

ISABELLA BANK CORP  
Form 10-Q  
May 08, 2014  
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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 March 31, 2014  
or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 0-18415

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

Michigan 38-2830092  
(State or other jurisdiction of (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 "large accelerated filer," "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

The number of shares outstanding of the registrant's Common Stock (no par value) was 7,735,097 as of May 5, 2014.

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ISABELLA BANK CORPORATION  
QUARTERLY REPORT ON FORM 10-Q

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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 Quarterly Report on Form 10-Q, or in our other filings. You may find it helpful to refer back to this page while reading this report.

AFS: Available-for-sale	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
CIK: Central Index Key	NASDAQ: NASDAQ Stock Market Index
CRA: Community Reinvestment Act	NASDAQ Banks: NASDAQ Bank Stock Index
DIF: Deposit Insurance Fund	NAV: Net asset value
DIFS: Department of Insurance and Financial Services	NOW: Negotiable order of withdrawal
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NSF: Non-sufficient funds
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	OCI: Other comprehensive income (loss)
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OMSRs: Originated mortgage servicing rights
ESOP: Employee stock ownership plan	OREO: Other real estate owned
Exchange Act: Securities Exchange Act of 1934	OTC: Over-the-Counter
FASB: Financial Accounting Standards Board	OTTI: Other-than-temporary impairment
FDI Act: Federal Deposit Insurance Act	PBO: Projected benefit obligation
FDIC: Federal Deposit Insurance Corporation	PCAOB: Public Company Accounting Oversight Board
FFIEC: Federal Financial Institutions Examinations Council	Rabbi Trust: A trust established to fund the Directors Plan
Fitch: Fitch Ratings	SEC: U.S. Securities & Exchange Commission
FRB: Federal Reserve Bank	SOX: Sarbanes-Oxley Act of 2002
FHLB: Federal Home Loan Bank	S&P: Standard & Poor’s
Freddie Mac: Federal Home Loan Mortgage Corporation	TDR: Troubled debt restructuring

FTE: Fully taxable equivalent

XBRL: eXtensible Business Reporting Language

GAAP: U.S. generally accepted accounting principles

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## PART I – FINANCIAL INFORMATION

## Item 1. Interim Condensed Consolidated Financial Statements (Unaudited)

## INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	March 31 2014	December 31 2013
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$17,745	\$21,755
Interest bearing balances due from banks	922	19,803
Total cash and cash equivalents	18,667	41,558
Certificates of deposit held in other financial institutions	580	580
Trading securities	521	525
AFS securities (amortized cost of \$555,176 in 2014 and \$517,614 in 2013)	555,144	512,062
Mortgage loans AFS	489	1,104
<b>Loans</b>		
Commercial	399,702	392,104
Agricultural	92,059	92,589
Residential real estate	284,586	289,931
Consumer	32,064	33,413
Gross loans	808,411	808,037
Less allowance for loan and lease losses	11,100	11,500
Net loans	797,311	796,537
Premises and equipment	26,009	25,719
Corporate owned life insurance policies	24,585	24,401
Accrued interest receivable	6,725	5,442
Equity securities without readily determinable fair values	18,965	18,293
Goodwill and other intangible assets	46,263	46,311
Other assets	18,112	20,605
<b>TOTAL ASSETS</b>	<b>\$1,513,371</b>	<b>\$1,493,137</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$158,241	\$158,428
NOW accounts	194,407	192,089
Certificates of deposit under \$100 and other savings	469,955	455,547
Certificates of deposit over \$100	243,332	237,702
Total deposits	1,065,935	1,043,766
Borrowed funds	272,536	279,326
Accrued interest payable and other liabilities	8,929	9,436
Total liabilities	1,347,400	1,332,528
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,727,547 shares (including 5,263 shares held in the Rabbi Trust) in 2014 and 7,723,023 shares (including 12,761 shares held in the Rabbi Trust) in 2013	137,804	137,580
Shares to be issued for deferred compensation obligations	3,892	4,148
Retained earnings	26,835	25,222
Accumulated other comprehensive income (loss)	(2,560	) (6,341 )
Total shareholders' equity	165,971	160,609
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,513,371</b>	<b>\$1,493,137</b>

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 March 31	
	2014	2013
Interest income		
Loans, including fees	\$9,751	\$10,330
AFS securities		
Taxable	1,998	1,834
Nontaxable	1,457	1,234
Trading securities	5	14
Federal funds sold and other	153	116
Total interest income	13,364	13,528
Interest expense		
Deposits	1,616	1,874
Borrowings	884	947
Total interest expense	2,500	2,821
Net interest income	10,864	10,707
Provision for loan losses	(242	) 300
Net interest income after provision for loan losses	11,106	10,407
Noninterest income		
Service charges and fees	1,394	1,281
Net gain on sale of mortgage loans	115	358
Earnings on corporate owned life insurance policies	184	169
Net gains (losses) on sale of AFS securities	—	99
Other	556	540
Total noninterest income	2,249	2,447
Noninterest expenses		
Compensation and benefits	5,486	5,445
Furniture and equipment	1,268	1,189
Occupancy	742	665
Other	1,990	1,892
Total noninterest expenses	9,486	9,191
Income before federal income tax expense	3,869	3,663
Federal income tax expense	560	576
NET INCOME	\$3,309	\$3,087
Earnings per share		
Basic	\$0.43	\$0.40
Diluted	\$0.42	\$0.39
Cash dividends per basic share	\$0.22	\$0.21

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		
	March 31		
	2014	2013	
Net income	\$3,309	\$3,087	
Unrealized gains (losses) on AFS securities			
Unrealized gains (losses) arising during the period	5,520	(1,961	)
Reclassification adjustment for net realized (gains) losses included in net income	—	(99	)
Net unrealized gains (losses)	5,520	(2,060	)
Tax effect (1)	(1,739	) 923	
Other comprehensive income (loss), net of tax	3,781	(1,137	)
Comprehensive income (loss)	\$7,090	\$1,950	

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

See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in thousands except per share amounts)

	Common Stock		Shares to be	Retained	Accumulated	Totals
	Shares	Amount	Issued for	Earnings	Other	
	Outstanding		Deferred		Comprehensive	
			Compensation		Income (Loss)	
			Obligations			
Balance, January 1, 2013	7,671,846	\$ 136,580	\$ 3,734	\$ 19,168	\$ 5,007	\$ 164,489
Comprehensive income (loss)	—	—	—	3,087	(1,137 )	1,950
Issuance of common stock	37,591	902	—	—	—	902
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	100	(100 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	146	—	—	146
Common stock purchased for deferred compensation obligations	—	(90 )	—	—	—	(90 )
Common stock repurchased pursuant to publicly announced repurchase plan	(20,509 )	(480 )	—	—	—	(480 )
Cash dividends (\$0.21 per share)	—	—	—	(1,609 )	—	(1,609 )
Balance, March 31, 2013	7,688,928	\$ 137,012	\$ 3,780	\$ 20,646	\$ 3,870	\$ 165,308
Balance, January 1, 2014	7,723,023	\$ 137,580	\$ 4,148	\$ 25,222	\$ (6,341 )	\$ 160,609
Comprehensive income (loss)	—	—	—	3,309	3,781	7,090
Issuance of common stock	35,814	850	—	—	—	850
Common stock issued for deferred compensation obligations	6,125	143	(143 )	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	250	(250 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	137	—	—	137
Common stock purchased for deferred compensation obligations	—	(126 )	—	—	—	(126 )
Common stock repurchased pursuant to publicly announced repurchase plan	(37,415 )	(893 )	—	—	—	(893 )
Cash dividends (\$0.22 per share)	—	—	—	(1,696 )	—	(1,696 )

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Balance, March 31, 2014	7,727,547	\$ 137,804	\$ 3,892	\$ 26,835	\$ (2,560 )	\$ 165,971
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See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Three Months Ended March 31		
	2014	2013	
<b>OPERATING ACTIVITIES</b>			
Net income	\$3,309	\$3,087	
Reconciliation of net income to net cash provided by operations:			
Provision for loan losses	(242	) 300	
Impairment of foreclosed assets	43	24	
Depreciation	619	625	
Amortization of OMSRs	68	204	
Amortization of acquisition intangibles	48	57	
Net amortization of AFS securities	457	578	
Net (gains) losses on sale of AFS securities	—	(99	)
Net unrealized (gains) losses on trading securities	4	10	
Net gain on sale of mortgage loans	(115	) (358	)
Increase in cash value of corporate owned life insurance policies	(184	) (169	)
Share-based payment awards under equity compensation plan	137	146	
Origination of loans held-for-sale	(5,364	) (21,587	)
Proceeds from loan sales	6,094	24,552	
Net changes in operating assets and liabilities which provided (used) cash:			
Accrued interest receivable	(1,283	) (933	)
Other assets	(272	) (385	)
Accrued interest payable and other liabilities	(507	) (255	)
Net cash provided by (used in) operating activities	2,812	5,797	
<b>INVESTING ACTIVITIES</b>			
Net change in certificates of deposit held in other financial institutions	—	960	
Activity in AFS securities			
Sales	—	9,857	
Maturities and calls	11,096	21,103	
Purchases	(49,115	) (50,420	)
Loan principal (originations) collections, net	(856	) 4,531	
Proceeds from sales of foreclosed assets	567	1,194	
Purchases of premises and equipment	(909	) (610	)
Proceeds from redemption of corporate owned life insurance policies	—	123	
Net cash provided by (used in) investing activities	(39,217	) (13,262	)

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

(Dollars in thousands)

	Three Months Ended March 31	
	2014	2013
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	22,169	12,093
Increase (decrease) in borrowed funds	(6,790	) (8,591
Cash dividends paid on common stock	(1,696	) (1,609
Proceeds from issuance of common stock	850	902
Common stock repurchased	(893	) (480
Common stock purchased for deferred compensation obligations	(126	) (90
Net cash provided by (used in) financing activities	13,514	2,225
Increase (decrease) in cash and cash equivalents	(22,891	) (5,240
Cash and cash equivalents at beginning of period	41,558	24,920
Cash and cash equivalents at end of period	\$18,667	\$19,680
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$2,547	\$2,842
Federal income taxes paid	552	200
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$324	\$373

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 month period ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013. Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

## Note 2 – Computation of Earnings Per 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	
	March 31	
	2014	2013
Average number of common shares outstanding for basic calculation	7,721,254	7,677,009
Average potential effect of shares in the Directors Plan (1)	173,279	165,260
Average number of common shares outstanding used to calculate diluted earnings per common share	7,894,533	7,842,269
Net income	\$3,309	\$3,087
Earnings per share		
Basic	\$0.43	\$0.40
Diluted	\$0.42	\$0.39

(1) Exclusive of shares held in the Rabbi Trust

## Note 3 – Pending Accounting Standards Updates

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

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

• It is probable that the tax credits allocable to the investor will be available.

• The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.

• Substantially all of the projected benefits are from tax credits and other tax benefits (e.g., operating losses).

• The investor's projected yield is based solely on the cash flows from the tax credits and other tax benefits are positive.

• The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

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Investors that do not meet the above criteria must utilize the cost method or equity method in accordance with previously issued authoritative accounting guidance. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations. ASU No. 2014-04: "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)"

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

## Note 4 – AFS Securities

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

March 31, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,775	\$5	\$897	\$23,883
States and political subdivisions	215,038	6,493	1,887	219,644
Auction rate money market preferred	3,200	—	445	2,755
Preferred stocks	6,800	—	747	6,053
Mortgage-backed securities	159,767	877	2,788	157,856
Collateralized mortgage obligations	145,596	1,241	1,884	144,953
Total	\$555,176	\$8,616	\$8,648	\$555,144

December 31, 2013

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

The amortized cost and fair value of AFS securities by contractual maturity at March 31, 2014 are as follows:

	Maturing				Securities with Variable Monthly Payments or Noncontractual Maturities	
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Total	
Government sponsored enterprises	\$—	\$72	\$24,703	\$—	\$—	\$24,775
States and political subdivisions	13,067	44,403	102,328	55,240	—	215,038
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	6,800	6,800
Mortgage-backed securities	—	—	—	—	159,767	159,767

Collateralized mortgage obligations	—	—	—	—	145,596	145,596
Total amortized cost	\$13,067	\$44,475	\$127,031	\$55,240	\$ 315,363	\$555,176
Fair value	\$13,170	\$46,153	\$128,612	\$55,592	\$ 311,617	\$555,144



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

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

A summary of the activity related to sales of AFS securities was as follows for the three month periods ended March 31:

	2014	2013
Proceeds from sales of AFS securities	\$—	\$9,857
Gross realized gains (losses)	\$—	\$99
Applicable income tax expense (benefit)	\$—	\$34

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

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

	March 31, 2014				Total Unrealized Losses
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$897	\$23,098	\$—	\$—	\$897
States and political subdivisions	1,025	35,389	862	9,302	1,887
Auction rate money market preferred	—	—	445	2,755	445
Preferred stocks	6	2,995	741	3,059	747
Mortgage-backed securities	1,664	60,711	1,124	21,435	2,788
Collateralized mortgage obligations	1,238	61,690	646	13,159	1,884
Total	\$4,830	\$183,883	\$3,818	\$49,710	\$8,648
Number of securities in an unrealized loss position:		152		39	191
	December 31, 2013				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	\$1,122	\$22,873	\$—	\$—	\$1,122
States and political subdivisions	2,566	42,593	981	6,115	3,547
Auction rate money market preferred	—	—	623	2,577	623
Preferred stocks	—	—	993	2,807	993
Mortgage-backed securities	2,424	101,816	1,410	21,662	3,834
Collateralized mortgage obligations	2,345	84,478	—	—	2,345
Total	\$8,457	\$251,760	\$4,007	\$33,161	\$12,464
Number of securities in an unrealized loss position:		182		19	201

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

- Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable the issuer will be unable to pay the amount when due?



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Is it more likely than not that we will have to sell the security before recovery of its cost basis?

Has the duration of the investment been extended?

Based on our 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 AFS securities are other-than-temporarily impaired as of March 31, 2014, or December 31, 2013.

Note 5 – Loans and ALLL

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

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income 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, 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, 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.

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

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

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

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

	Allowance for Loan Losses					
	Three Months Ended March 31, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2014	\$6,048	\$434	\$3,845	\$639	\$534	\$11,500
Loans charged-off	(192 )	(31 )	(113 )	(114 )	—	(450 )
Recoveries	214	—	36	42	—	292
Provision for loan losses	(1,256 )	22	959	63	(30 )	(242 )
March 31, 2014	\$4,814	\$425	\$4,727	\$630	\$504	\$11,100
	Allowance for Loan Losses and Recorded Investment in Loans					
	March 31, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$1,911	\$29	\$2,353	\$1	\$—	\$4,294
Collectively evaluated for impairment	2,903	396	2,374	629	504	6,806
Total	\$4,814	\$425	\$4,727	\$630	\$504	\$11,100
Loans						
Individually evaluated for impairment	\$14,034	\$1,780	\$13,329	\$61		\$29,204
Collectively evaluated for impairment	385,668	90,279	271,257	32,003		779,207
Total	\$399,702	\$92,059	\$284,586	\$32,064		\$808,411

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Allowance for Loan Losses						
Three Months Ended March 31, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2013	\$6,862	\$407	\$3,627	\$666	\$374	\$11,936
Loans charged-off	(211 )	—	(190 )	(121 )	—	(522 )
Recoveries	57	—	53	85	—	195
Provision for loan losses	189	(86 )	144	102	(49 )	300
March 31, 2013	\$6,897	\$321	\$3,634	\$732	\$325	\$11,909
Allowance for Loan Losses and Recorded Investment in Loans						
December 31, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$2,035	\$30	\$2,287	\$—	\$—	\$4,352
Collectively evaluated for impairment	4,013	404	1,558	639	534	7,148
Total	\$6,048	\$434	\$3,845	\$639	\$534	\$11,500
Loans						
Individually evaluated for impairment	\$13,816	\$1,538	\$14,302	\$119		\$29,775
Collectively evaluated for impairment	378,288	91,051	275,629	33,294		778,262
Total	\$392,104	\$92,589	\$289,931	\$33,413		\$808,037

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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	March 31, 2014					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
2 - High quality	\$16,016	\$15,907	\$31,923	\$5,093	\$3,319	\$8,412
3 - High satisfactory	94,147	38,980	133,127	24,021	13,018	37,039
4 - Low satisfactory	161,906	41,820	203,726	28,708	12,924	41,632
5 - Special mention	10,753	1,677	12,430	1,738	574	2,312
6 - Substandard	15,532	306	15,838	2,260	97	2,357
7 - Vulnerable	2,410	125	2,535	82	225	307
8 - Doubtful	107	16	123	—	—	—
Total	\$300,871	\$98,831	\$399,702	\$61,902	\$30,157	\$92,059

  

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

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

**1. EXCELLENT – Substantially Risk Free**

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

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

**2. HIGH QUALITY – Limited Risk**

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

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





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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:

	March 31, 2014				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
<b>Commercial</b>							
Commercial real estate	\$ 1,086	\$ 21	\$ 330	\$ 2,495	\$ 3,932	\$ 296,939	\$ 300,871
Commercial other	116	96	—	125	337	98,494	98,831
<b>Total commercial</b>	<b>1,202</b>	<b>117</b>	<b>330</b>	<b>2,620</b>	<b>4,269</b>	<b>395,433</b>	<b>399,702</b>
<b>Agricultural</b>							
Agricultural real estate	115	—	295	82	492	61,410	61,902
Agricultural other	—	—	—	225	225	29,932	30,157
<b>Total agricultural</b>	<b>115</b>	<b>—</b>	<b>295</b>	<b>307</b>	<b>717</b>	<b>91,342</b>	<b>92,059</b>
<b>Residential real estate</b>							
Senior liens	3,610	541	268	1,232	5,651	225,650	231,301
Junior liens	615	54	—	15	684	12,378	13,062
Home equity lines of credit	388	174	—	170	732	39,491	40,223
<b>Total residential real estate</b>	<b>4,613</b>	<b>769</b>	<b>268</b>	<b>1,417</b>	<b>7,067</b>	<b>277,519</b>	<b>284,586</b>
<b>Consumer</b>							
Secured	69	27	—	—	96	27,552	27,648
Unsecured	16	—	—	1	17	4,399	4,416
<b>Total consumer</b>	<b>85</b>	<b>27</b>	<b>—</b>	<b>1</b>	<b>113</b>	<b>31,951</b>	<b>32,064</b>
<b>Total</b>	<b>\$ 6,015</b>	<b>\$ 913</b>	<b>\$ 893</b>	<b>\$ 4,345</b>	<b>\$ 12,166</b>	<b>\$ 796,245</b>	<b>\$ 808,411</b>

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

## Impaired Loans

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

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

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

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

	March 31, 2014			December 31, 2013		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$6,775	\$7,012	\$1,864	\$6,748	\$6,888	\$1,915
Commercial other	1,074	1,074	47	521	521	120
Agricultural real estate	89	89	29	90	90	30
Residential real estate senior liens	13,117	14,239	2,336	14,061	15,315	2,278
Residential real estate junior liens	43	63	10	48	64	9
Home equity lines of credit	169	469	7	—	—	—
Consumer secured	61	68	1	—	—	—
Total impaired loans with a valuation allowance	21,328	23,014	4,294	21,468	22,878	4,352
Impaired loans without a valuation allowance						
Commercial real estate	5,929	6,655		5,622	6,499	
Commercial other	256	366		925	1,035	
Agricultural real estate	1,448	1,448		1,370	1,370	
Agricultural other	243	388		78	198	
Home equity lines of credit	—	—		193	493	
Consumer secured	—	—		119	148	
Total impaired loans without a valuation allowance	7,876	8,857		8,307	9,743	
Impaired loans						
Commercial	14,034	15,107	1,911	13,816	14,943	2,035
Agricultural	1,780	1,925	29	1,538	1,658	30
Residential real estate	13,329	14,771	2,353	14,302	15,872	2,287
Consumer	61	68	1	119	148	—
Total impaired loans	\$29,204	\$31,871	\$4,294	\$29,775	\$32,621	\$4,352

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

	March 31, 2014		March 31, 2013	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$6,762	\$94	\$8,178	\$119
Commercial other	798	18	1,100	1
Agricultural real estate	90	1	91	1
Agricultural other	—	—	210	—
Residential real estate senior liens	13,589	138	10,454	99
Residential real estate junior liens	46	—	86	—
Home equity lines of credit	85	1	—	—
Consumer secured	90	1	—	—
Total impaired loans with a valuation allowance	21,460	253	20,119	220
Impaired loans without a valuation allowance				
Commercial real estate	5,776	102	3,626	73
Commercial other	591	6	1,233	40
Agricultural real estate	1,409	16	67	2
Agricultural other	161	28	388	7
Home equity lines of credit	97	—	183	4
Consumer secured	—	—	74	1
Total impaired loans without a valuation allowance	8,034	152	5,571	127
Impaired loans				
Commercial	13,927	220	14,137	233
Agricultural	1,660	45	756	10
Residential real estate	13,817	139	10,723	103
Consumer	90	1	74	1
Total impaired loans	\$29,494	\$405	\$25,690	\$347

As of March 31, 2014 and December 31, 2013, we had committed to advance \$93 and \$134, 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:

	Three Months Ended March 31, 2014			Three Months Ended March 31, 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	4	\$ 355	\$ 355	—	\$ —	\$ —
Agricultural other	—	—	—	1	134	134
Residential real estate senior liens	9	490	490	8	799	783
Consumer unsecured	1	1	1	—	—	—
Total	14	\$ 846	\$ 846	9	\$ 933	\$ 917

The following tables summarize concessions we granted to borrowers in financial difficulty for the:

	Three Months Ended March 31, 2014				Three Months Ended March 31, 2013			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	4	\$ 355	—	\$ —	—	\$ —	—	\$ —
Agricultural other	—	—	—	—	1	134	—	—
Residential real estate senior liens	2	49	7	441	3	209	5	590
Consumer unsecured	1	1	—	—	—	—	—	—
Total	7	\$ 405	7	\$ 441	4	\$ 343	5	\$ 590

We did not restructure any loans through the forbearance of principal or accrued interest in the three month periods ended March 31, 2014 or 2013.

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 month periods ended March 31, 2014 or 2013, which were modified within 12 months prior to the default date.

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

	March 31, 2014	December 31, 2013
TDRs	\$25,633	\$25,865

#### Note 6 – 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:

	March 31 2014	December 31 2013
FHLB Stock	\$8,850	\$8,100
Corporate Settlement Solutions, LLC	6,895	6,970
FRB Stock	1,879	1,879
Valley Financial Corporation	1,000	1,000
Other	341	344

Total	\$18,965	\$18,293
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## Note 7 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	March 31 2014		December 31 2013		
	Amount	Rate	Amount	Rate	
FHLB advances	\$162,000	2.02	% \$162,000	2.02	%
Securities sold under agreements to repurchase without stated maturity dates	94,741	0.13	% 106,025	0.13	%
Securities sold under agreements to repurchase with stated maturity dates	1,195	4.27	% 11,301	3.30	%
Federal funds purchased	14,600	0.39	% —	—	
Total	\$272,536	1.29	% \$279,326	1.35	%

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.

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

	March 31 2014		December 31 2013		
	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	% 32,000	0.84	%
Fixed rate advances due 2016	10,000	2.15	% 10,000	2.15	%
Fixed rate advances due 2017	30,000	1.95	% 30,000	1.95	%
Fixed rate advances due 2018	40,000	2.35	% 40,000	2.35	%
Fixed rate advances due 2019	20,000	3.11	% 20,000	3.11	%
Fixed rate advances due 2020	10,000	1.98	% 10,000	1.98	%
Fixed rate advances due 2023	10,000	3.90	% 10,000	3.90	%
Total	\$162,000	2.02	% \$162,000	2.02	%

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 \$145,481 and \$148,930 at March 31, 2014 and December 31, 2013, 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 lists the maturity and weighted average interest rates of securities sold under agreements to repurchase with stated maturity dates as of:

	March 31 2014		December 31 2013		
	Amount	Rate	Amount	Rate	
Repurchase agreements due 2014	\$766	4.85	% \$10,876	3.30	%
Repurchase agreements due 2015	429	3.25	% 425	3.25	%
Total	\$1,195	4.27	% \$11,301	3.30	%

Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following table provides a summary

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of short-term borrowings for the three month periods ended:

	March 31 2014			March 31 2013				
	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	\$94,741	\$94,362	0.13 %	\$64,527	\$63,573	0.15 %		
Federal funds purchased	15,000	5,755	0.47 %	4,400	1,215	0.50 %		

We had pledged trading securities, AFS securities, and 1-4 family residential real estate loans in the following amounts at:

	March 31 2014	December 31 2013
Pledged to secure borrowed funds	\$304,146	\$320,173
Pledged to secure repurchase agreements	145,481	148,930
Pledged for public deposits and for other purposes necessary or required by law	20,559	20,922
Total	\$470,186	\$490,025

As of March 31, 2014, we had the ability to borrow up to an additional \$109,677, based on assets pledged as collateral. We had no investment securities that are restricted to be pledged for specific purposes.

#### Note 8 – Other Noninterest Expenses

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

	Three Months Ended March 31	
	2014	2013
Marketing and community relations	\$243	\$242
FDIC insurance premiums	202	272
Directors fees	195	199
Audit and related fees	138	139
Education and travel	121	122
Postage and freight	108	99
Printing and supplies	102	86
Loan underwriting fees	95	116
Consulting fees	91	72
All other	695	545
Total other	\$1,990	\$1,892

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## Note 9 – 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		
	March 31		
	2014	2013	
Income taxes at 34% statutory rate	\$1,315	\$1,245	
Effect of nontaxable income			
Interest income on tax exempt municipal securities	(469	) (401	)
Earnings on corporate owned life insurance policies	(63	) (57	)
Other	(236	) (228	)
Total effect of nontaxable income	(768	) (686	)
Effect of nondeductible expenses	13	17	
Federal income tax expense	\$560	\$576	

## Note 10 – 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 (the projected benefit obligation is equal to the accumulated benefit obligation), 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 \$0 and \$215 to the plan during the three month periods ended March 31, 2014 and 2013, respectively. We do not anticipate any contributions to the plan in 2014.

Following are the components of net periodic benefit cost for the:

	Three Months Ended		
	March 31		
	2014	2013	
Interest cost on benefit obligation	\$122	\$113	
Expected return on plan assets	(154	) (143	)
Amortization of unrecognized actuarial net loss	42	83	
Net periodic benefit cost	\$10	\$53	

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## Note 11 – 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, or liquidation value. 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. The following tables list the quantitative fair value information about impaired loans as of:

		March 31, 2014	
Valuation Techniques	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 50%
		Equipment	30% - 75%
		Cash crop inventory	40%
Discounted appraisal value	\$14,220	Other inventory	50%
		Accounts receivable	50%
		Stocks and brokerage accounts	30%

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75%

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Valuation Techniques	December 31, 2013		
	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 30%
		Equipment	50%
Discounted appraisal value	\$13,902	Livestock	50%
		Cash crop inventory	50%
		Other inventory	75%
		Accounts receivable	75%

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

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 2008. 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 community 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 2014 and 2013, 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.

The table below lists the quantitative fair value information related to foreclosed assets as of:

Valuation Techniques	March 31, 2014		
	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 50%
Discounted appraisal value	\$1,126		
Valuation Techniques	December 31, 2013		
	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 30%
Discounted appraisal value	\$1,412		

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

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

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value adjustments as Level 3. During 2014 and 2013, 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:

	March 31, 2014				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$18,667	\$18,667	\$18,667	\$—	\$—
Certificates of deposit held in other financial institutions	580	580	—	580	—
Mortgage loans AFS	489	493	—	493	—
Total loans	808,411	808,077	—	—	808,077
Less allowance for loan and lease losses	11,100	11,100	—	—	11,100
Net loans	797,311	796,977	—	—	796,977
Accrued interest receivable	6,725	6,725	6,725	—	—
Equity securities without readily determinable fair values (1)	18,965	18,965	—	—	—
OMSRs	2,645	2,787	—	2,787	—
<b>LIABILITIES</b>					
Deposits without stated maturities	614,092	614,092	614,092	—	—
Deposits with stated maturities	451,843	453,980	—	453,980	—
Borrowed funds	272,536	276,357	—	276,357	—
Accrued interest payable	586	586	586	—	—
	December 31, 2013				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$41,558	\$41,558	\$41,558	\$—	\$—
Certificates of deposit held in other financial institutions	580	582	—	582	—
Mortgage loans AFS	1,104	1,123	—	1,123	—
Total loans	808,037	808,246	—	—	808,246
Less allowance for loan and lease losses	11,500	11,500	—	—	11,500
Net loans	796,537	796,746	—	—	796,746
Accrued interest receivable	5,442	5,442	5,442	—	—
Equity securities without readily determinable fair values (1)	18,293	18,293	—	—	—
OMSRs	2,555	2,667	—	2,667	—
<b>LIABILITIES</b>					
Deposits without stated maturities	593,754	593,754	593,754	—	—
Deposits with stated maturities	450,012	452,803	—	452,803	—
Borrowed funds	279,326	283,060	—	283,060	—
Accrued interest payable	633	633	633	—	—

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:

	March 31, 2014				December 31, 2013				
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)	
Recurring items									
Trading securities									
States and political subdivisions	\$521	\$—	\$521	\$—	\$525	\$—	\$525	\$—	
AFS securities									
Government-sponsored enterprises	23,883	—	23,883	—	23,745	—	23,745	—	
States and political subdivisions	219,644	—	219,644	—	201,988	—	201,988	—	
Auction rate money market preferred	2,755	—	2,755	—	2,577	—	2,577	—	
Preferred stocks	6,053	6,053	—	—	5,827	5,827	—	—	
Mortgage-backed securities	157,856	—	157,856	—	144,115	—	144,115	—	
Collateralized mortgage obligations	144,953	—	144,953	—	133,810	—	133,810	—	
Total AFS securities	555,144	6,053	549,091	—	512,062	5,827	506,235	—	
Nonrecurring items									
Impaired loans (net of the ALLL)	14,220	—	—	14,220	13,902	—	—	13,902	
Foreclosed assets	1,126	—	—	1,126	1,412	—	—	1,412	
Total	\$571,011	\$6,053	\$549,612	\$15,346	\$527,901	\$5,827	\$506,760	\$15,314	
Percent of assets and liabilities measured at fair value		1.06	% 96.25	% 2.69	%	1.10	% 96.00	% 2.90	%

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 Months Ended March 31			2013		
	2014			2013		
	Trading Losses	Other Gains (Losses)	Total	Trading Losses	Other Gains (Losses)	Total
Recurring items						
Trading securities	\$(4 )	\$—	\$(4 )	\$(10 )	\$—	\$(10 )
Nonrecurring items						
Foreclosed assets	—	(43 )	(43 )	—	(24 )	(24 )
Total	\$(4 )	\$(43 )	\$(47 )	\$(10 )	\$(24 )	\$(34 )

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## Note 12 – Accumulated Other Comprehensive Income (Loss)

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

	Three Months Ended March 31			Three Months Ended March 31		
	2014			2013		
	Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan	Total	Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan	Total
Balance, January 1	\$ (4,207 )	\$ (2,134 )	\$ (6,341 )	\$ 8,678	\$ (3,671 )	\$ 5,007
OCI before reclassifications	5,520	—	5,520	(1,961 )	—	(1,961 )
Amounts reclassified from AOCI	—	—	—	(99 )	—	(99 )
Subtotal	5,520	—	5,520	(2,060 )	—	(2,060 )
Tax effect	(1,739 )	—	(1,739 )	923	—	923
OCI, net of tax	3,781	—	3,781	(1,137 )	—	(1,137 )
Balance, March 31	\$ (426 )	\$ (2,134 )	\$ (2,560 )	\$ 7,541	\$ (3,671 )	\$ 3,870

Included in OCI for the three month periods ended March 31, 2014 and 2013 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.

A summary of the components of unrealized holding gains on AFS securities included in OCI follows for the:

	Three Months Ended March 31			Three Months Ended March 31		
	2014			2013		
	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	\$ 25	\$ 5,495	\$ 5,520	\$ 658	\$ (2,619 )	\$ (1,961 )
Reclassification adjustment for net realized (gains) losses included in net income	—	—	—	—	(99 )	(99 )
Net unrealized gains (losses)	25	5,495	5,520	658	(2,718 )	(2,060 )
Tax effect	—	(1,739 )	(1,739 )	—	923	923
Unrealized gains (losses), net of tax	\$ 25	\$ 3,756	\$ 3,781	\$ 658	\$ (1,795 )	\$ (1,137 )

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	Affected Line Item in the
	Reclassified from AOCI	Interim Condensed Consolidated Statements of Income
	Three Months Ended March 31	
	2014	2013
Unrealized holding gains (losses) on AFS securities		

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\$—	\$99	Net gains (losses) on sale of AFS securities
—	99	Income before federal income tax expense
—	34	Federal income tax expense
\$—	\$65	Net income

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Interim Condensed Balance Sheets

	March 31 2014	December 31 2013
<b>ASSETS</b>		
Cash on deposit at the Bank	\$330	\$529
AFS securities	3,514	3,542
Investments in subsidiaries	116,295	110,192
Premises and equipment	1,988	2,013
Other assets	54,136	54,223
<b>TOTAL ASSETS</b>	<b>\$176,263</b>	<b>\$170,499</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$10,292	\$9,890
Shareholders' equity	165,971	160,609
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$176,263</b>	<b>\$170,499</b>
Interim Condensed Statements of Income		
	Three Months Ended March 31	
	2014	2013
<b>Income</b>		
Dividends from subsidiaries	\$1,500	\$1,500
Interest income	39	43
Management fee and other	506	508
Total income	2,045	2,051
<b>Expenses</b>		
Compensation and benefits	832	712
Occupancy and equipment	114	111
Audit and related fees	71	65
Other	268	204
Total expenses	1,285	1,092
Income before income tax benefit and equity in undistributed earnings of subsidiaries	760	959
Federal income tax benefit	254	189
Income before equity in undistributed earnings of subsidiaries	1,014	1,148
Undistributed earnings of subsidiaries	2,295	1,939
Net income	\$3,309	\$3,087

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## Interim Condensed Statements of Cash Flows

	Three Months Ended March 31	
	2014	2013
Operating activities		
Net income	\$3,309	\$3,087
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(2,295	) (1,939
Undistributed earnings of equity securities without readily determinable fair values	78	(6
Share-based payment awards	137	146
Depreciation	33	36
Net amortization of AFS securities	—	1
Changes in operating assets and liabilities which provided (used) cash		
Other assets	9	(137
Accrued interest and other liabilities	153	(271
Net cash provided by (used in) operating activities	1,424	917
Investing activities		
Purchases of premises and equipment	(8	) (86
Advances to subsidiaries, net of repayments	—	101
Net cash provided by (used in) investing activities	(8	) 15
Financing activities		
Net increase (decrease) in borrowed funds	250	900
Cash dividends paid on common stock	(1,696	) (1,609
Proceeds from the issuance of common stock	850	902
Common stock repurchased	(893	) (480
Common stock purchased for deferred compensation obligations	(126	) (90
Net cash provided by (used in) financing activities	(1,615	) (377
Increase (decrease) in cash and cash equivalents	(199	) 555
Cash and cash equivalents at beginning of period	529	332
Cash and cash equivalents at end of period	\$330	\$887

## Note 14 – 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 March 31, 2014 and 2013 and each of the three month periods then ended, represent approximately 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 month periods ended March 31, 2014 and 2013. This analysis should be read in conjunction with our 2013 Annual Report on Form 10-K and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

Executive Summary

Net income for the first quarter of 2014 was \$3,309 an increase of \$222 when compared to the same period in 2013. As of March 31, 2014, our total assets were \$1,513,371, and assets under management - which included loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$651,193 - were \$2,164,564. The primary driver for the increase in net income was an improvement of various credit quality indicators. These improvements resulted in declines in the level of the ALLL in both amount and as a percentage of gross loans; and a reversal of provision for loan losses of \$242. During the first quarter of 2014, net loans charged-off declined to \$158 which represented our lowest quarterly charge-offs since the first quarter of 2007. Additionally, we continue to see reductions in loans classified as less than satisfactory. While we experienced improvements in net loans charged-off and reductions in the level of loans classified as less than satisfactory, nonperforming loans increased during the quarter. This increase was primarily the result of three loans, all of which are well collateralized and closely monitored by management.

While competition for high quality commercial loans continues to be intense, we were able to grow our portfolio during the quarter by \$7,598 without relaxing our underwriting standards. This growth was partially offset by declines in both residential real estate loans of \$5,345 and consumer loans of \$1,349, resulting in an increase in total loans of \$374. The lack of demand for residential real estate loans has also led to noticeable declines in loan fees and a corresponding decline in the net yield on interest earning assets. Despite the relatively small net increase in loans during the quarter, we generated additional interest income through the purchases of AFS investment securities which were funded by increases in deposit accounts.

We anticipate that competition for commercial loans will continue to be significant, residential mortgage loan activity will remain soft, and growing our deposit base will be challenging throughout the foreseeable future. Despite these challenges, our unwavering commitment to core community banking principles and long term sustainable growth has, and will continue to, enable us to meet the needs of the communities we serve and increase shareholder value.

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## Results of Operations

The following table outlines our quarterly results of operations and provides certain performance measures as of, and for the three month periods ended March 31, 2014, December 31, 2013, September 30, 2013, June 30, 2013, and March 31, 2013:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$ 13,364	\$ 13,603	\$ 13,505	\$ 13,440	\$ 13,528	
Interest expense	2,500	2,683	2,736	2,781	2,821	
Net interest income	10,864	10,920	10,769	10,659	10,707	
Provision for loan losses	(242 )	245	351	215	300	
Noninterest income	2,249	2,130	2,862	2,736	2,447	
Noninterest expenses	9,486	9,578	9,320	9,324	9,191	
Federal income tax expense	560	303	674	643	576	
Net Income	\$ 3,309	\$ 2,924	\$ 3,286	\$ 3,213	\$ 3,087	
<b>PER SHARE</b>						
Basic earnings	0.43	0.38	0.43	0.42	0.40	
Diluted earnings	0.42	0.37	0.42	0.41	0.39	
Dividends	0.22	0.21	0.21	0.21	0.21	
Tangible book value*	15.82	15.62	15.43	15.19	14.95	
<b>Market value</b>						
High	23.94	24.84	25.50	26.00	25.10	
Low	22.25	21.12	23.40	21.12	21.55	
Close*	23.00	23.85	24.85	24.75	25.00	
Common shares outstanding*	7,727,547	7,723,023	7,709,781	7,703,589	7,688,928	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets (annualized)	0.88	% 0.80	% 0.91	% 0.89	% 0.86	%
Return on average shareholders' equity (annualized)	8.04	% 7.18	% 8.27	% 7.76	% 7.51	%
Return on average tangible shareholders' equity (annualized)	10.92	% 9.78	% 11.16	% 11.10	% 10.86	%
Net interest margin yield (FTE annualized)	3.42	% 3.50	% 3.48	% 3.50	% 3.54	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$ 808,411	\$ 808,037	\$ 807,849	\$ 803,452	\$ 767,522	
AFS securities	555,144	512,062	501,057	499,424	520,931	
Total assets	1,513,371	1,493,137	1,459,341	1,451,415	1,434,705	
Deposits	1,065,935	1,043,766	1,023,931	1,021,424	1,029,760	
Borrowed funds	272,536	279,326	266,001	262,460	232,410	
Shareholders' equity	165,971	160,609	161,305	159,288	165,308	
Gross loans to deposits	75.84	% 77.42	% 78.90	% 78.66	% 74.53	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$ 292,382	\$ 293,665	\$ 294,999	\$ 295,047	\$ 301,476	
Assets managed by our Investment and Trust Services Department	358,811	351,420	351,505	336,132	336,632	
Total assets under management	2,164,564	2,138,222	2,105,845	2,082,594	2,072,813	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.65	% 0.42	% 0.53	% 0.52	% 0.90	%
Nonperforming assets to total assets	0.42	% 0.32	% 0.37	% 0.36	% 0.56	%



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ALLL to gross loans	1.37	% 1.42	% 1.44	% 1.46	% 1.55	%
<b>CAPITAL RATIOS</b>						
Shareholders' equity to assets*	10.97	% 10.76	% 11.05	% 10.97	% 11.52	%
Tier 1 capital to average assets*	8.38	% 8.46	% 8.45	% 8.38	% 8.28	%
Tier 1 risk-based capital*	13.88	% 13.67	% 13.75	% 13.59	% 13.61	%
Total risk-based capital*	15.13	% 14.92	% 15.00	% 14.84	% 14.86	%

\* 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. These schedules also present an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a 34% federal income 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:

	March 31 2014			December 31 2013			March 31 2013		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>									
Loans	\$805,812	\$9,751	4.84 %	\$806,749	\$10,293	5.10 %	\$766,741	\$10,330	5.39 %
Taxable investment securities	353,013	1,998	2.26 %	326,717	1,809	2.21 %	343,518	1,834	2.14 %
Nontaxable investment securities	189,000	2,332	4.94 %	178,678	2,214	4.96 %	155,668	2,009	5.16 %
Trading account securities	524	8	6.11 %	741	9	4.86 %	1,570	21	5.35 %
Other	26,604	153	2.30 %	31,341	116	1.48 %	30,376	116	1.53 %
Total earning assets	1,374,953	14,242	4.14 %	1,344,226	14,441	4.30 %	1,297,873	14,310	4.41 %
<b>NONEARNING ASSETS</b>									
ALLL	(11,634 )			(11,668 )			(12,085 )		
Cash and demand deposits due from banks	17,690			18,406			18,661		
Premises and equipment	26,018			25,956			25,937		
Accrued income and other assets	94,704			92,958			101,816		
Total assets	\$1,501,731			\$1,469,878			\$1,432,202		
<b>INTEREST BEARING LIABILITIES</b>									
Interest bearing demand deposits	\$197,776	41	0.08 %	\$183,022	40	0.09 %	\$186,798	41	0.09 %
Savings deposits	252,979	94	0.15 %	242,141	91	0.15 %	241,401	91	0.15 %
Time deposits	451,350	1,481	1.31 %	450,792	1,571	1.39 %	461,537	1,742	1.51 %
Borrowed funds	270,010	884	1.31 %	270,327	981	1.45 %	230,573	947	1.64 %
Total interest bearing liabilities	1,172,115	2,500	0.85 %	1,146,282	2,683	0.94 %	1,120,309	2,821	1.01 %

NONINTEREST  
BEARING  
LIABILITIES

Demand deposits	155,176	151,526	137,959
Other	9,861	9,114	9,420
Shareholders' equity	164,579	162,956	164,514
Total liabilities and shareholders' equity	\$1,501,731	\$1,469,878	\$1,432,202
Net interest income (FTE)	\$ 11,742	\$ 11,758	\$ 11,489
Net yield on interest earning assets (FTE)	3.42 %	3.50 %	3.54 %

Net Interest Income

Net interest income is the amount by which interest income on earning assets exceeds the interest expenses on interest bearing liabilities. Net interest income is influenced by changes in the balance and mix of assets and liabilities and market interest rates. We exert some control over these factors; however, FRB monetary policy and competition have a significant impact. Interest

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income includes loan fees of \$476, \$761, and \$821 for the three month periods ended March 31, 2014, December 31, 2013, and March 31, 2013, respectively. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans, AFS securities, and trading 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—change in volume multiplied by the previous period's rate.

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

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

	Three Months Ended March 31, 2014 Compared to December 31, 2013			Three Months Ended March 31, 2014 Compared to March 31, 2013		
	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Increase (Decrease) Due to Net	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Increase (Decrease) Due to Net
Changes in interest income						
Loans	\$(12 )	\$(530 )	\$(542 )	\$509	\$(1,088 )	\$(579 )
Taxable AFS securities	148	41	189	52	112	164
Nontaxable AFS securities	127	(9 )	118	414	(91 )	323
Trading securities	(3 )	2	(1 )	(16 )	3	(13 )
Other	(20 )	57	37	(16 )	53	37
Total changes in interest income	240	(439 )	(199 )	943	(1,011 )	(68 )
Changes in interest expense						
Interest bearing demand deposits	3	(2 )	1	2	(2 )	—
Savings deposits	4	(1 )	3	4	(1 )	3
Time deposits	2	(92 )	(90 )	(38 )	(223 )	(261 )
Borrowed funds	(1 )	(96 )	(97 )	142	(205 )	(63 )
Total changes in interest expense	8	(191 )	(183 )	110	(431 )	(321 )
Net change in interest margin (FTE)	\$232	\$(248 )	\$(16 )	\$833	\$(580 )	\$253

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 as a percentage of earnings assets has also placed downward pressure on net interest margin yield and net interest income.

	Average Yield / Rate for the Three Month Periods Ended:					
	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013	
Total earning assets	4.14	% 4.30	% 4.31	% 4.35	% 4.41	%
Total interest bearing liabilities	0.85	% 0.94	% 0.96	% 0.99	% 1.01	%
Net yield on interest earning assets (FTE)	3.42	% 3.50	% 3.48	% 3.50	% 3.54	%

	Quarter to Date Net Interest Income (FTE)				
	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013
Total interest income (FTE)	\$14,242	\$14,441	\$14,290	\$14,225	\$14,310
Total interest expense	2,500	2,683	2,736	2,781	2,821
Net interest income (FTE)	\$11,742	\$11,758	\$11,554	\$11,444	\$11,489



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One of the the primary contributors to the decline in the net yield on interest earning assets and net interest income has been a drastic decline in loan fees in the first quarter of 2014. Loan fees have declined as the demand for residential mortgage loans has diminished and the competition for commercial loans remains intense. As shown in the following table, the net yield on interest earning assets and net interest income excluding the impact of loan fees (FTE) has consistently improved since the second quarter of 2013.

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013	
Net interest income (FTE)	\$ 11,742	\$ 11,758	\$ 11,554	\$ 11,444	\$ 11,489	
Less loan fees	476	761	738	862	821	
Net interest income excluding loan fees (FTE)	\$ 11,266	\$ 10,997	\$ 10,816	\$ 10,582	\$ 10,668	
Net yield on interest earning assets excluding loan fees (FTE)	3.28	% 3.27	% 3.26	% 3.23	% 3.29	%

Despite the challenging current interest rate and competitive loan environments, we anticipate that net interest income and the net yield on interest earning assets (FTE) will modestly increase in future periods as most interest earning assets have already repriced at lower rates while some interest bearing liabilities will likely reprice at lower interest rates in coming periods and loan fees are expected to stabilize.

## Allowance for Loan and Lease Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans represent our single largest concentration of risk. The ALLL is our estimation of losses within 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 valuation allowances, 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 table summarizes our charge-off and recovery activity for the three month periods ended March 31:

	2014	2013	Variance	
ALLL at beginning of period	\$ 11,500	\$ 11,936	\$(436	)
Loans charged-off				
Commercial and agricultural	223	211	12	
Residential real estate	113	190	(77	)
Consumer	114	121	(7	)
Total loans charged-off	450	522	(72	)
Recoveries				
Commercial and agricultural	214	57	157	
Residential real estate	36	53	(17	)
Consumer	42	85	(43	)
Total recoveries	292	195	97	
Net loans charged-off	158	327	(169	)
Provision for loan losses	(242	) 300	(542	)
ALLL at end of period	\$ 11,100	\$ 11,909	\$(809	)

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The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the three month periods ended:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013		
Total loans charged-off	\$450	\$497	\$602	\$719	\$522		
Total recoveries	292	152	151	295	195		
Net loans charged-off	158	345	451	424	327		
Net loans charged-off to average loans outstanding	0.02	% 0.04	% 0.06	% 0.05	% 0.04	%	%
Provision for loan losses	\$(242)	\$245	\$351	\$215	\$300		
Provision for loan losses to average loans outstanding	(0.03)	% 0.03	% 0.04	% 0.03	% 0.04	%	%
ALLL as a% of loans at end of period	1.37	% 1.42	% 1.44	% 1.46	% 1.55	%	%

As the level of net loans charged-off continues to decline and credit quality indicators return to pre-recessionary levels, we have reduced the ALLL in both amount and as a percentage of loans. While overall net loans charged-off is likely to approximate current levels, charge-offs on residential real estate loans are anticipated to increase slightly as a percentage of net loans charged-off due to anticipated increased foreclosures as a result of the impact of the CFPB ability to repay rules. For further discussion of the allocation of the ALLL, see “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Loans Past Due and Loans in Nonaccrual Status**

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

	Total Past Due and Nonaccrual						
	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013		
Commercial and agricultural	\$4,986	\$3,621	\$5,371	\$4,962	\$8,713		
Residential real estate	7,067	7,008	6,339	5,080	4,077		
Consumer	113	259	152	104	212		
Total	\$12,166	\$10,888	\$11,862	\$10,146	\$13,002		
Total past due and nonaccrual loans to gross loans	1.50	% 1.35	% 1.47	% 1.26	% 1.69	%	%

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 5 – 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 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 March 31, 2014 or December 31, 2013.

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.



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

	Three Months Ended March 31, 2014					
	Accruing Interest		Nonaccrual		Total	
	Number of Loans	Balance	Number of Loans	Balance	Number of Loans	Balance
January 1, 2014	165	\$24,423	15	\$1,442	180	\$25,865
New modifications	12	770	2	77	14	847
Principal payments	—	(273 )	—	(30 )	—	(303 )
Loans paid-off	(10 )	(718 )	—	—	(10 )	(718 )
Partial charge-off	—	—	—	(18 )	—	(18 )
Balances charged-off	(1 )	(6 )	—	—	(1 )	(6 )
Transfers to OREO	—	—	(2 )	(34 )	(2 )	(34 )
Transfers to accrual status	2	57	(2 )	(57 )	—	—
Transfers to nonaccrual status	(3 )	(1,299 )	3	1,299	—	—
March 31, 2014	165	\$22,954	16	\$2,679	181	\$25,633
	Three Months Ended March 31, 2013					
	Accruing Interest		Nonaccrual		Total	
	Number of Loans	Balance	Number of Loans	Balance	Number of Loans	Balance
January 1, 2013	115	\$16,531	19	\$2,824	134	\$19,355
New modifications	8	819	1	98	9	917
Principal payments	—	(265 )	—	(37 )	—	(302 )
Loans paid-off	(3 )	(130 )	(1 )	(200 )	(4 )	(330 )
Partial charge-off	—	(15 )	—	(211 )	—	(226 )
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(1 )	(12 )	(1 )	(12 )
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	(1 )	(40 )	1	40	—	—
March 31, 2013	119	\$16,900	19	\$2,502	138	\$19,402

The following table summarizes our TDRs as of:

	March 31, 2014			December 31, 2013			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$20,459	\$2,076	\$22,535	\$21,690	\$1,189	\$22,879	\$(344 )
Past due 30-59 days	1,674	8	1,682	2,158	37	2,195	(513 )
Past due 60-89 days	486	—	486	575	—	575	(89 )
Past due 90 days or more	335	595	930	—	216	216	714
Total	\$22,954	\$2,679	\$25,633	\$24,423	\$1,442	\$25,865	\$(232 )

Additional disclosures about TDRs are included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

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## Impaired Loans

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

	March 31, 2014			December 31, 2013		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
<b>TDRs</b>						
Commercial real estate	\$10,870	\$11,399	\$1,580	\$10,663	\$11,193	\$1,585
Commercial other	1,305	1,335	47	1,310	1,340	62
Agricultural real estate	1,455	1,455	29	1,459	1,459	30
Agricultural other	18	138	—	79	199	—
Residential real estate senior liens	11,904	12,455	2,157	12,266	12,841	2,010
Residential real estate junior liens	20	20	4	20	20	4
Consumer secured	61	68	1	68	69	—
<b>Total TDRs</b>	<b>25,633</b>	<b>26,870</b>	<b>3,818</b>	<b>25,865</b>	<b>27,121</b>	<b>3,691</b>
<b>Other impaired loans</b>						
Commercial real estate	1,835	2,268	284	1,707	2,193	330
Commercial other	24	105	—	136	217	58
Agricultural real estate	82	82	—	—	—	—
Agricultural other	225	250	—	—	—	—
Residential real estate senior liens	1,212	1,784	179	1,795	2,473	268
Residential real estate junior liens	24	43	6	28	45	5
Home equity lines of credit	169	469	7	193	493	—
Consumer secured	—	—	—	51	79	—
<b>Total other impaired loans</b>	<b>3,571</b>	<b>5,001</b>	<b>476</b>	<b>3,910</b>	<b>5,500</b>	<b>661</b>
<b>Total impaired loans</b>	<b>\$29,204</b>	<b>\$31,871</b>	<b>\$4,294</b>	<b>\$29,775</b>	<b>\$32,621</b>	<b>\$4,352</b>

Additional disclosure related to impaired loans is included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

	March 31 2014	December 31 2013		
Nonaccrual loans	\$4,345	\$3,244		
Accruing loans past due 90 days or more	893	142		
<b>Total nonperforming loans</b>	<b>5,238</b>	<b>3,386</b>		
Foreclosed assets	1,126	1,412		
<b>Total nonperforming assets</b>	<b>\$6,364</b>	<b>\$4,798</b>		
Nonperforming loans as a % of total loans	0.65	% 0.42		%
Nonperforming assets as a % of total assets	0.42	% 0.32		%

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

During the first quarter of 2014, total nonperforming loans increased primarily as a result of three loans (two were accruing loans past due 90 days or more and one was in nonaccrual status), all of which were fully collateralized and

closely monitored by management. Included in the increase in accruing loans past due 90 days or more are two loans totaling \$625 as of March 31, 2014. We anticipate full payoffs on these loans in the near future.

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

	March 31 2014	December 31 2013
Commercial and agricultural	\$2,024	\$833
Residential real estate	654	609
Consumer	1	—
Total	\$2,679	\$1,442

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of March 31, 2014 and December 31, 2013. 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.

	March 31, 2014		December 31, 2013	
	Outstanding Balance	Specific Allocation	Outstanding Balance	Specific Allocation
Borrower 1	\$1,119	\$—	\$—	\$—
Others not individually significant	3,226		3,244	
Total	\$4,345		\$3,244	

<sup>1</sup> No specific allocation as the net realizable value of the loan's underlying collateral value exceeded the loan's carrying balance.

Additional disclosures about nonaccrual loans are included in “Note 5 – 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 March 31, 2014 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 Noninterest Expenses

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 income. Significant account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended March 31		Change		
	2014	2013	\$	%	
Service charges and fees					
NSF and overdraft fees	\$513	\$516	\$(3)	(0.58)	)%
ATM and debit card fees	487	455	32	7.03	)%
Freddie Mac servicing fee	183	184	(1)	(0.54)	)%
Service charges on deposit accounts	86	90	(4)	(4.44)	)%
Net OMSRs income (loss)	91	8	83	N/M	
All other	34	28	6	21.43	)%
Total service charges and fees	1,394	1,281	113	8.82	)%
Gain on sale of mortgage loans	115	358	(243)	(67.88)	)%
Earnings on corporate owned life insurance policies	184	169	15	8.88	)%
Gains (losses) on sale of AFS securities	—	99	(99)	(100.00)	)%
Other					
Trust and brokerage advisory fees	507	410	97	23.66	)%
Other	49	130	(81)	(62.31)	)%
Total other	556	540	16	2.96	)%
Total noninterest income	\$2,249	\$2,447	\$(198)	(8.09)	)%

Significant changes in noninterest income are detailed below:

As customers continue to increase their dependence on ATM and debit cards, we have seen a corresponding increase in fees. We do not anticipate significant changes to our ATM and debit fee structure; however, we do expect that these fees will continue to increase as the usage of ATM and debit cards increase.

Offering rates on residential mortgage loans is the most significant driver behind fluctuations in the gain on sale of mortgage loans and net OMSRs income (loss). As offering rates increase, we typically experience reductions in the gain on sale of mortgage loans. Offsetting these declines are increases in the value of our mortgage servicing portfolio leading to the increase in net OMSRs income. As mortgage rates are expected to approximate current levels in the foreseeable future and purchase money mortgage activity will likely remain soft, we do not anticipate any significant changes in origination volumes or 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 that made economic sense to sell. Currently we are not planning any significant investment sales during 2014.

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

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 in 2014.

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Noninterest expenses include compensation and benefits, furniture and equipment, occupancy, and other expenses. Significant account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended March 31				
	2014	2013	Change \$	%	
Compensation and benefits					
Employee salaries	\$4,042	\$3,876	\$166	4.28	%
Employee benefits	1,444	1,569	(125)	(7.97)	)%
Total compensation and benefits	5,486	5,445	41	0.75	%
Furniture and equipment					
Service contracts	620	536	84	15.67	%
Depreciation	445	464	(19)	(4.09)	)%
ATM and debit card fees	188	168	20	11.90	%
All other	15	21	(6)	(28.57)	)%
Total furniture and equipment	1,268	1,189	79	6.64	%
Occupancy					
Outside services	207	170	37	21.76	%
Depreciation	174	161	13	8.07	%
Utilities	156	136	20	14.71	%
Property taxes	134	135	(1)	(0.74)	)%
All other	71	63	8	12.70	%
Total occupancy	742	665	77	11.58	%
Other					
Marketing and community relations	243	242	1	0.41	%
FDIC insurance premiums	202	272	(70)	(25.74)	)%
Directors fees	195	199	(4)	(2.01)	)%
Audit and related fees	138	139	(1)	(0.72)	)%
Education and travel	121	122	(1)	(0.82)	)%
Postage and freight	108	99	9	9.09	%
Printing and supplies	102	86	16	18.60	%
Loan underwriting fees	95	116	(21)	(18.10)	)%
Consulting fees	91	72	19	26.39	%
All other	695	545	150	27.52	%
Total other	1,990	1,892	98	5.18	%
Total noninterest expenses	\$9,486	\$9,191	\$295	3.21	%

Significant changes in noninterest expenses are detailed below:

Employee salaries have increased as a result of normal merit increases and additional staffing required by our continued growth. The decline in employee benefits is related to health care costs as a result of lower than anticipated claims. Employee benefits are expected to increase in future periods as a result of anticipated increases in health care costs.

Service contracts have increased during 2014 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 2014.

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 have returned to normalized levels and are anticipated to approximate current levels for the remainder of 2014.

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



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## Analysis of Changes in Financial Condition

	March 31 2014	December 31 2013	\$ Change	% Change (unannualized)	
<b>ASSETS</b>					
Cash and cash equivalents	\$ 18,667	\$ 41,558	\$(22,891)	(55.08)	)%
Certificates of deposit held in other financial institutions	580	580	—	—	
Trading securities	521	525	(4)	(0.76)	)%
AFS securities					
Amortized cost of AFS securities	555,176	517,614	37,562	7.26	%
Unrealized Gains (losses) on AFS securities	(32)	(5,552)	5,520	N/M	
AFS securities	555,144	512,062	43,082	8.41	%
Mortgage loans AFS	489	1,104	(615)	(55.71)	)%
Loans					
Gross loans	808,411	808,037	374	0.05	%
Less allowance for loan and lease losses	11,100	11,500	(400)	(3.48)	)%
Net loans	797,311	796,537	774	0.10	%
Premises and equipment	26,009	25,719	290	1.13	%
Corporate owned life insurance policies	24,585	24,401	184	0.75	%
Accrued interest receivable	6,725	5,442	1,283	23.58	%
Equity securities without readily determinable fair values	18,965	18,293	672	3.67	%
Goodwill and other intangible assets	46,263	46,311	(48)	(0.10)	)%
Other assets	18,112	20,605	(2,493)	(12.10)	)%
<b>TOTAL ASSETS</b>	<b>\$ 1,513,371</b>	<b>\$ 1,493,137</b>	<b>\$ 20,234</b>	<b>1.36</b>	<b>%</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
Liabilities					
Deposits	\$ 1,065,935	\$ 1,043,766	\$ 22,169	2.12	%
Borrowed funds	272,536	279,326	(6,790)	(2.43)	)%
Accrued interest payable and other liabilities	8,929	9,436	(507)	(5.37)	)%
Total liabilities	1,347,400	1,332,528	14,872	1.12	%
Shareholders' equity	165,971	160,609	5,362	3.34	%
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,513,371</b>	<b>\$ 1,493,137</b>	<b>\$ 20,234</b>	<b>1.36</b>	<b>%</b>

The following table outlines the changes in loans:

	March 31 2014	December 31 2013	\$ Change	% Change (unannualized)	
Commercial	\$ 399,702	\$ 392,104	\$ 7,598	1.94	%
Agricultural	92,059	92,589	(530)	(0.57)	)%
Residential real estate	284,586	289,931	(5,345)	(1.84)	)%
Consumer	32,064	33,413	(1,349)	(4.04)	)%
Total	\$ 808,411	\$ 808,037	\$ 374	0.05	%



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The following table displays loan balances as of:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013
Commercial	\$399,702	\$392,104	\$388,973	\$389,044	\$364,350
Agricultural	92,059	92,589	92,927	87,516	81,196
Residential real estate	284,586	289,931	291,825	293,158	288,962
Consumer	32,064	33,413	34,124	33,734	33,014
Total	\$808,411	\$808,037	\$807,849	\$803,452	\$767,522

While loan balances have increased by almost \$41,000 since March 31, 2013, our portfolio has remained essentially unchanged since June 30, 2013. We continue to see declines in residential real estate loans which have been offset by increases in commercial and agricultural loans. This trend is likely to continue as the demand for residential real estate loans is anticipated to remain soft due to continuing uncertainty in the residential real estate markets, increases in interest rates, and the implementation of CFPB underwriting guidelines.

The following table outlines the changes in deposits:

	March 31 2014	December 31 2013	\$ Change	% Change (unannualized)
Noninterest bearing demand deposits	\$158,241	\$158,428	\$(187)	(0.12)%
Interest bearing demand deposits	194,407	192,089	2,318	1.21%
Savings deposits	261,444	243,237	18,207	7.49%
Certificates of deposit	356,847	362,473	(5,626)	(1.55)%
Brokered certificates of deposit	65,273	56,329	8,944	15.88%
Internet certificates of deposit	29,723	31,210	(1,487)	(4.76)%
Total	\$1,065,935	\$1,043,766	\$22,169	2.12%

The following table displays balances of deposits as of:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013
Noninterest bearing demand deposits	\$158,241	\$158,428	\$143,013	\$139,942	\$137,322
Interest bearing demand deposits	194,407	192,089	186,630	173,184	183,055
Savings deposits	261,444	243,237	245,217	248,098	248,881
Certificates of deposit	356,847	362,473	366,349	368,713	374,280
Brokered certificates of deposit	65,273	56,329	51,410	57,701	53,329
Internet certificates of deposit	29,723	31,210	31,312	33,786	32,893
Total	\$1,065,935	\$1,043,766	\$1,023,931	\$1,021,424	\$1,029,760

While loan growth since June 30, 2013 has been sluggish, we have enjoyed consistent deposit growth over the same time period. As a result of the current interest rate environment, we continue to see declines in certificates of deposits. However, these declines have been offset by increases in noninterest bearing demand deposits, interest bearing demand deposits, and savings accounts. We expect this trend to continue for the foreseeable future.

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As deposit growth has outpaced loan demand, we continue to deploy deposits into purchases of AFS securities to provide additional interest income. While most of the growth in AFS securities over the past 12 months has been in states and political subdivisions, we anticipate that future increases in our AFS securities will be in the form of mortgage-backed securities and collateralized mortgage obligations. The following table displays fair values of AFS securities as of:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013
Government sponsored enterprises	\$23,883	\$23,745	\$24,155	\$24,249	\$25,491
States and political subdivisions	219,644	201,988	193,786	187,302	192,564
Auction rate money market preferred	2,755	2,577	2,639	2,943	3,091
Preferred stocks	6,053	5,827	6,144	6,559	6,708
Mortgage-backed securities	157,856	144,115	146,393	149,407	163,533
Collateralized mortgage obligations	144,953	133,810	127,940	128,964	129,544
Total	\$555,144	\$512,062	\$501,057	\$499,424	\$520,931

The following table displays balances of borrowed funds as of:

	March 31 2014	December 31 2013	September 30 2013	June 30 2013	March 31 2013
FHLB advances	\$162,000	\$162,000	\$162,000	\$162,000	\$152,000
Securities sold under agreements to repurchase without stated maturity dates	94,741	106,025	81,405	71,668	64,122
Securities sold under agreements to repurchase with stated maturity dates	1,195	11,301	16,296	16,292	16,288
Federal funds purchased	14,600	—	6,300	12,500	—
Total	\$272,536	\$279,326	\$266,001	\$262,460	\$232,410

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 35,814 shares or \$850 of common stock during the first three months of 2014, as compared to 37,591 shares or \$902 of common stock during the same period in 2013. We also offer the Directors Plan in which participants either directly purchase stock or purchase stock units through deferred fees, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$137 and \$146 during the three month periods ended March 31, 2014 and 2013, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 37,415 shares or \$893 of common stock compared to 20,509 shares for \$480 during the first three months of 2014 and 2013, respectively. As of March 31, 2014, we were authorized to repurchase up to an additional 99,981 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 6.00%. Our primary capital to adjusted average assets, which consists of shareholders' equity plus the ALLL acquisition intangibles, was 8.38% as of March 31, 2014.

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 8.00%, of which at least 4.00% 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:

Required

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	March 31	December 31			
	2014	2013			
Equity Capital	13.88	% 13.67	% 4.00		%
Secondary Capital	1.25	% 1.25	% 4.00		%
Total Capital	15.13	% 14.92	% 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 March 31, 2014, 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:

	March 31 2014	December 31 2013
Unfunded commitments under lines of credit	\$121,480	\$121,959
Commercial and standby letters of credit	4,229	4,169
Commitments to grant loans	14,220	29,096
Total	\$139,929	\$155,224

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 11 – Fair Value" of our notes to the interim condensed consolidated financial statements.



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## 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 \$574,912 or 37.99% of assets as of March 31, 2014 as compared to \$554,725 or 37.15% as of December 31, 2013. 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 March 31, 2014, we had available lines of credit of \$109,677.

The following table summarizes our sources and uses of cash for the three month periods ended March 31:

	2014	2013	\$ Variance
Net cash provided by (used in) operating activities	\$2,812	\$5,797	\$(2,985 )
Net cash provided by (used in) investing activities	(39,217 )	(13,262 )	(25,955 )
Net cash provided by (used in) financing activities	13,514	2,225	11,289
Increase (decrease) in cash and cash equivalents	(22,891 )	(5,240 )	(17,651 )
Cash and cash equivalents January 1	41,558	24,920	16,638
Cash and cash equivalents March 31	\$18,667	\$19,680	\$(1,013 )

## 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 IRR 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 March 31, 2014, 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:

	March 31, 2014					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(2.55 )%	—	(0.18 )%	(0.99 )%	(2.16 )%	(3.79 )%
	December 31, 2013					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(2.85 )%	—	0.25 %	(0.28 )%	(0.99 )%	(2.16 )%

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of March 31, 2014 and December 31, 2013. The principal amounts of investments, loans, other interest earning assets, borrowings, and time deposits maturing were calculated based on the contractual maturity dates. Estimated cash flows for savings and NOW accounts are based on our estimated deposit decay rates.



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	March 31, 2014							Fair Value
	2015	2016	2017	2018	2019	Thereafter	Total	
Rate sensitive assets								
Other interest bearing assets	\$922	\$480	\$100	\$—	\$—	\$—	\$1,502	\$1,502
Average interest rates	0.25	% 1.15	% 0.35	% —	—	—	0.52	%
Trading securities	\$521	\$—	\$—	\$—	\$—	\$—	\$521	\$521
Average interest rates	3.32	% —	—	—	—	—	3.32	%
AFS securities	\$125,595	\$75,207	\$65,406	\$55,800	\$40,650	\$192,486	\$555,144	\$555,144
Average interest rates	2.29	% 2.38	% 2.49	% 2.55	% 2.44	% 2.66	% 2.49	%
Fixed interest rate loans (1)	\$113,066	\$98,984	\$105,700	\$108,492	\$76,874	\$137,021	\$640,137	\$639,803
Average interest rates	5.26	% 5.09	% 4.78	% 4.49	% 4.39	% 4.29	% 4.71	%
Variable interest rate loans (1)	\$65,731	\$28,953	\$21,378	\$12,992	\$15,241	\$23,979	\$168,274	\$168,274
Average interest rates	4.41	% 4.08	% 3.77	% 3.41	% 3.34	% 3.86	% 4.02	%
Rate sensitive liabilities								
Borrowed funds	\$130,536	\$22,000	\$30,000	\$40,000	\$30,000	\$20,000	\$272,536	\$276,357
Average interest rates	0.28	% 0.90	% 1.88	% 2.46	% 2.72	% 2.94	% 1.29	%
Savings and NOW accounts	\$40,265	\$36,318	\$32,642	\$29,371	\$26,456	\$290,799	\$455,851	\$455,851
Average interest rates	0.11	% 0.11	% 0.11	% 0.11	% 0.11	% 0.10	% 0.11	%
Fixed interest rate certificates of deposit	\$217,177	\$78,846	\$57,171	\$43,085	\$36,158	\$18,254	\$450,691	\$452,828
Average interest rates	0.87	% 1.94	% 1.81	% 1.53	% 1.33	% 1.64	% 1.31	%
Variable interest rate certificates of deposit	\$746	\$406	\$—	\$—	\$—	\$—	\$1,152	\$1,152
Average interest rates	0.04	% 0.40	% —	—	—	—	0.17	%
	December 31, 2013							
	2014	2015	2016	2017	2018	Thereafter	Total	Fair Value
Rate sensitive assets								
Other interest bearing assets	\$19,903	\$480	\$—	\$—	\$—	\$—	\$20,383	\$20,385
Average interest rates	0.25	% 1.15	% —	—	—	—	0.27	%

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Average interest rates									
Trading securities	\$525	\$—	\$—	\$—	\$—	\$—	\$525	\$525	
Average interest rates	2.77	% —	—	—	—	—	2.77	%	
AFS securities	\$131,892	\$73,723	\$63,190	\$52,078	\$37,972	\$153,207	\$512,062	\$512,062	
Average interest rates	2.26	% 2.23	% 2.42	% 2.48	% 2.48	% 2.80	% 2.48	%	
Fixed interest rate loans (1)	\$115,183	\$94,841	\$91,140	\$118,479	\$85,448	\$134,614	\$639,705	\$639,914	
Average interest rates	5.31	% 5.17	% 4.93	% 4.53	% 4.33	% 4.33	% 4.75	%	
Variable interest rate loans (1)	\$69,036	\$29,460	\$20,332	\$14,208	\$15,699	\$19,597	\$168,332	\$168,332	
Average interest rates	4.76	% 3.90	% 4.06	% 3.36	% 3.35	% 3.99	% 4.19	%	
Rate sensitive liabilities									
Borrowed funds	\$126,950	\$32,376	\$10,000	\$30,000	\$40,000	\$40,000	\$279,326	\$283,060	
Average interest rates	0.43	% 0.86	% 2.15	% 1.95	% 2.35	% 3.02	% 1.35	%	
Savings and NOW accounts	\$47,000	\$33,569	\$30,200	\$27,198	\$24,522	\$272,837	\$435,326	\$435,326	
Average interest rates	0.19	% 0.12	% 0.11	% 0.11	% 0.11	% 0.11	% 0.12	%	
Fixed interest rate certificates of deposit	\$206,514	\$81,038	\$58,627	\$46,336	\$39,214	\$17,144	\$448,873	\$451,664	
Average interest rates	0.89	% 1.93	% 1.95	% 1.63	% 1.34	% 1.66	% 1.36	%	
Variable interest rate certificates of deposit	\$764	\$375	\$—	\$—	\$—	\$—	\$1,139	\$1,139	
Average interest rates	0.04	% 0.40	% —	—	—	—	0.16	%	

(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 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.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

The information presented in the section captioned “Market Risk” in 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 Exchange Act) as of March 31, 2014, 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 March 31, 2014, 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, 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, 2013.

## 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 October 23, 2013, 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 March 31, 2014, 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, December 31				137,396
January 1 - 31	10,409	\$23.83	10,409	126,987
February 1 - 28	13,221	23.75	13,221	113,766
March 1 - 31	13,785	23.79	13,785	99,981
Balance, March 31	37,415	\$23.79	37,415	99,981

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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: May 8, 2014

/s/ Jae A. Evans  
Jae A. Evans  
Chief Executive Officer  
(Principal Executive Officer)

Date: May 8, 2014

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