ISABELLA BANK CORP
Form 10-Q
May 09, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2016
or
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to
Commission File Number: 0-18415

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes ý No
The number of common shares outstanding of the registrant’s Common Stock (no par value) was 7,839,650 as of May 5, 2016.

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Forward Looking Statements

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

Glossary of Acronyms and Abbreviations

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

AFS: Available-for-sale	GAAP: U.S. generally accepted accounting principles
ALLL: Allowance for loan and lease losses	GLB Act: Gramm-Leach-Bliley Act of 1999
AOCI: Accumulated other comprehensive income	IFRS: International Financial Reporting Standards
ASC: FASB Accounting Standards Codification	IRR: Interest rate risk
ASU: FASB Accounting Standards Update	JOBS Act: Jumpstart our Business Startups Act
ATM: Automated Teller Machine	LIBOR: London Interbank Offered Rate
BHC Act: Bank Holding Company Act of 1956	N/A: Not applicable
CFPB: Consumer Financial Protection Bureau	N/M: Not meaningful
CIK: Central Index Key	NASDAQ: NASDAQ Stock Market Index
CRA: Community Reinvestment Act	NASDAQ Banks: NASDAQ Bank Stock Index
DIF: Deposit Insurance Fund	NAV: Net asset value
DIFS: Department of Insurance and Financial Services	NOW: Negotiable order of withdrawal
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NSF: Non-sufficient funds
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	OCI: Other comprehensive income (loss)
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OMSR: Originated mortgage servicing rights
ESOP: Employee Stock Ownership Plan	OREO: Other real estate owned
Exchange Act: Securities Exchange Act of 1934	OTTI: Other-than-temporary impairment
FASB: Financial Accounting Standards Board	PBO: Projected benefit obligation
FDI Act: Federal Deposit Insurance Act	PCAOB: Public Company Accounting Oversight Board
FDIC: Federal Deposit Insurance Corporation	

FFIEC: Federal Financial Institutions Examinations Council

FRB: Federal Reserve Bank

FHLB: Federal Home Loan Bank

Freddie Mac: Federal Home Loan Mortgage Corporation

FTE: Fully taxable equivalent

Rabbi Trust: A trust established to fund the Directors Plan

SEC: U.S. Securities & Exchange Commission

SOX: Sarbanes-Oxley Act of 2002

TDR: Troubled debt restructuring

XBRL: eXtensible Business Reporting Language

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

	March 31 2016	December 31 2015
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$16,670	$ 18,810
Interest bearing balances due from banks	11,457	2,759
Total cash and cash equivalents	28,127	21,569
AFS securities (amortized cost of $636,797 in 2016 and $654,348 in 2015)	649,859	660,136
Mortgage loans AFS	1,240	1,187
Loans		
Commercial	470,305	448,381
Agricultural	115,686	115,911
Residential real estate	249,318	251,501
Consumer	34,982	34,699
Gross loans	870,291	850,492
Less allowance for loan and lease losses	7,500	7,400
Net loans	862,791	843,092
Premises and equipment	28,269	28,331
Corporate owned life insurance policies	26,611	26,423
Accrued interest receivable	6,995	6,269
Equity securities without readily determinable fair values	22,226	22,286
Goodwill and other intangible assets	48,785	48,828
Other assets	6,915	9,991
TOTAL ASSETS	$1,681,818	$ 1,668,112
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Deposits		
Noninterest bearing	$183,820	$ 191,376
NOW accounts	215,327	212,666
Certificates of deposit under $100 and other savings	534,022	521,793
Certificates of deposit over $100	240,338	238,728
Total deposits	1,173,507	1,164,563
Borrowed funds	307,896	309,732
Accrued interest payable and other liabilities	10,168	9,846
Total liabilities	1,491,571	1,484,141
Shareholders’ equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,809,079 shares (including 15,764 shares held in the Rabbi Trust) in 2016 and 7,799,867 shares (including 19,401 shares held in the Rabbi Trust) in 2015	139,501	139,198
Shares to be issued for deferred compensation obligations	4,623	4,592
Retained earnings	41,105	39,960
Accumulated other comprehensive income	5,018	221
Total shareholders’ equity	190,247	183,971
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$1,681,818	$ 1,668,112

See notes to interim condensed consolidated financial statements (unaudited).

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

	Three Months Ended March 31	
	2016	2015
Interest income		
Loans, including fees	$9,038	$9,025
AFS securities		
Taxable	2,400	2,107
Nontaxable	1,485	1,482
Federal funds sold and other	158	139
Total interest income	13,081	12,753
Interest expense		
Deposits	1,399	1,466
Borrowings	1,215	1,022
Total interest expense	2,614	2,488
Net interest income	10,467	10,265
Provision for loan losses	156	(726)
Net interest income after provision for loan losses	10,311	10,991
Noninterest income		
Service charges and fees	1,213	1,163
Net gain on sale of mortgage loans	82	149
Earnings on corporate owned life insurance policies	188	187
Other	740	629
Total noninterest income	2,223	2,128
Noninterest expenses		
Compensation and benefits	4,788	4,766
Furniture and equipment	1,468	1,314
Occupancy	758	721
Other	2,066	1,874
Total noninterest expenses	9,080	8,675
Income before federal income tax expense	3,454	4,444
Federal income tax expense	437	771
NET INCOME	$3,017	$3,673
Earnings per common share		
Basic	$0.39	$0.47
Diluted	$0.38	$0.46
Cash dividends per common share	$0.24	$0.23

See notes to interim condensed consolidated financial statements (unaudited).

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

	Three Months Ended March 31	
	2016	2015
Net income	$3,017	$3,673
Unrealized gains on AFS securities arising during the period	7,274	4,356
Tax effect (1)	(2,477)	(1,366)
Other comprehensive income, net of tax	4,797	2,990
Comprehensive income	$7,814	$6,663

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

See notes to interim condensed consolidated financial statements (unaudited).

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

	Common Stock					
	Common Shares Outstanding	Amount	Common Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2015	7,776,274	$138,755	$ 4,242	$32,103	$ (506)	$174,594
Comprehensive income (loss)	—	—	—	3,673	2,990	6,663
Issuance of common stock	41,217	945	—	—	—	945
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	123	(123)	—	—	—
Share-based payment awards under equity compensation plan	—	—	146	—	—	146
Common stock purchased for deferred compensation obligations	—	(100)	—	—	—	(100)
Common stock repurchased pursuant to publicly announced repurchase plan	(35,671)	(820)	—	—	—	(820)
Cash dividends paid ($0.23 per common share)	—	—	—	(1,775)	—	(1,775)
Balance, March 31, 2015	7,781,820	$138,903	$ 4,265	$34,001	$ 2,484	$179,653
Balance, January 1, 2016	7,799,867	$139,198	$ 4,592	$39,960	$ 221	$183,971
Comprehensive income (loss)	—	—	—	3,017	4,797	7,814
Issuance of common stock	37,465	1,072	—	—	—	1,072
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	127	(127)	—	—	—
Share-based payment awards under equity compensation plan	—	—	158	—	—	158
Common stock purchased for deferred compensation obligations	—	(97)	—	—	—	(97)
Common stock repurchased pursuant to publicly announced repurchase plan	(28,253)	(799)	—	—	—	(799)
Cash dividends paid ($0.24 per common share)	—	—	—	(1,872)	—	(1,872)
Balance, March 31, 2016	7,809,079	$139,501	$ 4,623	$41,105	$ 5,018	$190,247

See notes to interim condensed consolidated financial statements (unaudited).

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

	Three Months Ended March 31	
	2016	2015
OPERATING ACTIVITIES		
Net income	$3,017	$3,673
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	156	(726)
Depreciation	727	654
Amortization of OMSR	64	70
Amortization of acquisition intangibles	43	38
Net amortization of AFS securities	705	478
Net gain on sale of mortgage loans	(82)	(149)
Increase in cash value of corporate owned life insurance policies	(188)	(187)
Share-based payment awards under equity compensation plan	158	146
Origination of loans held-for-sale	(4,499)	(11,209)
Proceeds from loan sales	4,528	11,202
Net changes in operating assets and liabilities which provided (used) cash:		
Accrued interest receivable	(726)	(947)
Other assets	450	(207)
Accrued interest payable and other liabilities	322	(810)
Net cash provided by (used in) operating activities	4,675	2,026
INVESTING ACTIVITIES		
Activity in AFS securities		
Maturities, calls, and principal payments	19,452	14,419
Purchases	(2,606)	(48,215)
Net loan principal (originations) collections	(19,944)	18,149
Proceeds from sales of foreclosed assets	234	302
Purchases of premises and equipment	(665)	(943)
Purchases of corporate owned life insurance policies	—	(500)
Net cash provided by (used in) investing activities	(3,529)	(16,788)

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

	Three Months Ended March 31	
	2016	2015
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	$8,944	$24,171
Net increase (decrease) in borrowed funds	(1,836)	(6,388)
Cash dividends paid on common stock	(1,872)	(1,775)
Proceeds from issuance of common stock	1,072	945
Common stock repurchased	(799)	(820)
Common stock purchased for deferred compensation obligations	(97)	(100)
Net cash provided by (used in) financing activities	5,412	16,033
Increase (decrease) in cash and cash equivalents	6,558	1,271
Cash and cash equivalents at beginning of period	21,569	19,906
Cash and cash equivalents at end of period	$28,127	$21,177
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	$2,574	$2,462
Income taxes paid	—	1,393
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	$89	$134

See notes to interim condensed consolidated financial statements (unaudited).

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(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,” the “Corporation”, “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 or the “Bank” refer 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 month period ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2015.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2015.

Reclassifications: Certain amounts reported in the 2015 consolidated financial statements have been reclassified to conform with the 2016 presentation.

Restatements: In this Quarterly Report on Form 10-Q, certain prior period financial information has been restated due to an accounting correction. Impacted sections of the Consolidated Financial Statements include:

1. Consolidated Statements of Income for the three month period ended March 31, 2015 and Consolidated Statements of Cash Flows for the three month period ended March 31, 2015; and
2. Notes to Consolidated Financial Statements for the three month period ended March 31, 2015.

On the Consolidated Statements of Income, the effects of the restatement reduced loan interest and fee income by $659 and compensation and benefits were reduced by $659 for the three months ended March 31, 2015. The restatement did not impact net income for the three month period ended March 31, 2015.

All amounts in this Quarterly Report on Form 10-Q affected by the restatement adjustments reflect such amounts as restated. For information related to the restatement, refer to our Annual Report on Form 10-K for the year ended December 31, 2015.

Note 2 – Computation of Earnings Per Common Share

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

	Three Months Ended March 31	
	2016	2015
Average number of common shares outstanding for basic calculation	7,795,294	7,773,428
Average potential effect of common shares in the Directors Plan (1)	184,461	177,001
Average number of common shares outstanding used to calculate diluted earnings per common share	7,979,755	7,950,429
Net income	$3,017	$ 3,673
Earnings per common share		
Basic	$0.39	$ 0.47
Diluted	$0.38	$ 0.46

(1) Exclusive of shares held in the Rabbi Trust

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Note 3 – Accounting Standards Updates
Pending Accounting Standards Updates
ASU No. 2016-01: “Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities”
In January 2016, ASU No. 2016-01 set forth the following: 1) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment and when an impairment exists, an entity is required to measure the investment at fair value; 3) for public entities, eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; 4) for public entities, requires the use of exit price notion when measuring the fair value of financial instruments for disclosure purposes; 5) requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; 6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and 7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2017 and is expected to have an impact on financial statement disclosures due to existing equity investments.
ASU No. 2016-02: “Leases (Topic 842)”
In February 2016, ASU No. 2016-02 was issued to create Topic 842 - Leases which will require recognition of lease assets and lease liabilities on the balance sheet for leases previously classified as operating leases. Accounting guidance is set forth for both lessee and lessor accounting. Under lessee accounting, a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term.
For finance leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income; and 3) classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows. For operating leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis; and 3) classify all cash payments within operating activities in the statement of cash flows.
The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018 and is not expected to have a significant impact on our operations or financial statement disclosures.
ASU No. 2016-07: “Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition of the Equity Method of Accounting”
In March 2016, ASU No. 2016-07 eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. Additionally, the update requires that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2016 and is not expected to have a significant impact on our operations

or financial statement disclosures.

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ASU No. 2016-09: “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”

In March 2016, ASU No. 2016-09 updated several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2016 and is not expected to have a significant impact on our operations or financial statement disclosures.

Note 4 – AFS Securities

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

	March 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$24,383	$ 57	$ 12	$24,428
States and political subdivisions	222,835	8,649	12	231,472
Auction rate money market preferred	3,200	—	393	2,807
Preferred stocks	3,800	—	454	3,346
Mortgage-backed securities	255,009	3,409	134	258,284
Collateralized mortgage obligations	127,570	2,206	254	129,522
Total	$636,797	$ 14,321	$ 1,259	$649,859

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$24,407	$ 13	$ 75	$24,345
States and political subdivisions	224,752	7,511	46	232,217
Auction rate money market preferred	3,200	—	334	2,866
Preferred stocks	3,800	—	501	3,299
Mortgage-backed securities	264,109	1,156	1,881	263,384
Collateralized mortgage obligations	134,080	1,136	1,191	134,025
Total	$654,348	$ 9,816	$ 4,028	$660,136

The amortized cost and fair value of AFS securities by contractual maturity at March 31, 2016 are as follows:

	Maturing					
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	Total
Government sponsored enterprises	$—	$ 24,029	$354	$ —	$ —	$24,383
States and political subdivisions	31,685	66,833	91,042	33,275	—	222,835
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	3,800	3,800
Mortgage-backed securities	—	—	—	—	255,009	255,009
Collateralized mortgage obligations	—	—	—	—	127,570	127,570
Total amortized cost	$31,685	$ 90,862	$91,396	$ 33,275	$ 389,579	$636,797
Fair value	$31,742	$ 93,332	$96,031	$ 34,795	$ 393,959	$649,859

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.

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

Information pertaining to AFS securities with gross unrealized losses at March 31, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	March 31, 2016				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	$12	$8,985	$ —	$ —	$ 12
States and political subdivisions	1	576	11	681	12
Auction rate money market preferred	—	—	393	2,807	393
Preferred stocks	—	—	454	3,346	454
Mortgage-backed securities	12	6,955	122	25,526	134
Collateralized mortgage obligations	—	—	254	30,281	254
Total	$25	$16,516	$ 1,234	$ 62,641	$ 1,259
Number of securities in an unrealized loss position:		4		17	21

	December 31, 2015				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	$—	$—	$ 75	$ 4,925	$ 75
States and political subdivisions	14	3,355	32	2,623	46
Auction rate money market preferred	—	—	334	2,866	334
Preferred stocks	—	—	501	3,299	501
Mortgage-backed securities	882	131,885	999	37,179	1,881
Collateralized mortgage obligations	415	53,441	776	26,717	1,191
Total	$1,311	$188,681	$ 2,717	$ 77,609	$ 4,028
Number of securities in an unrealized loss position:		36		26	62

As of March 31, 2016 and December 31, 2015, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

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

Based on our analyses, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell any AFS securities in an unrealized loss position before recovery of their cost basis, we do not believe that the values of any AFS securities were other-than-temporarily impaired as of March 31, 2016 or December 31, 2015.

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Note 5 – Loans and ALLL

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

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

The accrual of interest on commercial, agricultural, and residential real estate loans is 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. 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. 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 status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance.

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 dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to $15,000. Borrowers with direct credit needs of more than $15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. 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.

We offer adjustable rate mortgages, construction loans, and fixed rate residential real estate loans which have amortization periods up to a maximum of 30 years. We consider the anticipated direction of interest rates, balance sheet duration, the sensitivity of our balance sheet to changes in interest rates, and overall loan demand to determine whether or not to sell fixed rate loans to Freddie Mac.

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 97% 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%.

Underwriting criteria for residential real estate loans include:

- Evaluation of the borrower’s ability to make monthly payments.
- Evaluation of 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.
- Ensuring all debt servicing does not exceed 36% of income.
- Verification of acceptable credit reports.
- Verification of employment, income, and financial information.

Appraisals are performed by independent appraisers and reviewed for appropriateness. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market underwriting system; loans in excess of $500 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors’

Loan Committee, or the Board of Directors.

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Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 12 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.
The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectability of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.
The appropriateness of the ALLL is evaluated on a quarterly 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 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. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding five years. 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 March 31, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2016	$2,171	$ 329	$ 3,330	$ 522	$ 1,048	$7,400
Charge-offs	(16)	—	(241)	(84)	—	(341)
Recoveries	89	92	50	54	—	285
Provision for loan losses	177	(85)	(9)	48	25	156
March 31, 2016	$2,421	$ 336	$ 3,130	$ 540	$ 1,073	$7,500

	Allowance for Loan Losses and Recorded Investment in Loans March 31, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$908	$ —	$ 1,823	$ —	$ —	$2,731
Collectively evaluated for impairment	1,513	336	1,307	540	1,073	4,769
Total	$2,421	$ 336	$ 3,130	$ 540	$ 1,073	$7,500
Loans						
Individually evaluated for impairment	$6,840	$ 4,065	$ 10,088	$ 34		$21,027
Collectively evaluated for impairment	463,465	111,621	239,230	34,948		849,264
Total	$470,305	$ 115,686	$ 249,318	$ 34,982		$870,291

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Allowance for Loan Losses
Three Months Ended March 31, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2015	$3,821	$ 216	$ 4,235	$ 645	$ 1,183	$10,100
Charge-offs	(17)	—	(50)	(93)	—	(160)
Recoveries	213	72	33	68	—	386
Provision for loan losses	(209)	(82)	(490)	91	(36)	(726)
March 31, 2015	$3,808	$ 206	$ 3,728	$ 711	$ 1,147	$9,600

Allowance for Loan Losses and Recorded Investment in Loans
December 31, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$829	$ 2	$ 1,989	$ —	$ —	$2,820
Collectively evaluated for impairment	1,342	327	1,341	522	1,048	4,580
Total	$2,171	$ 329	$ 3,330	$ 522	$ 1,048	$7,400
Loans						
Individually evaluated for impairment	$7,969	$ 4,068	$ 10,266	$ 35		$22,338
Collectively evaluated for impairment	440,412	111,843	241,235	34,664		828,154
Total	$448,381	$ 115,911	$ 251,501	$ 34,699		$850,492

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

	March 31, 2016					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
1 - Excellent	$—	$729	$729	$—	$—	$—
2 - High quality	10,638	9,950	20,588	4,469	1,608	6,077
3 - High satisfactory	99,591	25,599	125,190	27,867	11,771	39,638
4 - Low satisfactory	238,565	72,438	311,003	37,292	21,809	59,101
5 - Special mention	4,069	483	4,552	3,742	4,266	8,008
6 - Substandard	7,834	241	8,075	2,113	603	2,716
7 - Vulnerable	168	—	168	146	—	146
8 - Doubtful	—	—	—	—	—	—
Total	$360,865	$109,440	$470,305	$75,629	$40,057	$115,686

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	December 31, 2015					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
1 - Excellent	$—	$499	$499	$—	$—	$—
2 - High quality	7,397	11,263	18,660	4,647	2,150	6,797
3 - High satisfactory	99,136	29,286	128,422	28,886	13,039	41,925
4 - Low satisfactory	222,431	62,987	285,418	37,279	22,166	59,445
5 - Special mention	4,501	473	4,974	3,961	1,875	5,836
6 - Substandard	9,941	256	10,197	1,623	139	1,762
7 - Vulnerable	211	—	211	146	—	146
8 - Doubtful	—	—	—	—	—	—
Total	$343,617	$104,764	$448,381	$76,542	$39,369	$115,911

Internally assigned credit 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 credit 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 a positive trend in earnings supplemented by:

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

3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

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

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

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

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

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

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

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

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

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

	March 31, 2016						
	Accruing Interest and Past Due:				Total Past Due		
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual	and Nonaccrual	Current	Total
Commercial							
Commercial real estate	$859	$—	$ 55	$ 168	$ 1,082	$359,783	$360,865
Commercial other	231	—	—	—	231	109,209	109,440
Total commercial	1,090	—	55	168	1,313	468,992	470,305
Agricultural							
Agricultural real estate	629	—	—	146	775	74,854	75,629
Agricultural other	79	—	—	—	79	39,978	40,057
Total agricultural	708	—	—	146	854	114,832	115,686
Residential real estate							
Senior liens	1,665	134	—	702	2,501	199,836	202,337
Junior liens	43	—	—	—	43	8,941	8,984
Home equity lines of credit	303	—	—	—	303	37,694	37,997
Total residential real estate	2,011	134	—	702	2,847	246,471	249,318
Consumer							
Secured	24	—	—	—	24	31,500	31,524
Unsecured	4	—	—	—	4	3,454	3,458
Total consumer	28	—	—	—	28	34,954	34,982
Total	$3,837	$134	$ 55	$ 1,016	$ 5,042	$865,249	$870,291

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	December 31, 2015 Accruing Interest and Past Due: 30-59 Days	60-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual	Current	Total
Commercial							
Commercial real estate	$505	$281	$ —	$ 211	$ 997	$342,620	$343,617
Commercial other	18	—	—	—	18	104,746	104,764
Total commercial	523	281	—	211	1,015	447,366	448,381
Agricultural							
Agricultural real estate	196	890	—	146	1,232	75,310	76,542
Agricultural other	—	—	—	—	—	39,369	39,369
Total agricultural	196	890	—	146	1,232	114,679	115,911
Residential real estate							
Senior liens	1,551	261	—	429	2,241	199,622	201,863
Junior liens	40	8	—	6	54	9,325	9,379
Home equity lines of credit	225	—	—	—	225	40,034	40,259
Total residential real estate	1,816	269	—	435	2,520	248,981	251,501
Consumer							
Secured	27	—	—	—	27	30,839	30,866
Unsecured	4	—	—	—	4	3,829	3,833
Total consumer	31	—	—	—	31	34,668	34,699
Total	$2,566	$1,440	$ —	$ 792	$ 4,798	$845,694	$850,492

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 unpaid principal 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 classified as nonaccrual, interest income is recognized daily, as earned, according to the terms of the loan agreement and the principal amount outstanding. The following is a summary of information pertaining to impaired loans as of:

	March 31, 2016			December 31, 2015		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	$5,856	$ 5,976	$ 906	$5,659	$ 5,777	$ 818
Commercial other	96	96	2	8	8	11
Agricultural real estate	—	—	—	—	—	