148      | (13)    | (8.78)  | )% |
| Total occupancy                   | 1,306                    | 1,240    | 66      | 5.32    | %  |
| Net AFS security impairment loss  | —                        | 282      | (282)   | N/M     |    |
| Other                             |                          |          |         |         |    |
| Marketing and community relations | 674                      | 1,029    | (355)   | (34.50) | )% |
| FDIC insurance premiums           | 545                      | 428      | 117     | 27.34   | %  |
| Directors fees                    | 404                      | 419      | (15)    | (3.58)  | )% |
| Audit and related fees            | 301                      | 330      | (29)    | (8.79)  | )% |
| Education and travel              | 238                      | 266      | (28)    | (10.53) | )% |
| Postage and freight               | 193                      | 195      | (2)     | (1.03)  | )% |
| Printing and supplies             | 185                      | 219      | (34)    | (15.53) | )% |
| Legal fees                        | 180                      | 143      | 37      | 25.87   | %  |
| Consulting fees                   | 155                      | 258      | (103)   | (39.92) | )% |
| Other                             | 1,272                    | 1,159    | 113     | 9.75    | %  |
| Total other                       | 4,147                    | 4,446    | (299)   | (6.73)  | )% |
| Total noninterest expenses        | \$18,515                 | \$18,761 | \$(246) | (1.31)  | )% |

To help offset our current declining net interest margin yields, we have made a conscious effort to limit increases, or reduce, noninterest expenses. These efforts translated into a decline of 1.31% in total noninterest expenses when the first six months of 2013 are compared to the same period in 2012.

Significant changes in noninterest expenses are detailed below:

During the first quarter of 2012, we recorded a credit impairment on an AFS security through earnings due to a bond being downgraded below investment grade. We continuously monitor the AFS security portfolio for other potential OTTI. For further discussion, see “Note 5 – AFS Securities” of our notes to interim condensed consolidated financial statements.

We have consistently been a strong supporter of the various communities, schools, and charities in the markets we serve. We sponsor a foundation, which we established in 1996, that is generally funded from non-recurring, or extraordinary, revenue sources. The foundation provides centralized oversight for donations to organizations that benefit our communities. Included in marketing and community relations were discretionary donations to the foundation of \$200 and \$200 for the three and six month periods ended June 30, 2013, respectively, as compared to \$250 and \$500 during the same periods in 2012.



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Audit and related fees fluctuate from period to period based on the timing of services performed. Audit and related fees are expected to approximate current levels throughout the remainder of 2013.

Education and travel expenses were higher in 2012 as a result of a company-wide customer service seminar which occurred in the second quarter of 2012. Our 2013 company-wide customer service seminar is scheduled for the fourth quarter of 2013.

Legal fees increased in 2013 as a result of higher costs associated with filing documents with the SEC, primarily those associated with XBRL tagging. We expect legal fees to approximate current levels for the remainder of 2013.

Printing and supplies expenses declined in 2013 as a result of increased utilization of paperless office opportunities.

During the first quarter of 2012, we incurred consulting fees to review our FHLB advances for potential restructuring options. They were also elevated in 2012 due to the engagement of consultants to review our loan prepayment and deposit decay assumptions and various information technology projects. Consulting fees are anticipated to approximate current levels for the remainder of 2013.

The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.

## ANALYSIS OF CHANGES IN FINANCIAL CONDITION

|  | June 30, 2013      | December 31, 2012  | \$ Change       | % Change<br>(unannualized) |          |
|--|--------------------|--------------------|-----------------|----------------------------|----------|
| <b>ASSETS</b>  |                    |                    |                 |                            |          |
| Cash and cash equivalents                                    | \$21,366           | \$24,920           | \$(3,554)       | (14.26)                    | %        |
| Certificates of deposit held in other financial institutions | 1,810              | 4,465              | (2,655)         | (59.46)                    | %        |
| Trading securities   | 950                | 1,573              | (623)           | (39.61)                    | %        |
| AFS securities   | 499,424            | 504,010            | (4,586)         | (0.91)                     | %        |
| Mortgage loans AFS   | 743                | 3,633              | (2,890)         | (79.55)                    | %        |
| Loans  | 803,452            | 772,753            | 30,699          | 3.97                       | %        |
| ALLL   | (11,700)           | (11,936)           | 236             | N/M                        |          |
| Premises and equipment                                       | 25,852             | 25,787             | 65              | 0.25                       | %        |
| Corporate owned life insurance policies                      | 24,101             | 22,773             | 1,328           | 5.83                       | %        |
| Accrued interest receivable                                  | 5,232              | 5,227              | 5               | 0.10                       | %        |
| Equity securities without readily determinable fair values   | 18,242             | 18,118             | 124             | 0.68                       | %        |
| Goodwill and other intangible assets                         | 46,418             | 46,532             | (114)           | (0.24)                     | %        |
| Other assets   | 15,525             | 12,784             | 2,741           | 21.44                      | %        |
| <b>TOTAL ASSETS</b>  | <b>\$1,451,415</b> | <b>\$1,430,639</b> | <b>\$20,776</b> | <b>1.45</b>                | <b>%</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                  |                    |                    |                 |                            |          |
| <b>Liabilities</b>   |                    |                    |                 |                            |          |
| Deposits   | \$1,021,424        | \$1,017,667        | \$3,757         | 0.37                       | %        |
| Borrowed funds   | 262,460            | 241,001            | 21,459          | 8.90                       | %        |
| Accrued interest payable and other liabilities               | 8,243              | 7,482              | 761             | 10.17                      | %        |
| Total liabilities  | 1,292,127          | 1,266,150          | 25,977          | 2.05                       | %        |
| Shareholders' equity   | 159,288            | 164,489            | (5,201)         | (3.16)                     | %        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>            | <b>\$1,451,415</b> | <b>\$1,430,639</b> | <b>\$20,776</b> | <b>1.45</b>                | <b>%</b> |

As shown above, total assets have increased since December 31, 2012. In the first six months of 2013, loans grew by \$30,699. This loan growth was primarily funded by increases in borrowed funds. We expect that loans will continue to grow throughout the rest of the year.

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The following table outlines the changes in loans:

|                         | June 30, 2013 | December 31,<br>2012 | \$ Change | % Change<br>(unannualized) |   |
|-------------------------|---------------|----------------------|-----------|----------------------------|---|
| Commercial              | \$ 389,044    | \$ 371,505           | \$ 17,539 | 4.72                       | % |
| Agricultural            | 87,516        | 83,606               | 3,910     | 4.68                       | % |
| Residential real estate | 293,158       | 284,148              | 9,010     | 3.17                       | % |
| Consumer                | 33,734        | 33,494               | 240       | 0.72                       | % |
| Total                   | \$ 803,452    | \$ 772,753           | \$ 30,699 | 3.97                       | % |

The following table outlines the changes in deposits:

|                                     | June 30, 2013 | December 31,<br>2012 | \$ Change  | % Change<br>(unannualized) |    |
|-------------------------------------|---------------|----------------------|------------|----------------------------|----|
| Noninterest bearing demand deposits | \$ 139,942    | \$ 143,735           | \$ (3,793) | (2.64)                     | )% |
| Interest bearing demand deposits    | 173,184       | 181,259              | (8,075)    | (4.45)                     | )% |
| Savings deposits                    | 248,098       | 228,338              | 19,760     | 8.65                       | %  |
| Certificates of deposit             | 368,713       | 376,790              | (8,077)    | (2.14)                     | )% |
| Brokered certificates of deposit    | 57,701        | 55,348               | 2,353      | 4.25                       | %  |
| Internet certificates of deposit    | 33,786        | 32,197               | 1,589      | 4.94                       | %  |
| Total                               | \$ 1,021,424  | \$ 1,017,667         | \$ 3,757   | 0.37                       | %  |

**Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income (loss). We are currently authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 77,568 shares or \$1,900 of common stock during the first six months of 2013, as compared to 54,900 shares or \$1,322 of common stock during the same period in 2012. We also offer the Directors Plan which allows participants to purchase stock units, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$258 and \$295 during the six month periods ended June 30, 2013 and 2012, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 45,825 shares or \$1,114 of common stock compared to 41,581 shares for \$995 during the first six months of 2013 and 2012, respectively. As of June 30, 2013, we were authorized to repurchase up to an additional 39,585 shares of common stock.

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.0%. Our primary capital to adjusted average assets, which consists of shareholders' equity plus the allowance for loan losses less acquisition intangibles, was 8.38% as of June 30, 2013. The FRB has established a minimum risk based capital standard. Under this standard, a framework has been established that assigns risk weights to each category of on and off balance sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. The minimum standard is 8%, of which at least 4% must consist of equity capital net of goodwill. The following table sets forth the percentages required under the Risk Based Capital guidelines and our values as of:

|                   | June 30<br>2013 | December 31<br>2012 | Required |   |
|-------------------|-----------------|---------------------|----------|---|
| Equity Capital    | 13.59           | % 13.23             | % 4.00   | % |
| Secondary Capital | 1.25            | % 1.25              | % 4.00   | % |
| Total Capital     | 14.84           | % 14.48             | % 8.00   | % |

Secondary capital includes only the ALLL. The percentage for the secondary capital under the required column is the maximum amount allowed from all sources.

The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At June 30, 2013, the Bank exceeded these minimum capital requirements. On July 3, 2013, the FRB published revised BASEL III Capital standards for Banks. The rules redefine what is included or deducted from equity capital, changes risk weighting for



certain on and off-balance sheet

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assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital cushion buffer. The rules take effect for us on January 1, 2015 and are not expected to have a material impact on the Corporation.

**Contractual Obligations and Loan Commitments**

We are party to credit related financial instruments with off-balance-sheet risk. These financial instruments are entered into in the normal course of business to meet the financing needs of our customers. These financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of involvement we have in a particular class of financial instrument.

The following table summarizes our credit related financial instruments with off-balance-sheet risk as of:

|  | June 30<br>2013 | December 31<br>2012 |
|--|-----------------|---------------------|
| Unfunded commitments under lines of credit | \$ 121,516      | \$ 115,233          |
| Commercial and standby letters of credit   | 3,058           | 3,935               |
| Commitments to grant loans                 | 25,571          | 40,507              |

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. These commitments may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements.

Commercial and standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements, including commercial paper, bond financing, and similar transactions. These commitments to extend credit and letters of credit generally mature within one year. The credit risk involved in these transactions is essentially the same as that involved in extending loans to customers. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon the extension of credit, is based on a credit evaluation of the borrower. While we consider standby letters of credit to be guarantees, the amount of the liability related to such guarantees on the commitment date is not significant and a liability related to such guarantees is not recorded on the consolidated balance sheets.

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if it is deemed necessary, is based on management's credit evaluation of the customer. Commitments to grant loans include loans committed to be sold to the secondary market. Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are anticipated as a result of these commitments.

**Fair Value**

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Trading securities, AFS securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time-to-time, we may be required to record at fair value other assets on a nonrecurring basis, such as mortgage loans AFS, foreclosed assets, OMSRs, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

For further information regarding fair value measurements see "Note 12 – Fair Value" of our notes to the interim condensed consolidated financial statements.

Table of Contents**Liquidity**

Liquidity is monitored regularly by our Market Risk Committee, which consists of members of senior management. The committee reviews projected cash flows, key ratios, and liquidity available from both primary and secondary sources.

Our primary sources of liquidity are cash and cash equivalents, certificates of deposit held in other financial institutions, trading securities, and AFS securities. These categories totaled \$523,550 or 36.1% of assets as of June 30, 2013 as compared to \$534,968 or 37.4% as of December 31, 2012. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity varies significantly daily, based on customer activity.

Our primary source of funds is deposit accounts. We also have the ability to borrow from the FHLB, the FRB, and through various correspondent banks in the form of federal funds purchased. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB Advances, FRB Discount Window Advances, and repurchase agreements, require us to pledge assets, typically in the form of certificates of deposits held in other financial institutions, trading securities, AFS securities, or loans as collateral. As of June 30, 2013, we had available lines of credit of \$91,951.

The following table summarizes our sources and uses of cash for the six month periods ended June 30:

|   | 2013      | 2012      | \$ Variance |
|---|-----------|-----------|-------------|
| Net cash provided by (used in) operating activities | \$ 14,594 | \$ 11,947 | \$ 2,647    |
| Net cash provided by (used in) investing activities | (40,760   | ) (56,047 | ) 15,287    |
| Net cash provided by (used in) financing activities | 22,612    | 35,761    | (13,149     |
| Increase (decrease) in cash and cash equivalents    | (3,554    | ) (8,339  | ) 4,785     |
| Cash and cash equivalents January 1                 | 24,920    | 28,590    | (3,670      |
| Cash and cash equivalents June 30                   | \$ 21,366 | \$ 20,251 | \$ 1,115    |

**Market Risk**

Our primary market risks are interest rate risk and liquidity risk. We have no significant foreign exchange risk and do not utilize interest rate swaps or derivatives, except for interest rate locks and forward loan commitments, in the management of IRR. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on our interest income and cash flows.

IRR is the exposure of our net interest income to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. IRR is the fundamental method by which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to our earnings and capital.

The FRB has adopted a policy requiring us to effectively manage the various risks that can have a material impact on our safety and soundness. The risks include credit, interest rate, liquidity, operational, and reputational. We have policies, procedures, and internal controls for measuring and managing these risks. Specifically, our Funds Management policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to our Board.

The primary technique to measure interest rate risk is simulation analysis. Simulation analysis forecasts the effects on the balance sheet structure and net interest income under a variety of scenarios that incorporate changes in interest rates, the shape of yield curves, interest rate relationships, and loan prepayments. These forecasts are compared against net interest income projected in a stable interest rate environment. While many assets and liabilities reprice either at maturity or in accordance with their contractual terms, several balance sheet components demonstrate characteristics that require an evaluation to more accurately reflect their repricing behavior. Key assumptions in the simulation analysis include prepayments on loans, probable calls of investment securities, changes in market conditions, loan volumes and loan pricing, deposit sensitivity, and customer preferences. These assumptions are inherently uncertain as they are subject to fluctuation and revision in a dynamic environment. As a result, the

simulation analysis cannot precisely forecast the impact of rising and falling interest rates on net interest income. Actual results will differ from simulated results due to many other factors, including changes in balance sheet components, interest rate changes, changes in market conditions, and management strategies.

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Our interest rate sensitivity is estimated by first forecasting the next twelve months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At June 30, 2013, we projected the change in net interest income during the next twelve months assuming market interest rates were to immediately decrease by 100 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. We did not project scenarios showing decreases in interest rates beyond 100 basis points as this is considered extremely unlikely given current interest rate levels. These projections were based on our assets and liabilities remaining static over the next twelve months, while factoring in probable calls and prepayments of certain investment securities and real estate residential and consumer loans. While it is extremely unlikely that interest rates would immediately increase to these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our forecasted net interest income sensitivity to ensure that it remains within established limits.

The following table summarizes our interest rate sensitivity as of:

|   | June 30, 2013     |   |        |          |          |          |   |
|---|-------------------|---|--------|----------|----------|----------|---|
| Immediate basis point change assumption<br>(short-term rates) | (100)             | 0 | 100    | 200      | 300      | 400      |   |
| Percent change in net income vs. constant rates               | (2.86 )%          | — | 0.42 % | 0.69 %   | 0.65 %   | 0.50 %   | % |
|   | December 31, 2012 |   |        |          |          |          |   |
| Immediate basis point change assumption<br>(short-term rates) | (100)             | 0 | 100    | 200      | 300      | 400      |   |
| Percent change in net income vs. constant rates               | (1.61 )%          | — | 0.49 % | (1.58 )% | (1.74 )% | (2.16 )% | % |

The secondary method to measure IRR is gap analysis. Gap analysis measures the cash flows and/or the earliest repricing of our interest bearing assets and liabilities. This analysis is useful for measuring trends in the repricing characteristics of the balance sheet. Significant assumptions are required in this process because of the embedded repricing options contained in assets and liabilities. Residential real estate and consumer loans allow the borrower to repay the balance prior to maturity without penalty, while commercial and agricultural loans have prepayment penalties. The amount of prepayments is dependent upon many factors, including the interest rate of a given loan in comparison to the current offering rates, the level of sales of used homes, and the overall availability of credit in the market place. Generally, a decrease in interest rates will result in an increase in cash flows from these assets. A significant portion of our securities are callable or have prepayment options. The call and prepayment options are more likely to be exercised in a period of decreasing interest rates. Savings and demand accounts may generally be withdrawn on request without prior notice. The timing of cash flows from these deposits is estimated based on historical experience. Certificates of deposit have penalties that discourage early withdrawals.

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of June 30, 2013 and December 31, 2012. The principal amounts of assets and time deposits maturing were calculated based on the contractual maturity dates. Savings and NOW accounts are based on management's estimate of their future cash flows. During the first quarter of 2012, we engaged the services of a third party to analyze our historical loan prepayment speeds and non-contractual deposit decay rates. We have reviewed the results of the analyses in detail and feel that it reasonably reflects the prepayment speeds and decay rates of our loan and deposit portfolios.

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|  | June 30, 2013     |           |          |           |          |            |           | Fair Value |
|--|-------------------|-----------|----------|-----------|----------|------------|-----------|------------|
|  | 2014              | 2015      | 2016     | 2017      | 2018     | Thereafter | Total     |            |
| Rate sensitive assets                          |                   |           |          |           |          |            |           |            |
| Other interest bearing assets                  | \$1,647           | \$240     | \$—      | \$—       | \$—      | \$—        | \$1,887   | \$1,890    |
| Average interest rates                         | 0.86              | % 1.25    | % —      | —         | —        | —          | 0.91      | %          |
| Trading securities                             | \$950             | \$—       | \$—      | \$—       | \$—      | \$—        | \$950     | \$950      |
| Average interest rates                         | 2.83              | % —       | —        | —         | —        | —          | 2.83      | %          |
| AFS securities                                 | \$168,609         | \$90,752  | \$53,417 | \$38,028  | \$24,252 | \$124,366  | \$499,424 | \$499,424  |
| Average interest rates                         | 1.58              | % 1.62    | % 1.94   | % 2.64    | % 2.75   | % 2.70     | % 2.04    | %          |
| Fixed interest rate loans (1)                  | \$116,839         | \$100,362 | \$92,019 | \$100,014 | \$97,363 | \$117,502  | \$624,099 | \$629,549  |
| Average interest rates                         | 5.43              | % 5.42    | % 5.13   | % 4.64    | % 4.42   | % 4.37     | % 4.90    | %          |
| Variable interest rate loans (1)               | \$82,141          | \$30,652  | \$19,690 | \$17,726  | \$18,250 | \$10,894   | \$179,353 | \$179,353  |
| Average interest rates                         | 4.63              | % 3.88    | % 4.11   | % 3.32    | % 3.35   | % 3.64     | % 3.64    | %          |
| Rate sensitive liabilities                     |                   |           |          |           |          |            |           |            |
| Borrowed funds                                 | \$109,412         | \$33,048  | \$10,000 | \$30,000  | \$40,000 | \$40,000   | \$262,460 | \$266,633  |
| Average interest rates                         | 0.69              | % 0.68    | % 1.23   | % 1.88    | % 2.46   | % 3.02     | % 1.47    | %          |
| Savings and NOW accounts                       | \$38,098          | \$34,415  | \$30,886 | \$27,749  | \$24,952 | \$265,182  | \$421,282 | \$421,282  |
| Average interest rates                         | 0.13              | % 0.12    | % 0.12   | % 0.12    | % 0.12   | % 0.11     | % 0.12    | %          |
| Fixed interest rate certificates of deposit    | \$199,979         | \$80,929  | \$64,216 | \$48,369  | \$49,574 | \$16,006   | \$459,073 | \$463,021  |
| Average interest rates                         | 0.95              | % 1.71    | % 2.11   | % 1.87    | % 1.41   | % 1.64     | % 1.42    | %          |
| Variable interest rate certificates of deposit | \$637             | \$490     | \$—      | \$—       | \$—      | \$—        | \$1,127   | \$1,127    |
| Average interest rates                         | 0.42              | % 0.42    | % —      | —         | —        | —          | 0.42      | %          |
|  | December 31, 2012 |           |          |           |          |            |           |            |
|  | 2013              | 2014      | 2015     | 2016      | 2017     | Thereafter | Total     | Fair Value |
| Rate sensitive assets                          |                   |           |          |           |          |            |           |            |
| Other interest bearing assets                  | \$6,411           | \$100     | \$240    | \$—       | \$—      | \$—        | \$6,751   | \$6,761    |
| Average interest rates                         | 0.86              | % 0.35    | % 1.25   | % —       | —        | —          | 0.86      | %          |

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|  |           |          |          |          |           |           |           |           |  |
|--|-----------|----------|----------|----------|-----------|-----------|-----------|-----------|--|
| Average interest rates                         |           |          |          |          |           |           |           |           |  |
| Trading securities                             | \$1,051   | \$522    | \$—      | \$—      | \$—       | \$—       | \$1,573   | \$1,573   |  |
| Average interest rates                         | 2.68      | % 2.54   | % —      | —        | —         | —         | 2.63      | %         |  |
| AFS securities                                 | \$124,452 | \$83,606 | \$49,419 | \$42,655 | \$35,504  | \$168,374 | \$504,010 | \$504,010 |  |
| Average interest rates                         | 2.42      | % 2.30   | % 2.53   | % 2.82   | % 2.89    | % 2.48    | % 2.50    | %         |  |
| Fixed interest rate loans (1)                  | \$138,840 | \$96,013 | \$91,353 | \$85,095 | \$109,057 | \$89,760  | \$610,118 | \$622,329 |  |
| Average interest rates                         | 5.74      | % 5.62   | % 5.57   | % 5.21   | % 4.60    | % 4.63    | % 5.26    | %         |  |
| Variable interest rate loans (1)               | \$64,482  | \$28,076 | \$24,669 | \$12,650 | \$22,061  | \$10,697  | \$162,635 | \$162,635 |  |
| Average interest rates                         | 4.90      | % 3.77   | % 3.96   | % 3.89   | % 3.36    | % 3.90    | % 4.21    | %         |  |
| Rate sensitive liabilities                     |           |          |          |          |           |           |           |           |  |
| Borrowed funds                                 | \$77,865  | \$10,814 | \$42,322 | \$20,000 | \$40,000  | \$50,000  | \$241,001 | \$248,822 |  |
| Average interest rates                         | 0.46      | % 0.65   | % 1.14   | % 2.67   | % 2.15    | % 3.03    | % 1.59    | %         |  |
| Savings and NOW accounts                       | \$35,796  | \$32,794 | \$29,476 | \$26,520 | \$23,885  | \$261,126 | \$409,597 | \$409,597 |  |
| Average interest rates                         | 0.13      | % 0.13   | % 0.12   | % 0.12   | % 0.12    | % 0.11    | % 0.12    | %         |  |
| Fixed interest rate certificates of deposit    | \$204,972 | \$76,373 | \$71,685 | \$51,232 | \$40,523  | \$18,399  | \$463,184 | \$471,479 |  |
| Average interest rates                         | 1.13      | % 1.69   | % 2.10   | % 2.14   | % 1.72    | % 1.67    | % 1.55    | %         |  |
| Variable interest rate certificates of deposit | \$782     | \$369    | \$—      | \$—      | \$—       | \$—       | \$1,151   | \$1,151   |  |
| Average interest rates                         | 0.46      | % 0.45   | % —      | —        | —         | —         | 0.46      | %         |  |

(1) The fair value reported is exclusive of the allocation of the ALLL.

We do not believe that there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. As of the date of this report, we do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term. As of the date of this report, we

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do not expect to make material changes in those methods in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.

Item 3 – Quantitative and Qualitative Disclosures about Market Risk

The information presented in the “Market Risk” section of the Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 4 – Controls and Procedures

**DISCLOSURE CONTROLS AND PROCEDURES**

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934 ) as of June 30, 2013, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of June 30, 2013, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

During the most recent fiscal quarter, no change occurred in our internal control over financial reporting that materially affected, or is likely to materially effect, our internal control over financial reporting.



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## PART II – OTHER INFORMATION

## Item 1 – Legal Proceedings

We are not involved in any material legal proceedings. We are involved in ordinary, routine litigation incidental to our business; however, no such routine proceedings are expected to result in any material adverse effect on operations, earnings, or financial condition, or cash flows.

## Item 1A – Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2012.

## Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

(A) None

(B) None

## (C) Repurchases of Common Stock

We have adopted and publically announced a common stock repurchase plan. The plan was last amended on April 26, 2012, to allow for the repurchase of an additional 150,000 shares of common stock. These authorizations do not have expiration dates. As shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued shares.

The following table provides information for the three month period ended June 30, 2013, with respect to this plan:

|                         | Shares Repurchased |                            | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plan or<br>Program | Maximum Number of<br>Shares That May Yet Be<br>Purchased Under the<br>Plans or Programs |
|-------------------------|--------------------|----------------------------|--|---|
|                         | Number             | Average Price<br>Per Share |  |   |
| Balance, March 31, 2013 |                    |                            |  | 64,901  |
| April 1 - 30, 2013      | 7,811              | \$25.48                    | 7,811  | 57,090  |
| May 1 - 31, 2013        | 7,805              | 24.98                      | 7,805  | 49,285  |
| June 1 - 30, 2013       | 9,700              | 24.95                      | 9,700  | 39,585  |
| Total                   | 25,316             | \$25.12                    | 25,316   | 39,585  |

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Item 6 - Exhibits

(a) Exhibits

31(a) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer

31(b) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer

32 Section 1350 Certification of Principal Executive Officer and Principal Financial Officer

101.1\* 101.INS (XBRL Instance Document)

101.SCH (XBRL Taxonomy Extension Schema Document)

101.CAL (XBRL Calculation Linkbase Document)

101.LAB (XBRL Taxonomy Label Linkbase Document)

101.DEF (XBRL Taxonomy Linkbase Document)

101.PRE (XBRL Taxonomy Presentation Linkbase Document)

In accordance with Rule 406T of Regulations S-T, the XBRL related information shall not be deemed to be “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Isabella Bank Corporation

Date: July 29, 2013

/s/ Richard J. Barz  
Richard J. Barz  
Chief Executive Officer  
(Principal Executive Officer)

Date: July 29, 2013

/s/ Dennis P. Angner  
Dennis P. Angner  
President, Chief Financial Officer  
(Principal Financial Officer, Principal Accounting Officer)