

ISABELLA BANK CORP  
Form 10-Q  
November 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 September 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, 7,716,759 as of November 1, 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’s
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)

	September 30 2013	December 31 2012
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$20,255	\$22,634
Interest bearing balances due from banks	1,349	2,286
Total cash and cash equivalents	21,604	24,920
Certificates of deposit held in other financial institutions	2,045	4,465
Trading securities	745	1,573
AFS securities (amortized cost of \$500,931 in 2013 and \$490,420 in 2012)	501,057	504,010
Mortgage loans AFS	712	3,633
<b>Loans</b>		
Commercial	388,973	371,505
Agricultural	92,927	83,606
Residential real estate	291,825	284,148
Consumer	34,124	33,494
Total loans	807,849	772,753
Less allowance for loan and lease losses	11,600	11,936
Net loans	796,249	760,817
Premises and equipment	26,018	25,787
Corporate owned life insurance policies	24,213	22,773
Accrued interest receivable	6,584	5,227
Equity securities without readily determinable fair values	18,353	18,118
Goodwill and other intangible assets	46,361	46,532
Other assets	15,400	12,784
<b>TOTAL ASSETS</b>	<b>\$1,459,341</b>	<b>\$1,430,639</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$143,013	\$143,735
NOW accounts	186,630	181,259
Certificates of deposit under \$100 and other savings	462,249	455,546
Certificates of deposit over \$100	232,039	237,127
Total deposits	1,023,931	1,017,667
Borrowed funds	266,001	241,001
Accrued interest payable and other liabilities	8,104	7,482
Total liabilities	1,298,036	1,266,150
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,709,781 shares (including 9,583 shares held in the Rabbi Trust) in 2013 and 7,671,846 shares (including 5,130 shares held in the Rabbi Trust) in 2012	137,356	136,580
Shares to be issued for deferred compensation obligations	4,035	3,734
Retained earnings	23,916	19,168
Accumulated other comprehensive income (loss)	(4,002	) 5,007
Total shareholders' equity	161,305	164,489

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,459,341	\$1,430,639
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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		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Interest income				
Loans, including fees	\$10,330	\$10,918	\$30,940	\$32,707
AFS securities				
Taxable	1,787	1,878	5,419	5,755
Nontaxable	1,275	1,232	3,753	3,652
Trading securities	7	15	30	79
Federal funds sold and other	106	121	331	363
Total interest income	13,505	14,164	40,473	42,556
Interest expense				
Deposits	1,742	2,203	5,438	7,083
Borrowings	994	1,036	2,900	3,289
Total interest expense	2,736	3,239	8,338	10,372
Net interest income	10,769	10,925	32,135	32,184
Provision for loan losses	351	200	866	1,100
Net interest income after provision for loan losses	10,418	10,725	31,269	31,084
Noninterest income				
Service charges and fees	2,001	1,543	5,292	4,800
Gain (loss) on sale of mortgage loans	215	422	822	1,080
Earnings on corporate owned life insurance policies	185	171	544	519
Gain (loss) on sale of AFS securities	72	116	171	1,119
Other	389	507	1,216	1,326
Total noninterest income	2,862	2,759	8,045	8,844
Noninterest expenses				
Compensation and benefits	5,340	5,130	16,021	15,663
Furniture and equipment	1,303	1,113	3,684	3,373
Occupancy	676	649	1,982	1,889
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	2,001	2,236	6,148	6,682
Total noninterest expenses	9,320	9,128	27,835	27,889
Income before federal income tax expense	3,960	4,356	11,479	12,039
Federal income tax expense	674	899	1,893	2,344
NET INCOME	\$3,286	\$3,457	\$9,586	\$9,695
Earnings per share				
Basic	\$0.43	\$0.45	\$1.25	\$1.28
Diluted	\$0.42	\$0.44	\$1.22	\$1.24
Cash dividends per basic share	\$0.21	\$0.20	\$0.63	\$0.60

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		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Net income	\$3,286	\$3,457	\$9,586	\$9,695
Unrealized gains (losses) on AFS securities:				
Unrealized gains (losses) arising during the period	665	2,990	(13,293	) 5,209
Reclassification adjustment for net realized (gains) losses included in net income	(72	) (116	) (171	) (1,119
Reclassification adjustment for impairment loss included in net income	—	—	—	282
Net unrealized gains (losses)	593	2,874	(13,464	) 4,372
Tax effect (1)	(447	) (763	) 4,455	(790
Other comprehensive income (loss)	146	2,111	(9,009	) 3,582
Comprehensive income (loss)	\$3,432	\$5,568	\$577	\$13,277

(1) See "Note 13 – Accumulated Other Comprehensive Income (Loss)" for tax effect reconciliation.

See notes to interim condensed consolidated financial statements.

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(Dollars in thousands except per share amounts)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2012	7,589,226	\$ 134,734	\$ 4,524	\$ 13,036	\$ 2,489	\$ 154,783
Comprehensive income (loss)	—	—	—	9,695	3,582	13,277
Issuance of common stock	85,227	2,025	—	—	—	2,025
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	95	(95 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	496	—	—	496
Common stock purchased for deferred compensation obligations	—	(361 )	—	—	—	(361 )
Common stock repurchased pursuant to publicly announced repurchase plan	(63,103 )	(1,520 )	—	—	—	(1,520 )
Cash dividends (\$0.60 per share)	—	—	—	(4,553 )	—	(4,553 )
Balance, September 30, 2012	7,611,350	\$ 134,973	\$ 4,925	\$ 18,178	\$ 6,071	\$ 164,147
Balance, January 1, 2013	7,671,846	\$ 136,580	\$ 3,734	\$ 19,168	\$ 5,007	\$ 164,489
Comprehensive income (loss)	—	—	—	9,586	(9,009 )	577
Issuance of common stock	111,904	2,754	—	—	—	2,754
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	122	(122 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	423	—	—	423
Common stock purchased for deferred compensation obligations	—	(285 )	—	—	—	(285 )
Common stock repurchased pursuant to publicly announced repurchase plan	(73,969 )	(1,815 )	—	—	—	(1,815 )
Cash dividends (\$0.63 per share)	—	—	—	(4,838 )	—	(4,838 )
Balance, September 30, 2013	7,709,781	\$ 137,356	\$ 4,035	\$ 23,916	\$ (4,002 )	\$ 161,305

See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Nine Months Ended September 30	
	2013	2012
<b>OPERATING ACTIVITIES</b>		
Net income	\$9,586	\$9,695
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	866	1,100
Impairment of foreclosed assets	131	17
Depreciation	1,903	1,802
Amortization of OMSRs	453	526
Amortization of acquisition intangibles	171	200
Net amortization of AFS securities	1,595	1,683
AFS security impairment loss	—	282
(Gain) loss on sale of AFS securities	(171	) (1,119
Net unrealized (gains) losses on trading securities	23	41
Net gain on sale of mortgage loans	(822	) (1,080
Net unrealized (gains) losses on borrowings measured at fair value	—	(33
Increase in cash value of corporate owned life insurance policies	(544	) (519
Share-based payment awards under equity compensation plan	423	496
Origination of loans held-for-sale	(45,992	) (69,503
Proceeds from loan sales	49,735	70,968
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	805	2,881
Accrued interest receivable	(1,357	) (717
Other assets	319	(1,938
Accrued interest payable and other liabilities	622	78
Net cash provided by (used in) operating activities	17,746	14,860
<b>INVESTING ACTIVITIES</b>		
Net change in certificates of deposit held in other financial institutions	2,420	3,249
Activity in AFS securities		
Sales	16,229	40,677
Maturities and calls	70,164	58,598
Purchases	(98,328	) (138,043
Loan principal originations, net	(37,385	) (19,461
Proceeds from sales of foreclosed assets	1,788	1,446
Purchases of premises and equipment	(2,134	) (2,647
Purchases of corporate owned life insurance policies	(1,092	) —
Proceeds from redemption of corporate owned life insurance policies	196	—
Net cash provided by (used in) investing activities	(48,142	) (56,181

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2013	2012
<b>FINANCING ACTIVITIES</b>		
Acceptances and withdrawals of deposits, net	6,264	31,327
Increase (decrease) in borrowed funds	25,000	10,477
Cash dividends paid on common stock	(4,838	) (4,553
Proceeds from issuance of common stock	2,754	2,025
Common stock repurchased	(1,815	) (1,520
Common stock purchased for deferred compensation obligations	(285	) (361
Net cash provided by (used in) financing activities	27,080	37,395
Increase (decrease) in cash and cash equivalents	(3,316	) (3,926
Cash and cash equivalents at beginning of period	24,920	28,590
Cash and cash equivalents at end of period	\$21,604	\$24,664
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$8,376	\$10,526
Federal income taxes paid	1,333	1,467
<b>SUPPLEMENTAL NONCASH INVESTING AND FINANCING INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$1,087	\$1,588

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 nine month periods ended September 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		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Average number of common shares outstanding for basic calculation	7,698,066	7,600,443	7,689,350	7,595,806
Average potential effect of shares in the Directors Plan (1)	170,420	206,233	168,020	203,250
Average number of common shares outstanding used to calculate diluted earnings per common share	7,868,486	7,806,676	7,857,370	7,799,056
Net income	\$3,286	\$3,457	\$9,586	\$9,695
Earnings per share				
Basic	\$0.43	\$0.45	\$1.25	\$1.28
Diluted	\$0.42	\$0.44	\$1.22	\$1.24

(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:

	September 30 2013	December 31 2012
States and political subdivisions	\$745	\$1,573

Included in other noninterest income were net trading losses of \$23 during the first nine months of 2013 were \$4 of net unrealized trading losses on securities that were held in our trading portfolio as of September 30, 2013. Included in net trading losses of \$41 during the first nine months of 2012 were \$13 of net unrealized trading losses on securities that were held in our trading portfolio as of September 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:

	September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,985	\$7	\$837	\$24,155
States and political subdivisions	189,998	6,233	2,445	193,786
Auction rate money market preferred	3,200	—	561	2,639
Preferred stocks	6,800	2	658	6,144
Mortgage-backed securities	147,875	1,239	2,721	146,393
Collateralized mortgage obligations	128,073	1,331	1,464	127,940
Total	\$500,931	\$8,812	\$8,686	\$501,057
	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair 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 September 30, 2013 are as follows:

	Maturing	After One	After Five	After	Securities with	Total
	Due in	Year But	Years But	Ten Years	Variable	
	One Year	Within	Within		Monthly	
	or Less	Five Years	Ten Years		Payments or	
					Noncontractual	
					Maturities	
Government sponsored enterprises	\$—	\$72	\$24,913	\$—	\$—	\$24,985
States and political subdivisions	5,068	35,993	93,353	55,584	—	189,998
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	6,800	6,800
Mortgage-backed securities	—	—	—	—	147,875	147,875
Collateralized mortgage obligations	—	—	—	—	128,073	128,073
Total amortized cost	\$5,068	\$36,065	\$118,266	\$55,584	\$285,948	\$500,931
Fair value	\$5,237	\$37,363	\$120,324	\$55,017	\$283,116	\$501,057

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 nine month periods ended:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Proceeds from sales of AFS securities	\$6,372	\$16,436	\$16,229	\$40,677
Gross realized gains (losses)	\$72	\$116	\$171	\$1,119
Applicable income tax expense (benefit)	\$24	\$39	\$58	\$380

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

Information pertaining to AFS securities with gross unrealized losses at September 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:

	September 30, 2013				
	Less Than Twelve Months		Twelve Months or More		Total
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Unrealized Losses
Government sponsored enterprises	\$837	\$23,157	\$—	\$—	\$837
States and political subdivisions	1,952	39,713	493	2,069	2,445
Auction rate money market preferred	—	—	561	2,639	561
Preferred stocks	—	—	658	3,141	658
Mortgage-backed securities	2,721	77,269	—	—	2,721
Collateralized mortgage obligations	1,464	56,189	—	—	1,464
Total	\$6,974	\$196,328	\$1,712	\$7,849	\$8,686
Number of securities in an unrealized loss position:		154		6	160





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	December 31, 2012				Total Unrealized Losses
	Gross Unrealized Losses	Fair 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 September 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 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 Cash Flow Method
Fitch	Not Rated
Moody's	Caa3
S&P	A
Seniority	Senior
Discount rate	LIBOR + 6.35%
Credit discount rate	Credit Yield 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 nine months ended September 30, 2013, we obtained another investment valuation (from the same firm engaged to perform the initial valuation as of March 31, 2012) as of September 30, 2013. Based on our analysis, no additional OTTI was indicated as of September 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		Nine Months Ended	
	September 30		September 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 AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell AFS securities in an unrealized loss position before recovery of their cost basis, we do not believe that the values of any other AFS securities are other-than-temporarily impaired as of September 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. 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 September 30, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2013	\$6,472	\$335	\$3,676	\$647	\$570	\$11,700
Loans charged-off	(394 )	(12 )	(94 )	(102 )	—	(602 )
Recoveries	66	—	38	47	—	151
Provision for loan losses	69	108	127	74	(27 )	351
September 30, 2013	\$6,213	\$431	\$3,747	\$666	\$543	\$11,600
	Allowance for Loan Losses Nine Months Ended September 30, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2013	\$6,862	\$407	\$3,627	\$666	\$374	\$11,936
Loans charged-off	(839 )	(12 )	(681 )	(311 )	—	(1,843 )
Recoveries	289	—	152	200	—	641
Provision for loan losses	(99 )	36	649	111	169	866
September 30, 2013	\$6,213	\$431	\$3,747	\$666	\$543	\$11,600

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Allowance for Loan Losses and Recorded Investment in Loans September 30, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$2,080	\$31	\$1,890	\$—	\$—	\$4,001
Collectively evaluated for impairment	4,133	400	1,857	666	543	7,599
Total	\$6,213	\$431	\$3,747	\$666	\$543	\$11,600
Loans						
Individually evaluated for impairment	\$12,155	\$787	\$11,514	\$65		\$24,521
Collectively evaluated for impairment	376,818	92,140	280,311	34,059		783,328
Total	\$388,973	\$92,927	\$291,825	\$34,124		\$807,849
Allowance for Loan Losses Three Months Ended September 30, 2012						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2012	\$6,008	\$433	\$3,669	\$667	\$1,541	\$12,318
Loans charged-off	(271 )	—	(213 )	(127 )	—	(611 )
Recoveries	40	—	34	81	—	155
Provision for loan losses	1,132	6	(356 )	91	(673 )	200
September 30, 2012	\$6,909	\$439	\$3,134	\$712	\$868	\$12,062
Allowance for Loan Losses Nine Months Ended September 30, 2012						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2012	\$6,284	\$1,003	\$2,980	\$633	\$1,475	\$12,375
Loans charged-off	(957 )	—	(566 )	(364 )	—	(1,887 )
Recoveries	168	—	95	211	—	474
Provision for loan losses	1,414	(564 )	625	232	(607 )	1,100
September 30, 2012	\$6,909	\$439	\$3,134	\$712	\$868	\$12,062
Allowance for Loan Losses and Recorded Investment in Loans December 31, 2012						
	Commercial	Agricultural	Residential 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

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	September 30, 2013					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
2 - High quality	\$21,334	\$15,823	\$37,157	\$3,665	\$3,005	\$6,670
3 - High satisfactory	89,630	40,464	130,094	26,679	16,958	43,637
4 - Low satisfactory	141,646	45,022	186,668	25,564	11,672	37,236
5 - Special mention	13,246	1,256	14,502	1,917	1,027	2,944
6 - Substandard	17,532	1,497	19,029	805	1,387	2,192
7 - Vulnerable	1,085	186	1,271	—	248	248
8 - Doubtful	234	18	252	—	—	—
Total	\$284,707	\$104,266	\$388,973	\$58,630	\$34,297	\$92,927
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 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:

	September 30, 2013				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$343	\$889	\$167	\$1,266	\$2,665	\$282,042	\$284,707
Commercial other	867	32	—	239	1,138	103,128	104,266
Total commercial	1,210	921	167	1,505	3,803	385,170	388,973
Agricultural							
Agricultural real estate	642	—	—	—	642	57,988	58,630
Agricultural other	214	450	—	262	926	33,371	34,297
Total agricultural	856	450	—	262	1,568	91,359	92,927
Residential real estate							
Senior liens	2,549	898	290	1,957	5,694	232,710	238,404
Junior liens	166	—	—	68	234	13,649	13,883
Home equity lines of credit	347	64	—	—	411	39,127	39,538
Total residential real estate	3,062	962	290	2,025	6,339	285,486	291,825
Consumer							
Secured	115	1	—	—	116	29,190	29,306
Unsecured	6	10	—	20	36	4,782	4,818
Total consumer	121	11	—	20	152	33,972	34,124
Total	\$5,249	\$2,344	\$457	\$3,812	\$11,862	\$795,987	\$807,849

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	December 31, 2012				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days 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:

	September 30, 2013			December 31, 2012		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$6,023	\$6,161	\$1,818	\$7,295	\$7,536	\$1,653
Commercial other	658	658	262	2,140	2,140	397
Agricultural real estate	90	90	31	91	91	32
Agricultural other	—	—	—	420	420	59
Residential real estate senior liens	11,254	12,525	1,873	10,450	11,672	1,783
Residential real estate junior liens	88	135	17	72	118	13
Total impaired loans with a valuation allowance	\$18,113	\$19,569	\$4,001	\$20,468	\$21,977	\$3,937
Impaired loans without a valuation allowance						
Commercial real estate	\$4,656	\$5,494		\$3,749	\$4,408	
Commercial other	818	928		1,272	1,433	
Agricultural real estate	329	329		—	—	
Agricultural other	368	488		212	332	
Home equity lines of credit	172	472		182	482	
Consumer secured	65	72		75	84	
Total impaired loans without a valuation allowance	\$6,408	\$7,783		\$5,490	\$6,739	
Impaired loans						
Commercial	\$12,155	\$13,241	\$2,080	\$14,456	\$15,517	\$2,050
Agricultural	787	907	31	723	843	91
Residential real estate	11,514	13,132	1,890	10,704	12,272	1,796
Consumer	65	72	—	75	84	—
Total impaired loans	\$24,521	\$27,352	\$4,001	\$25,958	\$28,716	\$3,937

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	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$6,471	\$157	\$7,546	\$378
Commercial other	1,063	29	976	67
Agricultural real estate	91	2	91	4
Agricultural other	—	—	70	—
Residential real estate senior liens	10,865	230	10,595	439
Residential real estate junior liens	80	4	84	5
Total impaired loans with a valuation allowance	\$18,570	\$422	\$19,362	\$893
Impaired loans without a valuation allowance				
Commercial real estate	\$4,531	\$169	\$4,037	\$327
Commercial other	833	29	1,029	88
Agricultural real estate	231	15	144	19
Agricultural other	361	2	402	(2
Home equity lines of credit	173	8	178	17
Consumer secured	60	1	66	3
Total impaired loans without a valuation allowance	\$6,189	\$224	\$5,856	\$452
Impaired loans				
Commercial	\$12,898	\$384	\$13,588	\$860
Agricultural	683	19	707	21
Residential real estate	11,118	242	10,857	461
Consumer	60	1	66	3
Total impaired loans	\$24,759	\$646	\$25,218	\$1,345



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	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$6,260	\$106	\$6,197	\$287
Commercial other	1,996	67	1,183	95
Agricultural real estate	—	—	—	—
Agricultural other	1,023	—	1,878	73
Residential real estate senior liens	7,994	88	7,803	263
Residential real estate junior liens	158	3	174	7
Total impaired loans with a valuation allowance	\$17,431	\$264	\$17,235	\$725
Impaired loans without a valuation allowance				
Commercial real estate	\$5,651	\$72	\$6,749	\$251
Commercial other	2,026	15	1,860	80
Agricultural real estate	179	—	214	—
Agricultural other	1,417	34	869	41
Home equity lines of credit	188	6	194	14
Consumer secured	81	2	90	5
Total impaired loans without a valuation allowance	\$9,542	\$129	\$9,976	\$391
Impaired loans				
Commercial	\$15,933	\$260	\$15,989	\$713
Agricultural	2,619	34	2,961	114
Residential real estate	8,340	97	8,171	284
Consumer	81	2	90	5
Total impaired loans	\$26,973	\$393	\$27,211	\$1,116

As of September 30, 2013 and December 31, 2012, we had committed to advance \$88 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 September 30, 2013			Nine Months Ended September 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	3	\$ 159	\$ 159	10	\$ 3,313	\$ 3,116		
Agricultural other	1	198	198	2	332	332		
Residential real estate senior liens	15	1,176	1,176	30	2,611	2,595		
Residential real estate junior liens	1	20	20	1	20	20		
Consumer unsecured	2	34	34	2	34	34		
Total	22	\$ 1,587	\$ 1,587	45	\$ 6,310	\$ 6,097		
	Three Months Ended September 30, 2012			Nine Months Ended September 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	1	\$ 178	\$ 178	27	\$ 5,069	\$ 5,069		
Agricultural other	—	—	—	6	561	561		
Residential real estate senior liens	—	—	—	12	1,405	1,405		
Residential real estate junior liens	1	22	22	1	22	22		
Total	2	\$ 200	\$ 200	46	\$ 7,057	\$ 7,057		
	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013			
	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	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	\$ 159	—	\$ —	6	\$ 1,517	4	\$ 1,796
Agricultural other	1	198	—	—	2	332	—	—
Residential real estate senior liens	10	924	5	252	17	1,548	13	1,063
Residential real estate junior liens	—	—	1	20	—	—	1	20
Consumer unsecured	1	16	1	18	1	16	1	18
Total	15	\$ 1,297	7	\$ 290	26	\$ 3,413	19	\$ 2,897
	Three Months Ended September 30, 2012				Nine Months Ended September 30, 2012			
	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate and Extension of Amortization Period	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	1	\$ 178	—	\$ —	25	\$ 4,924	2	\$ 145
Agricultural other	—	—	—	—	6	561	—	—

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Residential real estate senior liens	—	—	—	—	4	324	8	1,081
Residential real estate junior liens	—	—	1	22	—	—	1	22
Total	1	\$ 178	1	\$ 22	35	\$ 5,809	11	\$ 1,248

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

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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 nine month periods ended September 30, 2013, which were modified within 12 months prior to the default date.

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

	Three Months Ended September 30, 2012				Nine Months Ended September 30, 2012			
	Number of Loans	Pre-Default Recorded Investment	Charge-Off Upon Default	Post-Default Recorded Investment	Number of Loans	Pre-Default Recorded Investment	Charge-Off Upon Default	Post-Default Recorded Investment
Commercial other	2	\$ 50	\$ 25	\$ 25	3	\$ 132	\$ 66	\$ 66
Residential real estate senior liens	—	—	—	—	1	47	43	4
Consumer secured	1	8	8	—	1	8	8	—
Total	3	\$ 58	\$ 33	\$ 25	5	\$ 187	\$ 117	\$ 70

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

	September 30 2013	December 31 2012
TDRs	\$20,337	\$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:

	September 30 2013	December 31 2012
FHLB Stock	\$8,100	\$7,850
Corporate Settlement Solutions, LLC	7,030	7,040
FRB Stock	1,879	1,879
Valley Financial Corporation	1,000	1,000
Other	344	349
Total	\$18,353	\$18,118

#### Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	September 30 2013		December 31 2012		
	Amount	Rate	Amount	Rate	
FHLB advances	\$162,000	2.02 %	\$152,000	2.05 %	
Securities sold under agreements to repurchase without stated maturity dates	81,405	0.15 %	66,147	0.15 %	
Securities sold under agreements to repurchase with stated maturity dates	16,296	3.57 %	16,284	3.57 %	
Federal funds purchased	6,300	0.50 %	6,570	0.50 %	
Total	\$266,001	1.51 %	\$241,001	1.59 %	

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 September 30, 2013, we had the ability to borrow up to an additional \$84,966, based

on assets pledged as collateral.

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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.

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

	September 30, 2013		December 31, 2012		
	Amount	Rate	Amount	Rate	
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	40,000	2.35	% 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	2.02	% \$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 \$139,082 and \$143,322 at September 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 nine month periods ended:

	Three Months Ended September 30, 2013			Three Months Ended September 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	\$81,405	\$78,148	0.15 %	\$58,471	\$57,983	0.20 %
Federal funds purchased	6,300	5,052	0.62 %	15,000	5,848	0.46 %
	Nine Months Ended September 30, 2013			Nine Months Ended September 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	\$81,405	\$69,224	0.15 %	\$58,584	\$55,721	0.20 %
Federal funds purchased	13,700	4,133	0.57 %	17,900	4,327	0.41 %

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:

	September 30 2013	December 31 2012
Pledged to secure borrowed funds	\$304,224	\$308,628
Pledged to secure repurchase agreements	139,082	143,322
Pledged for public deposits and for other purposes necessary or required by law	21,595	22,955
Total	\$464,901	\$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		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Marketing and community relations	\$271	\$610	\$945	\$1,639
FDIC insurance premiums	267	218	812	646
Directors fees	203	235	607	654
Audit and related fees	189	179	490	509
Education and travel	110	112	348	378
Loan underwriting fees	97	89	336	272
Postage and freight	103	105	296	300
Printing and supplies	106	91	291	310
Legal fees	87	50	267	193
Consulting fees	68	92	223	350
Other	500	455	1,533	1,431
Total other	\$2,001	\$2,236	\$6,148	\$6,682

## 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		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Income taxes at 34% statutory rate	\$1,347	\$1,481	\$3,903	\$4,093
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(411	) (391	) (1,212	) (1,170
Earnings on corporate owned life insurance policies	(63	) (58	) (185	) (176
Other	(217	) (147	) (667	) (439
Total effect of nontaxable income	(691	) (596	) (2,064	) (1,785
Effect of nondeductible expenses	18	14	54	36
Federal income tax expense	\$674	\$899	\$1,893	\$2,344



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A summary of OCI follows for the:

	Three Months Ended September 30 2013			2012		
	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total
Unrealized gains (losses) arising during the period	\$ (653 )	\$ 1,318	\$ 665	\$ 630	\$ 2,360	\$ 2,990
Reclassification adjustment for net realized (gains) losses included in net income	—	(72 )	(72 )	—	(116 )	(116 )
Reclassification adjustment for impairment loss included in net income	—	—	—	—	—	—
Net unrealized gains (losses)	(653 )	1,246	593	630	2,244	2,874
Tax effect	—	(447 )	(447 )	—	(763 )	(763 )
Unrealized gains (losses), net of tax	\$ (653 )	\$ 799	\$ 146	\$ 630	\$ 1,481	\$ 2,111
	Nine Months Ended September 30 2013			2012		
	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total
Unrealized gains (losses) arising during the period	\$ (358 )	\$ (12,935 )	\$ (13,293 )	\$ 2,049	\$ 3,160	\$ 5,209
Reclassification adjustment for net realized (gains) losses included in net income	—	(171 )	(171 )	—	(1,119 )	(1,119 )
Reclassification adjustment for impairment loss included in net income	—	—	—	—	282	282
Net unrealized gains (losses)	(358 )	(13,106 )	(13,464 )	2,049	2,323	4,372
Tax effect	—	4,455	4,455	—	(790 )	(790 )
Unrealized gains (losses), net of tax	\$ (358 )	\$ (8,651 )	\$ (9,009 )	\$ 2,049	\$ 1,533	\$ 3,582

## 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 nine month periods ended September 30, 2013 and 2012, respectively. We do not anticipate any further contributions to the plan in 2013.

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

	Three Months Ended		Nine Months Ended		
	September 30		September 30		
	2013	2012	2013	2012	
Interest cost on PBO	\$113	\$118	\$338	\$353	
Expected return on plan assets	(143	) (127	) (430	) (381	)
Amortization of unrecognized actuarial net loss	83	73	248	219	
Net periodic benefit cost	\$53	\$64	\$156	\$191	

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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:

		September 30, 2013	
Valuation Techniques	Fair Value	Unobservable Input	Range
Discounted cash flow	\$9,452	Duration of cash flows:	5-120 Months
		Reduction in interest rate from original loan terms:	5.00% - 6.38%
Discounted appraisal value	\$11,068	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	September 30, 2013		Range
	Fair Value	Unobservable Input Discount applied to collateral appraisal:	
Discounted appraisal value	\$1,186	Real Estate	20% - 30%
Valuation Techniques	December 31, 2012		Range
	Fair Value	Unobservable Input Discount applied to collateral appraisal:	
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:

	September 30, 2013				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$21,604	\$21,604	\$21,604	\$—	\$—
Certificates of deposit held in other financial institutions	2,045	2,048	—	2,048	—
Mortgage loans AFS	712	722	—	722	—
Total loans	807,849	808,884	—	—	808,884
Less allowance for loan and lease losses	(11,600 )	(11,600 )	—	—	(11,600 )
Net loans	796,249	797,284	—	—	797,284
Accrued interest receivable	6,584	6,584	6,584	—	—
Equity securities without readily determinable fair values (1)	18,353	18,353	—	—	—
OMSRs	2,659	2,732	—	2,732	—
<b>LIABILITIES</b>					
Deposits without stated maturities	574,860	574,860	574,860	—	—
Deposits with stated maturities	449,071	451,336	—	451,336	—
Borrowed funds	266,001	268,637	—	268,637	—
Accrued interest payable	713	713	713	—	—
	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:

	September 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	\$745	\$—	\$745	\$—	\$1,573	\$—	\$1,573	\$—
AFS Securities								
Government-sponsored enterprises	24,155	—	24,155	—	25,776	—	25,776	—
States and political subdivisions	193,786	—	193,786	—	182,743	—	182,743	—
Auction rate money market preferred	2,639	—	2,639	—	2,778	—	2,778	—
Preferred stocks	6,144	6,144	—	—	6,363	6,363	—	—
Mortgage-backed securities	146,393	—	146,393	—	155,345	—	155,345	—
Collateralized mortgage obligations	127,940	—	127,940	—	131,005	—	131,005	—
Total AFS Securities	501,057	6,144	494,913	—	504,010	6,363	497,647	—
Nonrecurring items								
Impaired loans (net of the ALLL)	20,520	—	—	20,520	22,021	—	—	22,021
Foreclosed assets	1,186	—	—	1,186	2,018	—	—	2,018
	\$523,508	\$6,144	\$495,658	\$21,706	\$529,622	\$6,363	\$499,220	\$24,039
Percent of assets and liabilities measured at fair value		1.17 %	94.68 %	4.15 %		1.20 %	94.26 %	4.54 %

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 gains or losses were recognized in the three and nine month periods ended:

	Three Months Ended September 30					
	2013			2012		
	Trading Losses	Other Gains (Losses)	Total	Trading Losses	Other Gains (Losses)	Total
Recurring items						
Trading securities	\$(5 )	\$—	\$(5 )	\$(9 )	\$—	\$(9 )
Borrowed funds	—	—	—	—	—	—
Nonrecurring items						
Foreclosed assets	—	(39 )	(39 )	—	—	—
Total	\$(5 )	\$(39 )	\$(44 )	\$(9 )	\$—	\$(9 )
	Nine Months Ended September 30					
	2013			2012		
	Trading Losses	Other Gains (Losses)	Total	Trading Losses	Other Gains (Losses)	Total
Recurring items						
Trading securities	\$(23 )	\$—	\$(23 )	\$(41 )	\$—	\$(41 )
Borrowed funds	—	—	—	—	33	33

Nonrecurring items							
Foreclosed assets	—	(131	) (131	) —	(17	) (17	)
Total	\$(23	) \$(131	) \$(154	) \$(41	) \$16	) \$(25	)

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

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

	Three Months Ended September 30			2012		
	2013			2012		
	Unrealized	Defined		Unrealized	Defined	
	Holding Gains	Benefit	Total	Holding Gains	Benefit	Total
	(Losses) on	Pension Plan		(Losses) on	Pension Plan	
	AFS			AFS		
	Securities			Securities		
July 1, 2013	\$ (477 )	\$ (3,671 )	\$ (4,148 )	\$ 7,413	\$ (3,453 )	\$ 3,960
OCI before reclassifications	665	—	665	2,990	—	2,990
Amounts reclassified from AOCI	(72 )	—	(72 )	(116 )	—	(116 )
Subtotal	593	—	593	2,874	—	2,874
Tax effect	(447 )	—	(447 )	(763 )	—	(763 )
OCI, net of tax	146	—	146	2,111	—	2,111
September 30, 2013	\$ (331 )	\$ (3,671 )	\$ (4,002 )	\$ 9,524	\$ (3,453 )	\$ 6,071
	Nine Months Ended September 30			2012		
	2013			2012		
	Unrealized	Defined		Unrealized	Defined	
	Holding Gains	Benefit	Total	Holding Gains	Benefit	Total
	(Losses) on	Pension Plan		(Losses) on	Pension Plan	
	AFS			AFS		
	Securities			Securities		
January 1, 2013	\$ 8,678	\$ (3,671 )	\$ 5,007	\$ 5,942	\$ (3,453 )	\$ 2,489
OCI before reclassifications	(13,293 )	—	(13,293 )	5,209	—	5,209
Amounts reclassified from AOCI	(171 )	—	(171 )	(837 )	—	(837 )
Subtotal	(13,464 )	—	(13,464 )	4,372	—	4,372
Tax effect	4,455	—	4,455	(790 )	—	(790 )
OCI, net of tax	(9,009 )	—	(9,009 )	3,582	—	3,582
September 30, 2013	\$ (331 )	\$ (3,671 )	\$ (4,002 )	\$ 9,524	\$ (3,453 )	\$ 6,071

Included in OCI for the three and nine month periods ended September 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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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 September 30		Nine Months Ended September 30		
	2013	2012	2013	2012	
Unrealized holding gains (losses) on AFS securities	\$72	\$116	\$171	\$1,119	Gain (loss) on sale of AFS securities
	—	—	—	(282	) Net AFS impairment loss
	72	116	171	837	Income before federal income tax expense
	24	39	58	285	Federal income tax expense
	\$48	\$77	\$113	\$552	Net income

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

	September 30 2013	December 31 2012
<b>ASSETS</b>		
Cash on deposit at the Bank	\$418	\$332
AFS Securities	3,527	3,939
Investments in subsidiaries	113,002	115,781
Premises and equipment	2,045	2,041
Other assets	52,454	52,398
<b>TOTAL ASSETS</b>	<b>\$171,446</b>	<b>\$174,491</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$10,141	\$10,002
Shareholders' equity	161,305	164,489
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$171,446</b>	<b>\$174,491</b>

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## Interim Condensed Statements of Income

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2013	2012	2013	2012
Income				
Dividends from subsidiaries	\$1,500	\$1,500	\$4,500	\$4,625
Interest income	39	42	123	131
Management fee and other	637	581	1,704	1,547
Total income	2,176	2,123	6,327	6,303
Expenses				
Compensation and benefits	680	596	2,061	1,810
Occupancy and equipment	132	91	362	273
Audit and related fees	98	98	256	273
Other	230	220	731	717
Total expenses	1,140	1,005	3,410	3,073
Income before income tax benefit and equity in undistributed earnings of subsidiaries	1,036	1,118	2,917	3,230
Federal income tax benefit	161	136	549	493
Undistributed earnings of subsidiaries	2,089	2,203	6,120	5,972
Net income	\$3,286	\$3,457	\$9,586	\$9,695

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## Interim Condensed Statements of Cash Flows

	Nine Months Ended September 30	
	2013	2012
<b>OPERATING ACTIVITIES</b>		
Net income	\$9,586	\$9,695
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(6,120	) (5,972
Undistributed earnings of equity securities without readily determinable fair values	14	—
Share-based payment awards	423	496
Depreciation	136	84
Net amortization of AFS securities	1	3
Changes in operating assets and liabilities which used cash		
Other assets	(65	) (363
Accrued interest and other liabilities	939	(224
<b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>	<b>4,914</b>	<b>3,719</b>
<b>INVESTING ACTIVITIES</b>		
Maturities, calls, and sales of AFS securities	395	370
Purchases of equipment and premises	(140	) (112
Advances to subsidiaries, net of repayments	(99	) (50
<b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>	<b>156</b>	<b>208</b>
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in borrowed funds	(800	) (297
Cash dividends paid on common stock	(4,838	) (4,553
Proceeds from the issuance of common stock	2,754	2,025
Common stock repurchased	(1,815	) (1,520
Common stock purchased for deferred compensation obligations	(285	) (361
<b>NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>	<b>(4,984</b>	<b>) (4,706</b>
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>86</b>	<b>(779</b>
Cash and cash equivalents at beginning of period	332	1,474
Cash and cash equivalents at end of period	\$418	\$695

## 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 September 30, 2013 and 2012 and each of the three and nine 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 nine month periods ended September 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

During the first nine months of 2013, we enjoyed loan growth of \$35.10 million and a continued improvement in credit quality indicators. This growth and credit quality improvement were the primary drivers behind year-to-date net income of \$9,586, which was a decline of \$109 from the same period in 2012. Despite earnings being down from last year, the first nine months of 2013 represents one of our strongest nine months ended results. As of September 30, 2013, our total assets were \$1.46 billion, and assets under management - which included loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$646.50 million - were \$2.11 billion, which was a 4.49% increase in assets under management from September 30, 2012.

While competition for high quality loans has been intense, we have not relaxed our underwriting standards and we remain committed to core community banking principles and long term sustainable growth. This continued focus has enabled us to continue to meet the needs of the communities we serve, which translates into increased shareholder value. Our loan quality remains sound as evidenced by the relatively low percentage of loans classified as nonperforming. As of September 30, 2013, our ratio of nonperforming loans to total loans was 0.53%. In comparison, the average percentage for all bank holding companies in our peer group was 1.86% as of June 30, 2013 (peer group ratios are not yet available for September 30, 2013). In addition, our risk based capital to risk adjusted total assets ratio of 15.00% as of September 30, 2013 compares favorably to the 8.00% ratio required to be classified as adequately capitalized under the Federal Reserve Board's risk based capital rules.

In August 2013, we opened our latest branch in Big Rapids, Michigan. We are excited about its growth potential and the new relationships that we have already established. The new location has complemented our existing Big Rapids office and will provide additional shareholder value for years to come.

In September 2013, Richard J. Barz announced that he will be retiring as CEO at the end of the year. In order to preserve our culture and provide strong leadership for the future we have placed a tremendous emphasis on succession planning. We have made significant investments in employee development and as a result, we have a tremendous amount of leadership and professional strength throughout our organization. The Board has elected Jae Evans, currently Isabella Bank's Chief Operations Officer, to serve as CEO, effective January 1, 2014. Evans has been with the Bank since 2008 and has more than 36 years of banking experience. Prior to his current position, he served as the president of the Greenville Division of Isabella Bank. Barz will continue to serve on the Board of Directors for both Isabella Bank and Isabella Bank Corporation.

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 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. 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 2, 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, which will be gradually phased in between 2015 and 2019, are not expected to have a material impact on the

Corporation.

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## RESULTS OF OPERATIONS

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

	Three Months Ended		Nine Months Ended		
	September 30		September 30		
	2013	2012	2013	2012	
<b>INCOME STATEMENT DATA</b>					
Interest income	\$13,505	\$14,164	\$40,473	\$42,556	
Interest expense	2,736	3,239	8,338	10,372	
Net interest income	10,769	10,925	32,135	32,184	
Provision for loan losses	351	200	866	1,100	
Noninterest income	2,862	2,759	8,045	8,844	
Noninterest expenses	9,320	9,128	27,835	27,889	
Federal income tax expense	674	899	1,893	2,344	
Net Income	\$3,286	\$3,457	\$9,586	\$9,695	
<b>PER SHARE</b>					
Basic earnings	0.43	0.45	1.25	1.28	
Diluted earnings	0.42	0.44	1.22	1.24	
Dividends	0.21	0.20	0.63	0.60	
Market value*	24.85	22.50	24.85	22.50	
Tangible book value*	15.43	14.65	15.43	14.65	
<b>BALANCE SHEET DATA</b>					
At end of period					
Loans	\$807,849	\$766,751	\$807,849	\$766,751	
Total assets	1,459,341	1,389,138	1,459,341	1,389,138	
Deposits	1,023,931	989,491	1,023,931	989,491	
Shareholders' equity	161,305	164,147	161,305	164,147	
Average balance					
Loans	\$806,128	\$761,069	\$784,593	\$751,071	
Total assets	1,451,303	1,391,955	1,441,292	1,372,433	
Deposits	1,023,019	988,136	1,024,289	979,934	
Shareholders' equity	158,859	152,537	163,028	154,428	
<b>PERFORMANCE RATIOS</b>					
Return on average total assets (annualized)	0.91	% 0.99	% 0.89	% 0.94	%
Return on average shareholders' equity (annualized)	8.27	% 9.07	% 7.84	% 8.37	%
Return on average tangible equity (annualized)	11.14	% 12.56	% 11.02	% 11.96	%
Net interest margin yield (FTE annualized)	3.48	% 3.73	% 3.50	% 3.72	%
Loan to deposit*	78.90	% 77.49	% 78.90	% 77.49	%
Nonperforming loans to total loans*	0.53	% 0.98	% 0.53	% 0.98	%
Nonperforming assets to total assets*	0.37	% 0.68	% 0.37	% 0.68	%
ALLL to nonperforming loans*	271.73	% 160.98	% 271.73	% 160.98	%
<b>CAPITAL RATIOS</b>					
Shareholders' equity to assets*	11.05	% 11.82	% 11.05	% 11.82	%
Tier 1 capital to average assets*	8.45	% 8.27	% 8.45	% 8.27	%
Tier 1 risk-based capital*	13.75	% 13.35	% 13.75	% 13.35	%
Total risk-based capital*	15.00	% 14.60	% 15.00	% 14.60	%
* At end of period					



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## 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 September 30:

	2013			2012			
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	
<b>INTEREST EARNING ASSETS</b>							
Loans	\$806,128	\$10,330	5.13	% \$761,069	\$10,918	5.74	%
Taxable investment securities	330,832	1,787	2.16	% 316,639	1,878	2.37	%
Nontaxable investment securities	166,122	2,056	4.95	% 149,390	2,006	5.37	%
Trading account securities	815	11	5.40	% 1,862	23	4.94	%
Other	23,690	106	1.79	% 26,367	121	1.84	%
Total earning assets	1,327,587	14,290	4.31	% 1,255,327	14,946	4.76	%
<b>NONEARNING ASSETS</b>							
ALLL	(11,867	)		(12,484	)		
Cash and demand deposits due from banks	18,430			19,483			
Premises and equipment	26,160			25,290			
Accrued income and other assets	90,993			104,339			
Total assets	\$1,451,303			\$1,391,955			
<b>INTEREST BEARING LIABILITIES</b>							
Interest bearing demand deposits	\$183,795	40	0.09	% \$172,931	52	0.12	%
Savings deposits	245,318	94	0.15	% 218,028	110	0.20	%
Time deposits	454,387	1,608	1.42	% 472,873	2,041	1.73	%
Borrowed funds	260,308	994	1.53	% 232,231	1,036	1.78	%
Total interest bearing liabilities	1,143,808	2,736	0.96	% 1,096,063	3,239	1.18	%
<b>NONINTEREST BEARING LIABILITIES</b>							
Demand deposits	139,519			124,304			
Other	9,117			19,051			
Shareholders' equity	158,859			152,537			
Total liabilities and shareholders' equity	\$1,451,303			\$1,391,955			
Net interest income (FTE)		\$11,554			\$11,707		
Net yield on interest earning assets (FTE)			3.48	%		3.73	%

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The following table displays the results for the nine month periods ended September 30:

	2013			2012				
	Average Balance	Tax Equivalent Interest	Average Yield / Rate		Average Balance	Tax Equivalent Interest	Average Yield / Rate	
<b>INTEREST EARNING ASSETS</b>								
Loans	\$784,593	\$30,940	5.26	%	\$751,071	\$32,707	5.81	%
Taxable investment securities	338,527	5,419	2.13	%	306,006	5,755	2.51	%
Nontaxable investment securities	161,472	6,080	5.02	%	144,170	5,956	5.51	%
Trading account securities	1,180	45	5.08	%	2,925	120	5.47	%
Other	25,866	331	1.71	%	33,619	363	1.44	%
Total earning assets	1,311,638	42,815	4.35	%	1,237,791	44,901	4.84	%
<b>NONEARNING ASSETS</b>								
ALLL	(11,947	)			(12,559	)		
Cash and demand deposits due from banks	18,083				19,455			
Premises and equipment	26,005				25,079			
Accrued income and other assets	97,513				102,667			
Total assets	\$1,441,292				\$1,372,433			
<b>INTEREST BEARING LIABILITIES</b>								
Interest bearing demand deposits	\$183,879	121	0.09	%	\$171,079	156	0.12	%
Savings deposits	242,989	275	0.15	%	212,040	341	0.21	%
Time deposits	458,767	5,042	1.47	%	476,186	6,586	1.84	%
Borrowed funds	245,344	2,900	1.58	%	223,668	3,289	1.96	%
Total interest bearing liabilities	1,130,979	8,338	0.98	%	1,082,973	10,372	1.28	%
<b>NONINTEREST BEARING LIABILITIES</b>								
Demand deposits	138,654				120,629			
Other	8,631				14,403			
Shareholders' equity	163,028				154,428			
Total liabilities and shareholders' equity	\$1,441,292				\$1,372,433			
Net interest income (FTE)		\$34,477				\$34,529		
Net yield on interest earning assets (FTE)			3.50	%			3.72	%

**Net Interest Income**

Net interest income is our primary source of income. Interest income includes loan fees of \$738 and \$2,421 for the three and nine month periods ended September 30, 2013, respectively, as compared to \$846 and \$2,302 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.

**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.

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	Three Months Ended			Nine Months Ended		
	September 30, 2013 Compared to			September 30, 2013 Compared to		
	September 30, 2012			September 30, 2012		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
<b>CHANGES IN INTEREST INCOME</b>						
Loans	\$622	\$(1,210)	\$(588)	\$1,416	\$(3,183)	\$(1,767)
Taxable AFS securities	82	(173)	(91)	574	(910)	(336)
Nontaxable AFS securities	214	(164)	50	678	(554)	124
Trading securities	(14)	2	(12)	(67)	(8)	(75)
Other	(12)	(3)	(15)	(92)	60	(32)
Total changes in interest income	892	(1,548)	(656)	2,509	(4,595)	(2,086)
<b>CHANGES IN INTEREST EXPENSE</b>						
Interest bearing demand deposits	3	(15)	(12)	11	(46)	(35)
Savings deposits	13	(29)	(16)	45	(111)	(66)
Time deposits	(77)	(356)	(433)	(233)	(1,311)	(1,544)
Borrowed funds	117	(159)	(42)	298	(687)	(389)
Total changes in interest expense	56	(559)	(503)	121	(2,155)	(2,034)
Net change in interest margin (FTE)	\$836	\$(989)	\$(153)	\$2,388	\$(2,440)	\$(52)

As shown in the following table, we experienced significant downward pressure on our net yield on interest earning assets over the past 12 months. 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:					
	September 30	June 30	March 31	December 31	September 30	
	2013	2013	2013	2012	2012	
Total earning assets	4.31	% 4.35	% 4.41	% 4.61	% 4.76	%
Total interest bearing liabilities	0.96	% 0.99	% 1.01	% 1.12	% 1.18	%
Net yield on interest earning assets (FTE)	3.48	% 3.50	% 3.54	% 3.65	% 3.73	%

While there have been increases in long term interest rates, short and medium term rates continue to be at historically low levels. We do not anticipate any significant changes in net interest margin yield 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 slight downward pressure in net interest margin yield. Despite this downward pressure, we anticipate that net interest income will increase in future periods as the increases in volume will overshadow declines in net interest margin yield. As shown in the following table net interest income increased in the third quarter of 2013, when compared to the second quarter of 2013.

	Quarter to Date Net Interest Income				
	September 30	June 30	March 31	December 31	September 30
	2013	2013	2013	2012	2012
Interest income	\$13,505	\$13,440	\$13,528	\$13,845	\$14,164
Interest expense	2,736	2,781	2,821	3,051	3,239
Net interest income	\$10,769	\$10,659	\$10,707	\$10,794	\$10,925

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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		Nine Months Ended		
	September 30		September 30		
	2013	2012	2013	2012	
ALLL at beginning of period	\$11,700	\$12,318	\$11,936	\$12,375	
Loans charged-off					
Commercial and agricultural	406	271	851	957	
Residential real estate	94	213	681	566	
Consumer	102	127	311	364	
Total loans charged-off	602	611	1,843	1,887	
Recoveries					
Commercial and agricultural	66	40	289	168	
Residential real estate	38	34	152	95	
Consumer	47	81	200	211	
Total recoveries	151	155	641	474	
Provision for loan losses	351	200	866	1,100	
ALLL at end of period	\$11,600	\$12,062	\$11,600	\$12,062	
Net loans charged-off	\$451	\$456	\$1,202	\$1,413	
Average loans outstanding	806,128	761,069	784,593	751,071	
Net loans charged-off to average loans outstanding	0.06	% 0.06	% 0.15	% 0.19	%
Total loans at end of period	\$807,849	\$766,751	\$807,849	\$766,751	
ALLL as a% of loans at end of period	1.44	% 1.57	% 1.44	% 1.57	%
	Three Months Ended				
	September 30	June 30	March 31	December 31	September 30
	2013	2013	2013	2012	2012
Total loans charged-off	\$602	\$719	\$522	\$1,469	\$611
Total recoveries	151	295	195	143	155
Net loans charged-off	451	424	327	1,326	456
Average loans outstanding	806,128	780,909	766,741	764,004	761,069
Net loans charged-off to average loans outstanding	0.06	% 0.05	% 0.04	% 0.17	% 0.06
Provision for loan losses	\$351	\$215	\$300	\$1,200	\$200

As the level of net loans charged-off has continued to decline since 2008, we have been able to gradually reduce 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 that the ALLL will approximate current levels, or decline, in future periods. For further discussion of the allocation of the ALLL, see "Note 6 – Loans and ALLL" of the interim condensed consolidated financial statements.





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## 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				
	September 30 2013	June 30 2013	March 31 2013	December 31 2012	September 30 2012
Commercial and agricultural	\$5,371	\$4,962	\$8,713	\$7,271	\$11,004
Residential real estate	6,339	5,080	4,077	5,431	4,879
Consumer	152	104	212	199	284
Total	\$11,862	\$10,146	\$13,002	\$12,901	\$16,167

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 September 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 September 30, 2013					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of		of		of	
	Loans		Loans		Loans	
July 1, 2013	123	\$19,134	15	\$1,723	138	\$20,857
New modifications	18	1,262	4	326	22	1,588
Principal payments	—	(180)	—	(22)	—	(202)
Loans paid-off	(4)	(1,273)	(1)	(103)	(5)	(1,376)
Partial charge-off	—	—	—	(197)	—	(197)
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(4)	(333)	(4)	(333)
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	(3)	(317)	3	317	—	—
September 30, 2013	134	\$18,626	17	\$1,711	151	\$20,337



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	Nine Months Ended September 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	40	5,673	5	424	45	6,097
Principal payments	—	(643)	) —	(265)	) —	(908)
Loans paid-off	(14)	) (2,492)	) (6)	) (800)	) (20)	) (3,292)
Partial charge-off	—	(15)	) —	(408)	) —	(423)
Balances charged-off	(3)	) (147)	) —	—	(3)	) (147)
Transfers to OREO	—	—	(5)	) (345)	) (5)	) (345)
Transfers to accrual status	1	105	(1)	) (105)	) —	—
Transfers to nonaccrual status	(5)	) (386)	) 5	386	—	—
September 30, 2013	134	\$18,626	17	\$1,711	151	\$20,337
	Three Months Ended September 30, 2012					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of		of		of	
	Loans		Loans		Loans	
July 1, 2012	126	\$19,634	20	\$2,909	146	\$22,543
New modifications	2	200	—	—	2	200
Principal payments	—	(445)	) —	(68)	) —	(513)
Loans paid-off	(6)	) (986)	) (1)	) (1)	) (7)	) (987)
Partial charge-off	—	(20)	) —	(40)	) —	(60)
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	(1)	) (122)	) —	—	(1)	) (122)
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	—	—	—	—	—	—
September 30, 2012	121	\$18,261	19	\$2,800	140	\$21,061
	Nine Months Ended September 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	38	5,840	9	1,217	47	7,057
Principal payments	—	(1,223)	) —	(159)	) —	(1,382)
Loans paid-off	(20)	) (2,577)	) (1)	) (1)	) (21)	) (2,578)
Partial charge-off	—	(172)	) —	(40)	) —	(212)
Balances charged-off	(1)	) (8)	) (4)	) (90)	) (5)	) (98)
Transfers to OREO	(1)	) (122)	) (4)	) (360)	) (5)	) (482)
Transfers to accrual status	1	21	(1)	) (21)	) —	—
Transfers to nonaccrual status	(8)	) (1,236)	) 8	1,236	—	—
September 30, 2012	121	\$18,261	19	\$2,800	140	\$21,061

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The following table summarizes our TDRs as of:

	September 30, 2013			December 31, 2012			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$17,168	\$1,147	\$18,315	\$16,301	\$941	\$17,242	\$1,073
Past due 30-59 days	911	—	911	158	561	719	192
Past due 60-89 days	467	182	649	72	41	113	536
Past due 90 days or more	80	382	462	—	1,281	1,281	(819 )
Total	\$18,626	\$1,711	\$20,337	\$16,531	\$2,824	\$19,355	\$982

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:

	September 30, 2013			December 31, 2012		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
<b>TDRs</b>						
Commercial real estate	\$8,910	\$9,400	\$1,473	\$9,227	\$9,640	\$1,333
Commercial other	1,338	1,368	204	1,167	1,197	38
Agricultural real estate	419	419	31	91	91	32
Agricultural other	105	225	—	569	689	59
Residential real estate senior liens	9,484	9,957	1,619	8,224	8,670	1,429
Residential real estate junior liens	20	20	4	21	57	4
Consumer secured	61	61	—	56	56	—
Total TDRs	20,337	21,450	3,331	19,355	20,400	2,895
<b>Other impaired loans</b>						
Commercial real estate	1,770	2,255	345	1,817	2,304	320
Commercial other	137	218	58	2,245	2,376	359
Agricultural other	263	263	—	63	63	—
Residential real estate senior liens	1,770	2,568	254	2,226	3,002	354
Residential real estate junior liens	68	115	13	51	61	9
Home equity lines of credit	172	472	—	182	482	—
Consumer secured	4	11	—	19	28	—
Total other impaired loans	4,184	5,902	670	6,603	8,316	1,042
Total impaired loans	\$24,521	\$27,352	\$4,001	\$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:

	September 30 2013	December 31 2012		
Nonaccrual loans	\$3,812	\$7,303		
Accruing loans past due 90 days or more	457	428		
Total nonperforming loans	4,269	7,731		
Foreclosed assets	1,186	2,018		
Total nonperforming assets	\$5,455	\$9,749		
Nonperforming loans as a % of total loans	0.53	% 1.00		%
Nonperforming assets as a % of total assets	0.37	% 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:

	September 30 2013	December 31 2012
Commercial and agricultural	\$868	\$2,325
Residential real estate	827	499
Consumer	16	—
Total	\$1,711	\$2,824

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of September 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.

	September 30, 2013		December 31, 2012	
	Outstanding Balance	Specific Allocation	Outstanding Balance	Specific Allocation
Borrower 1	\$—	\$—	\$2,077	\$359
Others not individually significant	3,812		5,226	
Total	\$3,812		\$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 September 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 September 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 fees, gains on sale of mortgage loans, earnings on corporate owned life insurance policies, gains and losses on sales of AFS securities, and other. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

	Three Months Ended September 30		Change		
	2013	2012	\$	%	
Service charges and fees					
NSF and overdraft fees	\$601	\$628	\$(27)	(4.30)	)%
ATM and debit card fees	509	473	36	7.61	%
Trust fees	301	279	22	7.89	%
Freddie Mac servicing fee	183	185	(2)	(1.08)	)%
Service charges on deposit accounts	96	80	16	20.00	%
Net OMSRs income (loss)	278	(135)	) 413	N/M	
All other	33	33	—	—	%
Total service charges and fees	2,001	1,543	458	29.68	%
Gain on sale of mortgage loans	215	422	(207)	(49.05)	)%
Earnings on corporate owned life insurance policies	185	171	14	8.19	%
Gain (loss) on sale of AFS securities	72	116	(44)	(37.93)	)%
Other					
Brokerage and advisory fees	165	143	22	15.38	%
Corporate Settlement Solutions joint venture	136	198	(62)	(31.31)	)%
Gain on sale of OREO	18	75	(57)	(76.00)	)%
Other	70	91	(21)	(23.08)	)%
Total other	389	507	(118)	(23.27)	)%
Total noninterest income	\$2,862	\$2,759	\$103	3.73	%

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	Nine Months Ended September 30			
	2013	2012	Change	
			\$	%
Service charges and fees				
NSF and overdraft fees	\$1,675	\$1,783	\$(108)	(6.06)%
ATM and debit card fees	1,453	1,407	46	3.27%
Trust fees	866	795	71	8.93%
Freddie Mac servicing fee	554	563	(9)	(1.60)%
Service charges on deposit accounts	281	238	43	18.07%
Net OMSRs income (loss)	374	(85)	459	N/M
All other	89	99	(10)	(10.10)%
Total service charges and fees	5,292	4,800	492	10.25%
Gain on sale of mortgage loans	822	1,080	(258)	(23.89)%
Earnings on corporate owned life insurance policies	544	519	25	4.82%
Gain (loss) on sale of AFS securities	171	1,119	(948)	(84.72)%
Other				
Brokerage and advisory fees	493	410	83	20.24%
Corporate Settlement Solutions joint venture	203	397	(194)	(48.87)%
Gain on sale of OREO	269	206	63	30.58%
Other	251	313	(62)	(19.81)%
Total other	1,216	1,326	(110)	(8.30)%
Total noninterest income	\$8,045	\$8,844	\$(799)	(9.03)%

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 primarily 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.

Offering rates on residential mortgage loans significantly increased in the second quarter of 2013, which triggered a noticeable decline in refinancing activity, which in turn drove the decline in the gain on sale of mortgage loans. Offsetting the decline in the gain on sale of mortgage loans was an increase in the value of our mortgage servicing portfolio leading to the increase in net OMSRs income. As mortgage rates are not expected to noticeably decline in the foreseeable future and purchase money mortgage activity will likely remain soft, we expect mortgage origination volumes to significantly decline in 2014 leading to further declines in the gain on sale of mortgage loans.

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.

Income from the joint venture in Corporate Settlement Solutions has declined in 2013 as a result of the decline in refinancing activity. Additionally, they have experienced staffing additions as they continue to move toward expansion of their national operations.

As property values and the facts and circumstances surrounding each property vary, gains or losses from the sale of OREO fluctuates from period to period. We do not anticipate any significant gains or losses on assets currently included in OREO.





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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.

## 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 September 30				
	2013	2012	Change \$	%	
Compensation and benefits					
Employee salaries	\$3,920	\$3,810	\$110	2.89	%
Employee benefits	1,420	1,320	100	7.58	%
Total compensation and benefits	5,340	5,130	210	4.09	%
Furniture and equipment					
Service contracts	603	455	148	32.53	%
Depreciation	488	451	37	8.20	%
ATM and debit card fees	191	177	14	7.91	%
All other	21	30	(9)	(30.00)	)%
Total furniture and equipment	1,303	1,113	190	17.07	%
Occupancy					
Depreciation	166	156	10	6.41	%
Outside services	168	147	21	14.29	%
Property taxes	124	129	(5)	(3.88)	)%
Utilities	127	125	2	1.60	%
All other	91	92	(1)	(1.09)	)%
Total occupancy	676	649	27	4.16	%
Net AFS security impairment loss	—	—	—	N/M	
Other					
Marketing and community relations	271	610	(339)	(55.57)	)%
FDIC insurance premiums	267	218	49	22.48	%
Directors fees	203	235	(32)	(13.62)	)%
Audit and related fees	189	179	10	5.59	%
Education and travel	110	112	(2)	(1.79)	)%
Loan underwriting fees	97	89	8	8.99	%
Postage and freight	103	105	(2)	(1.90)	)%
Printing and supplies	106	91	15	16.48	%
Legal fees	87	50	37	74.00	%
Consulting fees	68	92	(24)	(26.09)	)%
Other	500	455	45	9.89	%
Total other	2,001	2,236	(235)	(10.51)	)%
Total noninterest expenses	\$9,320	\$9,128	\$192	2.10	%

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	Nine Months Ended September 30		Change		
	2013	2012	\$	%	
Compensation and benefits					
Employee salaries	\$ 11,640	\$ 11,458	\$ 182	1.59	%
Employee benefits	4,381	4,205	176	4.19	%
Total compensation and benefits	16,021	15,663	358	2.29	%
Furniture and equipment					
Service contracts	1,673	1,469	204	13.89	%
Depreciation	1,411	1,337	74	5.53	%
ATM and debit card fees	544	507	37	7.30	%
All other	56	60	(4	) (6.67	)%
Total furniture and equipment	3,684	3,373	311	9.22	%
Occupancy					
Depreciation	492	465	27	5.81	%
Outside services	489	447	42	9.40	%
Property taxes	393	388	5	1.29	%
Utilities	382	349	33	9.46	%
All other	226	240	(14	) (5.83	)%
Total occupancy	1,982	1,889	93	4.92	%
Net AFS security impairment loss	—	282	(282	) N/M	
Other					
Marketing and community relations	945	1,639	(694	) (42.34	)%
FDIC insurance premiums	812	646	166	25.70	%
Directors fees	607	654	(47	) (7.19	)%
Audit and related fees	490	509	(19	) (3.73	)%
Education and travel	348	378	(30	) (7.94	)%
Loan underwriting fees	336	272	64	23.53	%
Postage and freight	296	300	(4	) (1.33	)%
Printing and supplies	291	310	(19	) (6.13	)%
Legal fees	267	193	74	38.34	%
Consulting fees	223	350	(127	) (36.29	)%
Other	1,533	1,431	102	7.13	%
Total other	6,148	6,682	(534	) (7.99	)%
Total noninterest expenses	\$27,835	\$27,889	\$(54	) (0.19	)%

Significant changes in noninterest expenses are detailed below:

Employee salaries have increased as a result of normal merit increases and due to our continued growth.

Service contracts have increased during 2013 due to costs related to data lines as well as increases in various other contracts as we continue to expand our on-line services offered to customers. Service contracts are anticipated to approximate current levels for the remainder of 2013.

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



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benefit our communities. Included in marketing and community relations were discretionary donations to the foundation of \$200 and \$850 for the nine month periods ended September 30, 2013 and 2012, respectively. FDIC insurance premiums increased in 2013 as a result of us receiving less of a refund for prepaid FDIC insurance premiums than we had anticipated. FDIC insurance premiums are anticipated to approximate current levels for the remainder of 2013 and decline slightly in 2014.

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 as well as legal costs incurred in relation to loan collection efforts. We expect legal fees to approximate current levels for the remainder of 2013.

During the first quarter of 2012, we incurred consulting fees to review our FHLB advances for potential restructuring options. These fees 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

	September 30 2013	December 31 2012	\$ Change	% Change (unannualized)	
<b>ASSETS</b>					
Cash and cash equivalents	\$21,604	\$24,920	\$(3,316)	(13.31)	)%
Certificates of deposit held in other financial institutions	2,045	4,465	(2,420)	(54.20)	)%
Trading securities	745	1,573	(828)	(52.64)	)%
AFS securities	501,057	504,010	(2,953)	(0.59)	)%
Mortgage loans AFS	712	3,633	(2,921)	(80.40)	)%
Loans	807,849	772,753	35,096	4.54	%
ALLL	(11,600)	(11,936)	336	N/M	
Premises and equipment	26,018	25,787	231	0.90	%
Corporate owned life insurance policies	24,213	22,773	1,440	6.32	%
Accrued interest receivable	6,584	5,227	1,357	25.96	%
Equity securities without readily determinable fair values	18,353	18,118	235	1.30	%
Goodwill and other intangible assets	46,361	46,532	(171)	(0.37)	)%
Other assets	15,400	12,784	2,616	20.46	%
<b>TOTAL ASSETS</b>	<b>\$1,459,341</b>	<b>\$1,430,639</b>	<b>\$28,702</b>	<b>2.01</b>	<b>%</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
<b>Liabilities</b>					
Deposits	\$1,023,931	\$1,017,667	\$6,264	0.62	%
Borrowed funds	266,001	241,001	25,000	10.37	%
Accrued interest payable and other liabilities	8,104	7,482	622	8.31	%
Total liabilities	1,298,036	1,266,150	31,886	2.52	%
Shareholders' equity	161,305	164,489	(3,184)	(1.94)	)%
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,459,341</b>	<b>\$1,430,639</b>	<b>\$28,702</b>	<b>2.01</b>	<b>%</b>



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As shown above, total assets have increased since December 31, 2012. In the first nine months of 2013, loans grew by \$35,096. This loan growth was primarily funded by increases in borrowed funds. While we do anticipate that generating quality loans will continue to be competitive, we expect that loans will continue to grow throughout the rest of the year.

The following table outlines the changes in loans:

	September 30 2013	December 31 2012	\$ Change	% Change (unannualized)	
Commercial	\$388,973	\$371,505	\$17,468	4.70	%
Agricultural	92,927	83,606	9,321	11.15	%
Residential real estate	291,825	284,148	7,677	2.70	%
Consumer	34,124	33,494	630	1.88	%
Total	\$807,849	\$772,753	\$35,096	4.54	%

The following table outlines the changes in deposits:

	September 30 2013	December 31 2012	\$ Change	% Change (unannualized)	
Noninterest bearing demand deposits	\$143,013	\$143,735	\$(722)	(0.50)	)%
Interest bearing demand deposits	186,630	181,259	5,371	2.96	%
Savings deposits	245,217	228,338	16,879	7.39	%
Certificates of deposit	366,349	376,790	(10,441)	(2.77)	)%
Brokered certificates of deposit	51,410	55,348	(3,938)	(7.11)	)%
Internet certificates of deposit	31,312	32,197	(885)	(2.75)	)%
Total	\$1,023,931	\$1,017,667	\$6,264	0.62	%

**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 111,904 shares or \$2,754 of common stock during the first nine months of 2013, as compared to 85,227 shares or \$2,025 of common stock during the same period in 2012. We also offer the Directors Plan in which participants purchase stock units, in lieu of cash payments.

Pursuant to this plan, we increased shareholders' equity by \$423 and \$496 during the nine month periods ended September 30, 2013 and 2012, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 73,969 shares or \$1,815 of common stock compared to 63,103 shares for \$1,520 during the first nine months of 2013 and 2012, respectively. As of September 30, 2013, we were authorized to repurchase up to an additional 11,441 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 ALLL acquisition intangibles, was 8.45% as of September 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:

	September 30 2013	December 31 2012	Required	
Equity Capital	13.75	% 13.23	% 4.00	%
Secondary Capital	1.25	% 1.25	% 4.00	%
Total Capital	15.00	% 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.

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The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At September 30, 2013, the Bank exceeded these minimum capital requirements. On July 2, 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, which will be gradually phased in between 2015 and 2019, 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:

	September 30 2013	December 31 2012
Unfunded commitments under lines of credit	\$117,592	\$115,233
Commercial and standby letters of credit	3,986	3,935
Commitments to grant loans	17,656	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 \$525,451 or 36.0% of assets as of September 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 September 30, 2013, we had available lines of credit of \$84,966.

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

	2013	2012	\$ Variance
Net cash provided by (used in) operating activities	\$ 17,746	\$ 14,860	\$ 2,886
Net cash provided by (used in) investing activities	(48,142 )	(56,181 )	8,039
Net cash provided by (used in) financing activities	27,080	37,395	(10,315 )
Increase (decrease) in cash and cash equivalents	(3,316 )	(3,926 )	610
Cash and cash equivalents January 1	24,920	28,590	(3,670 )
Cash and cash equivalents September 30	\$ 21,604	\$ 24,664	\$(3,060 )

**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 September 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:

	September 30, 2013					
Immediate basis point change assumption (short-term rates)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(2.86 )%	—	0.23 %	0.08 %	(0.38 )%	(1.06 )%
	December 31, 2012					
Immediate basis point change assumption (short-term rates)	(100)	0	100	200	300	400
Percent change in net interest 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 September 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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	September 30, 2013							
	2014	2015	2016	2017	2018	Thereafter	Total	Fair Value
Rate sensitive assets								
Other interest bearing assets	\$2,674	\$720	\$—	\$—	\$—	\$—	\$3,394	\$3,397
Average interest rates	0.63	% 1.13	% —	—	—	—	0.74	%
Trading securities	\$745	\$—	\$—	\$—	\$—	\$—	\$745	\$745
Average interest rates	2.98	% —	—	—	—	—	2.98	%
AFS securities	\$125,424	\$81,535	\$58,123	\$49,484	\$33,433	\$153,058	\$501,057	\$501,057
Average interest rates	2.06	% 2.18	% 2.26	% 2.60	% 2.54	% 2.71	% 2.39	%
Fixed interest rate loans (1)	\$116,590	\$96,391	\$91,327	\$111,943	\$87,643	\$125,683	\$629,577	\$630,612
Average interest rates	5.38	% 5.31	% 4.97	% 4.58	% 4.37	% 4.34	% 4.82	%
Variable interest rate loans (1)	\$80,238	\$30,252	\$20,423	\$21,771	\$14,599	\$10,989	\$178,272	\$178,272
Average interest rates	5.03	% 3.89	% 4.05	% 3.28	% 3.35	% 3.53	% 4.28	%
Rate sensitive liabilities								
Borrowed funds	\$102,964	\$33,037	\$20,000	\$30,000	\$40,000	\$40,000	\$266,001	\$268,637
Average interest rates	0.68	% 0.67	% 1.69	% 1.95	% 2.35	% 3.02	% 1.50	%
Savings and NOW accounts	\$38,290	\$34,526	\$31,017	\$27,895	\$25,112	\$275,007	\$431,847	\$431,847
Average interest rates	0.13	% 0.13	% 0.13	% 0.13	% 0.13	% 0.12	% 0.12	%
Fixed interest rate certificates of deposit	\$204,814	\$81,371	\$57,049	\$46,580	\$41,813	\$16,319	\$447,946	\$450,211
Average interest rates	0.93	% 1.85	% 2.05	% 1.80	% 1.35	% 1.69	% 1.40	%
Variable interest rate certificates of deposit	\$936	\$189	\$—	\$—	\$—	\$—	\$1,125	\$1,125
Average interest rates	0.42	% 0.44	% —	—	—	—	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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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 September 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 September 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 publicly 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 September 30, 2013, with respect to this plan:

	Shares Repurchased		Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
	Number	Average Price Per Share		
Balance, June 30, 2013				39,585
July 1 - 31, 2013	10,208	\$24.59	10,208	29,377
August 1 - 31, 2013	9,478	24.90	9,478	19,899
September 1 - 30, 2013	8,458	25.30	8,458	11,441
Total	28,144	\$24.91	28,144	11,441



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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: October 28, 2013

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

Date: October 28, 2013

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