

ISABELLA BANK CORP
Form 10-Q
May 07, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended March 31, 2013

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period from _____ to _____

Commission File Number: 0-18415

Isabella Bank Corporation

(Exact name of registrant as specified in its charter)

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Michigan
(State or other jurisdiction of
incorporation or organization)

38-2830092
(I.R.S. Employer
identification No.)

401 N. Main St, Mt. Pleasant, MI
(Address of principal executive offices)

48858
(Zip code)

(989) 772-9471

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "accelerated filer", "large accelerated filer", and "smaller reporting company", in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock no par value, 7,696,617 as of April 29, 2013

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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, or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the FRB, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning Isabella Bank Corporation and its business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

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

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

Table of Contents**PART I FINANCIAL INFORMATION****Item 1 Interim Condensed Consolidated Financial Statements (Unaudited)****INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

	March 31 2013	December 31 2012
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$ 14,921	\$ 22,634
Interest bearing balances due from banks	4,759	2,286
Total cash and cash equivalents	19,680	24,920
Certificates of deposit held in other financial institutions	3,505	4,465
Trading securities	1,563	1,573
AFS securities (amortized cost of \$509,401 in 2013 and \$490,420 in 2012)	520,931	504,010
Mortgage loans AFS	1,026	3,633
Loans		
Commercial	364,350	371,505
Agricultural	81,196	83,606
Residential real estate	288,962	284,148
Consumer	33,014	33,494
Total loans	767,522	772,753
Less allowance for loan losses	11,909	11,936
Net loans	755,613	760,817
Premises and equipment	25,772	25,787
Corporate owned life insurance	22,819	22,773
Accrued interest receivable	6,160	5,227
Equity securities without readily determinable fair values	18,123	18,118
Goodwill and other intangible assets	46,475	46,532
Other assets	13,038	12,784
TOTAL ASSETS	\$ 1,434,705	\$ 1,430,639
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	\$ 137,322	\$ 143,735
NOW accounts	183,055	181,259
Certificates of deposit under \$100 and other savings	472,765	455,546
Certificates of deposit over \$100	236,618	237,127
Total deposits	1,029,760	1,017,667
Borrowed funds	232,410	241,001
Accrued interest payable and other liabilities	7,227	7,482
Total liabilities	1,269,397	1,266,150
Shareholders equity		

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Common stock – no par value 15,000,000 shares authorized; issued and outstanding 7,688,928 shares (including 2,800 shares held in the Rabbi Trust) in 2013 and 7,671,846 shares (including 5,130 shares held in the Rabbi Trust) in 2012	137,012	136,580
Shares to be issued for deferred compensation obligations	3,780	3,734
Retained earnings	20,646	19,168
Accumulated other comprehensive income	3,870	5,007
Total shareholders' equity	165,308	164,489
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,434,705	\$ 1,430,639

See notes to interim condensed consolidated financial statements.

Table of Contents**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(Dollars in thousands except per share data)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2012	7,589,226	\$ 134,734	\$ 4,524	\$ 13,036	\$ 2,489	\$ 154,783
Comprehensive income				3,234	597	3,831
Issuance of common stock	25,998	609				609
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations		95	(95)			
Share based payment awards under equity compensation plan			169			169
Common stock purchased for deferred compensation obligations		(144)				(144)
Common stock repurchased pursuant to publicly announced repurchase plan	(18,452)	(426)				(426)
Cash dividends (\$0.20 per share)				(1,515)		(1,515)
Balance, March 31, 2012	7,596,772	\$ 134,868	\$ 4,598	\$ 14,755	\$ 3,086	\$ 157,307
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 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

See notes to interim condensed consolidated financial statements.

Table of Contents**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands except per share data)

	Three Months Ended March 31	
	2013	2012
Interest income		
Loans, including fees	\$ 10,330	\$ 10,940
AFS securities		
Taxable	1,834	1,889
Nontaxable	1,234	1,204
Trading securities	14	42
Federal funds sold and other	116	129
Total interest income	13,528	14,204
Interest expense		
Deposits	1,874	2,512
Borrowings	947	1,192
Total interest expense	2,821	3,704
Net interest income	10,707	10,500
Provision for loan losses	300	461
Net interest income after provision for loan losses	10,407	10,039
Noninterest income		
Service charges and fees	1,544	1,629
Gain on sale of mortgage loans	358	379
Earnings on corporate owned life insurance policies	169	171
Gain on sale of AFS securities	99	1,003
Other	277	359
Total noninterest income	2,447	3,541
Noninterest expenses		
Compensation and benefits	5,445	5,301
Furniture and equipment	1,189	1,090
Occupancy	665	641
AFS security impairment loss		
Total OTTI impairment loss		486
Portion of loss reported in other comprehensive income		(204)
Net AFS security impairment loss		282
Other	1,892	2,259
Total noninterest expenses	9,191	9,573
Income before federal income tax expense	3,663	4,007
Federal income tax expense	576	773
NET INCOME	\$ 3,087	\$ 3,234

Earnings per share			
Basic	\$ 0.40	\$ 0.43	
Diluted	\$ 0.39	\$ 0.41	
Cash dividends per basic share	\$ 0.21	\$ 0.20	

See notes to interim condensed consolidated financial statements.

Table of Contents**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Dollars in thousands)

	Three Months Ended	
	March 31	
	2013	2012
Net income	\$ 3,087	\$ 3,234
Unrealized gains on AFS securities:		
Unrealized (losses) gains arising during the period	(1,961)	799
Reclassification adjustment for net realized gains included in net income	(99)	(1,003)
Reclassification adjustment for impairment loss included in net income		282
Net unrealized (losses) gains	(2,060)	78
Tax effect (1)	923	519
OCI, net of tax	(1,137)	597
Comprehensive income	\$ 1,950	\$ 3,831

(1) See Note 10 Federal Income Taxes for tax effect reconciliation. See notes to interim condensed consolidated financial statements.

Table of Contents**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

	Three Months Ended March 31	
	2013	2012
OPERATING ACTIVITIES		
Net income	\$ 3,087	\$ 3,234
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	300	461
Impairment of foreclosed assets	24	17
Depreciation	625	597
Amortization and impairment of originated mortgage servicing rights	204	121
Amortization of acquisition intangibles	57	66
Net amortization of AFS securities	578	528
AFS security impairment loss		282
Gain on sale of AFS securities	(99)	(1,003)
Net unrealized losses on trading securities	10	16
Net gain on sale of mortgage loans	(358)	(379)
Net unrealized gains on borrowings measured at fair value		(33)
Increase in cash value of corporate owned life insurance policies	(169)	(171)
Share-based payment awards under equity compensation plan	146	169
Origination of loans held for sale	(21,587)	(25,966)
Proceeds from loan sales	24,552	26,154
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities		291
Accrued interest receivable	(933)	(196)
Other assets	(385)	(195)
Accrued interest payable and other liabilities	(255)	(548)
Net cash provided by operating activities	5,797	3,445
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	960	2,284
Activity in AFS securities		
Sales	9,857	24,241
Maturities and calls	21,103	19,789
Purchases	(50,420)	(90,294)
Loan principal originations, net	4,531	6,510
Proceeds from sales of foreclosed assets	1,194	328
Purchases of premises and equipment	(610)	(1,025)
Proceeds from the redemption of corporate owned life insurance policies	123	
Net cash used in investing activities	(13,262)	(38,167)

Table of Contents**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

(Dollars in thousands)

	Three Months Ended	
	March 31	
	2013	2012
FINANCING ACTIVITIES		
Acceptances and withdrawals of deposits, net	12,093	30,962
Increase in other borrowed funds	(8,591)	(1,610)
Cash dividends paid on common stock	(1,609)	(1,515)
Proceeds from issuance of common stock	902	609
Common stock repurchased	(480)	(426)
Common stock purchased for deferred compensation obligations	(90)	(144)
Net cash provided by financing activities	2,225	27,876
DECREASE IN CASH AND CASH EQUIVALENTS		
Cash and cash equivalents at beginning of period	24,920	28,590
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 19,680	\$ 21,744
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	\$ 2,842	\$ 3,784
Federal income taxes paid	200	
SUPPLEMENTAL NONCASH INVESTING AND FINANCING INFORMATION:		
Transfers of loans to foreclosed assets	\$ 373	\$ 188
See notes to interim condensed consolidated financial statements.		

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

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

NOTE 2 COMPUTATION OF EARNINGS PER SHARE

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

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

	Three Months Ended March 31	
	2013	2012
Average number of common shares outstanding for basic calculation	7,677,009	7,594,257
Average potential effect of shares in the Directors Plan (1)	165,260	199,882
Average number of common shares outstanding used to calculate diluted earnings per common share	7,842,269	7,794,139
Net income	\$ 3,087	\$ 3,234
Earnings per share		
Basic	\$ 0.40	\$ 0.43
Diluted	\$ 0.39	\$ 0.41

(1) Exclusive of shares held in the Rabbi Trust

NOTE 3 RECENTLY ADOPTED ACCOUNTING STANDARDS UPDATE

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

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

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NOTE 4 TRADING SECURITIES

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

	March 31 2013	December 31 2012
States and political subdivisions	\$ 1,563	\$ 1,573

Included in the net trading losses of \$10 during the first three months of 2013 were \$10 of net unrealized trading losses on securities that were held in our trading portfolio as of March 31, 2013. Included in the net trading losses of \$16 during the first three months of 2012 were \$13 of net unrealized trading losses on securities that were held in the trading portfolio as of March 31, 2012.

Table of Contents**NOTE 5 AVAILABLE-FOR-SALE SECURITIES**

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

	Amortized Cost	March 31, 2013		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Government sponsored enterprises	\$ 25,427	\$ 73	\$ 9	\$ 25,491
States and political subdivisions	184,935	8,297	668	192,564
Auction rate money market preferred	3,200		109	3,091
Preferred stocks	6,800	66	158	6,708
Mortgage-backed securities	161,475	2,574	516	163,533
Collateralized mortgage obligations	127,564	2,208	228	129,544
Total	\$ 509,401	\$ 13,218	\$ 1,688	\$ 520,931

	Amortized Cost	December 31, 2012		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Government sponsored enterprises	\$ 25,668	\$ 108	\$	\$ 25,776
States and political subdivisions	174,118	9,190	565	182,743
Auction rate money market preferred	3,200		422	2,778
Preferred stocks	6,800		437	6,363
Mortgage-backed securities	152,256	3,199	110	155,345
Collateralized mortgage obligations	128,378	2,627		131,005
Total	\$ 490,420	\$ 15,124	\$ 1,534	\$ 504,010

The amortized cost and fair value of AFS securities by contractual maturity at March 31, 2013 are as follows:

	Due in One Year or Less	Maturing			After Ten Years	Securities With Variable Monthly Payments or Noncontractual Maturities	Total
		After One Year But Within Five Years	After Five Years But Within Ten Years				
Government sponsored enterprises	\$	\$ 72	\$ 25,355	\$	\$	\$ 25,427	
States and political subdivisions	14,237	37,026	90,728	42,944		184,935	
Auction rate money market preferred					3,200	3,200	
Preferred stocks					6,800	6,800	
Mortgage-backed securities					161,475	161,475	
Collateralized mortgage obligations					127,564	127,564	
Total amortized cost	\$ 14,237	\$ 37,098	\$ 116,083	\$ 42,944	\$ 299,039	\$ 509,401	

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Fair value	\$ 14,311	\$ 38,576	\$ 121,573	\$ 43,595	\$ 302,876	\$ 520,931
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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.

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

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

	March 31	
	2013	2012
Proceeds from sales of AFS securities	\$ 9,857	\$ 24,241
Gross realized gains	\$ 99	\$ 1,003
Applicable income tax expense	\$ 34	\$ 341

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

Information pertaining to AFS securities with gross unrealized losses at March 31, 2013 and December 31, 2012 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	March 31, 2013				
	Less Than Twelve Months		Twelve Months or More		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$ 9	\$ 4,990	\$	\$	\$ 9
States and political subdivisions	236	15,413	432	2,296	668
Auction rate money market preferred			109	3,091	109
Preferred stocks			158	3,642	158
Mortgage-backed securities	516	52,379			516
Collateralized mortgage obligations	228	36,974			228
Total	\$ 989	\$ 109,756	\$ 699	\$ 9,029	\$ 1,688

Number of securities in an unrealized loss position: **61** **6** **67**

	December 31, 2012				
	Less Than Twelve Months		Twelve Months or More		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
States and political subdivisions	\$ 80	\$ 5,019	\$ 485	\$ 2,352	\$ 565
Auction rate money market preferred			422	2,778	422
Preferred stocks			437	3,363	437
Mortgage-backed securities	110	25,499			110
Total	\$ 190	\$ 30,518	\$ 1,344	\$ 8,493	\$ 1,534

Number of securities in an unrealized loss position: **15** **6** **21**

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As of March 31, 2013 and December 31, 2012, we conducted an analysis to determine whether any securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?

Is the investment credit rating below investment grade?

Is it probable the issuer will be unable to pay the amount when due?

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

Has the duration of the investment been extended?

During the three month period ended March 31, 2012, we had one state issued student loan auction rate AFS investment security (which is included in states and political subdivisions) that was downgraded by Moody's from A3 to Caa3. As a result of this downgrade, we engaged the services of an independent investment valuation firm to estimate the amount of credit losses (if any) related to this particular issue as of March 31, 2012. The evaluation calculated a range of estimated credit losses utilizing two different bifurcation methods: 1) Estimated Cash Flow Method and 2) Credit Yield Analysis Method. The two methods were then weighted, with a higher weighting applied to the Estimated Cash Flow Method, to determine the estimated credit related impairment. As a result of this analysis we recognized an OTTI of \$282 in earnings in the first quarter of 2012.

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

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

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

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

	Three Months Ended March 31
	2013 2012

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Balance at beginning of period	\$ 282	\$
Additions to credit losses for which no previous OTTI was recognized		282
Balance at end of period	\$ 282	\$ 282

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

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NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES

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 and tourism, higher education, and general economic conditions of this region. Substantially all of the 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 allowance for loan losses. The interest on these loans is accounted for on the cash basis, until qualifying for return to accrual status. Loans are typically returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and states and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business; thus, these loans generally involve greater risk than other types of lending. We minimize our risk by limiting the amount of loans to any one borrower to \$12,500. Borrowers with credit needs of more than \$12,500 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan-to-value limits of less than 80%. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports as deemed necessary.

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

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 95% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan to value ratios in excess of 80%. Substantially all loans upon origination have a loan to value ratio of less than 80%. Underwriting criteria for residential real estate loans include: evaluation of the borrower's ability to make monthly payments, the value of the property securing the loan, ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower's gross income, all debt servicing does not exceed 36% of income, acceptable credit reports, verification of employment, income, and financial information. Appraisals are performed by independent appraisers and reviewed internally. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market automated underwriting system; loans in excess of \$400 require the approval of our Internal Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

Consumer loans include automobile loans, secured and unsecured personal loans, and overdraft protection related loans. Loans are amortized generally for a period of up to 6 years. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

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

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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 loans 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 four 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, 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					
	As of March 31, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$ 1,949	\$ 32	\$ 1,803	\$	\$	\$ 3,784
Collectively evaluated for impairment	4,948	289	1,831	732	325	8,125
Total	\$ 6,897	\$ 321	\$ 3,634	\$ 732	\$ 325	\$ 11,909
Loans						
Individually evaluated for impairment	\$ 13,815	\$ 787	\$ 10,740	\$ 72		\$ 25,414
Collectively evaluated for impairment	350,535	80,409	278,222	32,942		742,108
Total	\$ 364,350	\$ 81,196	\$ 288,962	\$ 33,014		\$ 767,522

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	Allowance for Loan Losses					
	Three Months Ended March 31, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2012	\$ 6,284	\$ 1,003	\$ 2,980	\$ 633	\$ 1,475	\$ 12,375
Loans charged-off	(449)		(115)	(91)		(655)
Recoveries	86		41	67		194
Provision for loan losses	(193)	(144)	796	16	(14)	461
March 31, 2012	\$ 5,728	\$ 859	\$ 3,702	\$ 625	\$ 1,461	\$ 12,375

	Allowance for Loan Losses and Recorded Investment in Loans					
	As of December 31, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$ 2,050	\$ 91	\$ 1,796	\$	\$	\$ 3,937
Collectively evaluated for impairment	4,812	316	1,831	666	374	7,999
Total	\$ 6,862	\$ 407	\$ 3,627	\$ 666	\$ 374	\$ 11,936
Loans						
Individually evaluated for impairment	\$ 14,456	\$ 723	\$ 10,704	\$ 75		\$ 25,958
Collectively evaluated for impairment	357,049	82,883	273,444	33,419		746,795
Total	\$ 371,505	\$ 83,606	\$ 284,148	\$ 33,494		\$ 772,753

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, 2013					
	Real Estate	Commercial Other	Total	Real Estate	Agricultural Other	Total
2 - High quality	\$ 22,840	\$ 17,230	\$ 40,070	\$ 2,783	\$ 3,326	\$ 6,109
3 - High satisfactory	89,670	25,198	114,868	19,426	9,828	29,254
4 - Low satisfactory	126,361	42,821	169,182	25,549	14,618	40,167
5 - Special mention	13,407	1,518	14,925	1,155	2,200	3,355
6 - Substandard	18,195	2,100	20,295	998	1,164	2,162
7 - Vulnerable	3,305	117	3,422			
8 - Doubtful	1,479	109	1,588		149	149
Total	\$ 275,257	\$ 89,093	\$ 364,350	\$ 49,911	\$ 31,285	\$ 81,196

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

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

1. EXCELLENT Substantially Risk Free

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

High liquidity, strong cash flow, low leverage.

Unquestioned ability to meet all obligations when due.

Experienced management, with management succession in place.

Secured by cash.

2. HIGH QUALITY Limited Risk

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

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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If loan is secured, collateral is of high quality and readily marketable.

Access to alternative financing.

Well defined primary and secondary source of repayment.

If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.

3. **HIGH SATISFACTORY Reasonable Risk**

Credit with satisfactory financial condition and further characterized by:

Working capital adequate to support operations.

Cash flow sufficient to pay debts as scheduled.

Management experience and depth appear favorable.

Loan performing according to terms.

If loan is secured, collateral is acceptable and loan is fully protected.

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4. LOW SATISFACTORY Acceptable Risk

Credit with bankable risks, although some signs of weaknesses are shown:

Would include most start-up businesses.

Occasional instances of trade slowness or repayment delinquency may have been 10-30 days slow within the past year.

Management's abilities are apparent, yet unproven.

Weakness in primary source of repayment with adequate secondary source of repayment.

Loan structure generally in accordance with policy.

If secured, loan collateral coverage is marginal.

Adequate cash flow to service debt, but coverage is low.

To be classified as less than satisfactory, only one of the following criteria must be met.

5. SPECIAL MENTION Criticized

Credit constitutes an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific loan:

Downward trend in sales, profit levels, and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

Loan delinquency (30-60 days) and overdrafts may occur.

Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Collateral or guaranty offers limited protection.

Negative debt service coverage, however the credit is well collateralized and payments are current.

6. SUBSTANDARD Classified

Credit where the borrower's current net worth, paying capacity, and value of the collateral pledged is inadequate. There is a distinct possibility that we will implement collection procedures if the loan deficiencies are not corrected. In addition, the following characteristics may apply:

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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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.

9. LOSS Charge-off

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Credits are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification is for charged-off loans but does not mean that the asset has absolutely no recovery or salvage value. These loans are further characterized by:

Liquidation or reorganization under bankruptcy, with poor prospects of collection.

Fraudulently overstated assets and/or earnings.

Collateral has marginal or no value.

Debtor cannot be located.

Over 120 days delinquent.

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

	March 31, 2013						
	Accruing Interest and Past Due:			Nonaccrual	Total Past Due and Nonaccrual	Current	Total
	30-59 Days	60-89 Days	90 Days or More				
Commercial							
Commercial real estate	\$ 2,692	\$ 457	\$ 106	\$ 4,178	\$ 7,433	\$ 267,824	\$ 275,257
Commercial other	354	43	30	215	642	88,451	89,093
Total commercial	3,046	500	136	4,393	8,075	356,275	364,350
Agricultural							
Agricultural real estate	212				212	49,699	49,911
Agricultural other	29	248		149	426	30,859	31,285
Total agricultural	241	248		149	638	80,558	81,196
Residential real estate							
Senior liens	1,311	242	219	1,590	3,362	231,688	235,050
Junior liens	185	121		99	405	14,946	15,351
Home equity lines of credit			125	185	310	38,251	38,561
Total residential real estate	1,496	363	344	1,874	4,077	284,885	288,962
Consumer							
Secured	180	7			187	28,085	28,272
Unsecured	23	2			25	4,717	4,742
Total consumer	203	9			212	32,802	33,014
Total	\$ 4,986	\$ 1,120	\$ 480	\$ 6,416	\$ 13,002	\$ 754,520	\$ 767,522

	December 31, 2012						
	Accruing Interest and Past Due:			Nonaccrual	Total Past Due and Nonaccrual	Current	Total
	30-59 Days	60-89 Days	90 Days or More				
Commercial							
Commercial real estate	\$ 1,304	\$ 161	\$ 63	\$ 2,544	\$ 4,072	\$ 271,548	\$ 275,620
Commercial other	606		40	2,294	2,940	92,945	95,885
Total commercial	1,910	161	103	4,838	7,012	364,493	371,505
Agricultural							
Agricultural real estate						49,393	49,393
Agricultural other	90			169	259	33,954	34,213
Total agricultural	90			169	259	83,347	83,606

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Residential real estate							
Senior liens	2,000	346	320	2,064	4,730	223,532	228,262
Junior liens	232			50	282	16,207	16,489
Home equity lines of credit	237			182	419	38,978	39,397
Total residential real estate	2,469	346	320	2,296	5,431	278,717	284,148
Consumer							
Secured	127	33	4		164	28,118	28,282
Unsecured	31	3	1		35	5,177	5,212
Total consumer	158	36	5		199	33,295	33,494
Total	\$ 4,627	\$ 543	\$ 428	\$ 7,303	\$ 12,901	\$ 759,852	\$ 772,753

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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.

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

	March 31, 2013			December 31, 2012		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$ 9,061	\$ 9,513	\$ 1,915	\$ 7,295	\$ 7,536	\$ 1,653
Commercial other	59	59	34	2,140	2,140	397
Agricultural real estate	91	91	32	91	91	32
Agricultural other				420	420	59
Residential real estate senior liens	10,457	11,705	1,784	10,450	11,654	1,783
Residential real estate junior liens	99	109	19	72	118	13
Total impaired loans with a valuation allowance	\$ 19,767	\$ 21,477	\$ 3,784	\$ 20,468	\$ 21,959	\$ 3,937
Impaired loans without a valuation allowance						
Commercial real estate	\$ 3,502	\$ 4,161		\$ 3,749	\$ 4,408	
Commercial other	1,193	1,353		1,272	1,433	
Agricultural real estate	133	133				
Agricultural other	563	683		212	332	
Residential real estate senior liens					18	
Home equity lines of credit	184	484		182	482	
Consumer secured	72	81		75	84	
Total impaired loans without a valuation allowance	\$ 5,647	\$ 6,895		\$ 5,490	\$ 6,757	
Impaired loans						
Commercial	\$ 13,815	\$ 15,086	\$ 1,949	\$ 14,456	\$ 15,517	\$ 2,050
Agricultural	787	907	32	723	843	91
Residential real estate	10,740	12,298	1,803	10,704	12,272	1,796
Consumer	72	81		75	84	

Total impaired loans	\$ 25,414	\$ 28,372	\$ 3,784	\$ 25,958	\$ 28,716	\$ 3,937
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	Three Months Ended			
	March 31, 2013		March 31, 2012	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$ 8,178	\$ 119	\$ 5,887	\$ 98
Commercial other	1,100	1	724	12
Agricultural real estate	91	1		
Agricultural other	210		2,466	37
Residential real estate senior liens	10,454	99	7,550	83
Residential real estate junior liens	86		190	2
Total impaired loans with a valuation allowance	\$ 20,119	\$ 220	\$ 16,817	\$ 232
Impaired loans without a valuation allowance				
Commercial real estate	\$ 3,626	\$ 73	\$ 7,808	\$ 67
Commercial other	1,233	40	1,305	31
Agricultural real estate	67	2	190	
Agricultural other	388	7	584	4
Residential real estate senior liens			1	
Home equity lines of credit	183	4	199	4
Consumer secured	74	1	100	2
Total impaired loans without a valuation allowance	\$ 5,571	\$ 127	\$ 10,187	\$ 108
Impaired loans				
Commercial	\$ 14,137	\$ 233	\$ 15,724	\$ 208
Agricultural	756	10	3,240	41
Residential real estate	10,723	103	7,940	89
Consumer	74	1	100	2
Total impaired loans	\$ 25,690	\$ 347	\$ 27,004	\$ 340

As of March 31, 2013 and December 31, 2012, we had committed to advance \$13 and \$9, respectively, in connection with impaired loans, which include TDR s.

Table of Contents**Troubled Debt Restructurings**

Loan modifications are considered to be TDR s 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).

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

	Loans Restructured in the Three Month Period ended March 31, 2013			Loans Restructured in the Three Month Period ended March 31, 2012		
	Number of Loans	Pre-	Post-	Number of Loans	Pre-	Post-
		Modification Recorded Investment	Modification Recorded Investment		Modification Recorded Investment	Modification Recorded Investment
Commercial other		\$	\$	21	\$ 4,586	\$ 4,586
Agricultural other	1	134	134	6	561	561
Residential real estate senior liens	8	799	783	5	721	721
Total	9	\$ 933	917	\$ 32	5,868	\$ 5,868

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	Loans Restructured in the Three Month Period Ended March 31, 2013				Loans Restructured in the Three Month Period Ended March 31, 2012			
	Below Market Interest Rate Pre- Amortization Period		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate Pre- Amortization Period		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Modification Recorded Investment	Number of Loans	Modification Recorded Investment	Number of Loans	Modification Recorded Investment	Number of Loans	Modification Recorded Investment
Commercial other		\$		\$	21	\$ 4,586		\$
Agricultural other	1	134			6	561		
Residential real estate senior liens	3	209	5	590				
Residential real estate junior liens							5	721
Total	4	\$ 343	5	\$ 590	27	\$ 5,147	5	\$ 721

We did not restructure any loans through the forbearance of principal or accrued interest in the three month periods ended March 31, 2013 or 2012.

Based on our historical loss experience, losses associated with TDR s are not significantly different than other impaired loans within the same loan segment. As such, TDR s, including TDR s 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.

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Following is a summary of loans that defaulted in the three month periods ended March 31, 2013 and 2012, which were modified within 12 months prior to the default date:

	Three Months Ended March 31, 2013				Three Months Ended March 31, 2012			
	Number of Loans	Pre-Default Recorded Investment	Charge-Off Recorded Upon Default	Post-Default Recorded Investment	Number of Loans	Pre-Default Recorded Investment	Charge-Off Recorded Upon Default	Post-Default Recorded Investment
Commercial other		\$	\$	\$	1	\$ 82	\$ 42	\$ 40
Residential real estate senior liens					1	47	43	4
Consumer secured	1	8	8					
Total	1	\$ 8	\$ 8	\$	2	\$ 129	\$ 85	\$ 44

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

	March 31 2013	December 31 2012
Troubled debt restructurings	\$ 19,402	\$ 19,355

NOTE 7 EQUITY SECURITIES WITHOUT READILY DETERMINABLE FAIR VALUES

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

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

	March 31 2013	December 31 2012
FHLB Stock	\$ 7,850	\$ 7,850
Investment in Corporate Settlement Solutions	7,050	7,040
FRB Stock	1,879	1,879
Investment in Valley Financial Corporation	1,000	1,000
Other	344	349
Total	\$ 18,123	\$ 18,118

NOTE 8 BORROWED FUNDS

Borrowed funds consist of the following obligations as of:

	March 31 2013	December 31 2012
FHLB advances	\$ 152,000	\$ 152,000
Securities sold under agreements to repurchase without stated maturity dates	64,122	66,147
Securities sold under agreements to repurchase with stated maturity dates	16,288	16,284
Federal funds purchased		6,570

Total	\$ 232,410	\$ 241,001
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The FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans and certain mortgage-backed securities and collateralized mortgage obligations. Advances are also secured by our holdings of FHLB stock. As of March 31, 2013, we had the ability to borrow up to an additional \$116,058, based on assets pledged as collateral. During the first quarter of 2013 and 2012, we reduced funding costs by modifying the term of \$30,000 and \$60,000, respectively, of FHLB advances.

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

	March 31 2013		December 31 2012	
	Amount	Rate	Amount	Rate
Fixed rate advances due 2014	\$ 10,000	0.48%	\$ 10,000	0.48%
Fixed rate advances due 2015	32,000	0.84%	42,000	1.12%
Fixed rate advances due 2016	10,000	2.15%	10,000	2.15%
Fixed rate advances due 2017	30,000	1.95%	40,000	2.15%
Fixed rate advances due 2018	30,000	2.49%	20,000	2.86%
Fixed rate advances due 2019	20,000	3.11%	20,000	3.73%
Fixed rate advances due 2020	10,000	1.98%	10,000	1.98%
Fixed rate advances due 2023	10,000	3.90%		
Total	\$ 152,000	2.02%	\$ 152,000	2.05%

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$132,414 and \$143,322 at March 31, 2013 and December 31, 2012, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

The following table provides a summary of short term borrowings for the three month periods ended March 31:

	2013			2012		
	Maximum Month End Balance	Quarter to Date Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Quarter to Date Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$ 64,527	\$ 63,573	0.15%	\$ 56,923	\$ 56,172	0.23%
Federal funds purchased	4,400	1,215	0.50%		71	0.48%

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

	March 31 2013	December 31 2012
Pledged to secure borrowed funds	\$ 310,742	\$ 308,628
Pledged to secure repurchase agreements	132,414	143,322
Pledged for public deposits and for other purposes necessary or required by law	24,988	22,955
Total	\$ 468,144	\$ 474,905

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

NOTE 9 OTHER NONINTEREST EXPENSES

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

	Three Months Ended March 31	
	2013	2012
FDIC insurance premiums	\$ 272	\$ 215
Marketing and community relations	242	494
Directors fees	199	210
Audit fees	139	176
Education and travel	122	127
Postage and freight	99	101
Printing and supplies	86	109
Consulting fees	72	187
All other	661	640
Total other	\$ 1,892	\$ 2,259

NOTE 10 FEDERAL INCOME TAXES

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

	Three Months Ended March 31	
	2013	2012
Income taxes at 34% statutory rate	\$ 1,245	\$ 1,362
Effect of nontaxable income		
Interest income on tax exempt municipal securities	(401)	(391)
Earnings on corporate owned life insurance policies	(57)	(58)
Other	(228)	(151)
Total effect of nontaxable income	(686)	(600)
Effect of nondeductible expenses	17	11
Federal income tax expense	\$ 576	\$ 773

Included in OCI for the three month periods ended March 31, 2013 and 2012 are changes in unrealized holding gains, related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

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A summary of OCI follows for the:

	Three Months Ended					
	March 31, 2013			March 31, 2012		
	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	Total
Unrealized gains arising during the period	\$ 658	\$ (2,619)	\$ (1,961)	\$ 1,604	\$ (805)	\$ 799
Reclassification adjustment for net realized gains included in net income		(99)	(99)		(1,003)	(1,003)
Reclassification adjustment for impairment loss included in net income					282	282
Net unrealized gains (losses)	658	(2,718)	(2,060)	1,604	(1,526)	78
Tax effect		923	923		519	519
Unrealized gains (losses), net of tax	\$ 658	\$ (1,795)	\$ (1,137)	\$ 1,604	\$ (1,007)	\$ 597

NOTE 11 DEFINED BENEFIT PENSION PLAN

We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. As a result of the curtailment, future salary increases are no longer considered and plan benefits are based on years of service and the individual employee's five highest consecutive years of compensation out of the last ten years of service through March 1, 2007. We contributed \$215 and \$135 to the plan during the three month period ended March 31, 2013 and 2012, respectively. We do not anticipate any further contributions to the plan in 2013.

Following are the components of net periodic benefit cost for the three month periods ended March 31:

	2013	2012
Interest cost on PBO	\$ 113	\$ 118
Expected return on plan assets	(143)	(127)
Amortization of unrecognized actuarial net loss	83	73
Net periodic benefit cost	\$ 53	\$ 64

NOTE 12 FAIR VALUE

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

Cash and demand deposits due from banks: 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.

Investment securities: Investment 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

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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 available-for-sale are based on what price secondary markets are currently offering for portfolios with similar characteristics. As such, we classify loans subject to nonrecurring fair value adjustments as Level 2.

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

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

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, management utilizes independent appraisals, broker price opinions, or internal evaluations. These valuations are reviewed 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.

Impaired loans where an allowance is established based on the net realizable value of collateral require classification in the fair value hierarchy. Due to the inherent level of estimation in the valuation process, we record impaired loans as nonrecurring Level 3.

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

Valuation Techniques	March 31, 2013 Fair Value	Unobservable Input	Range
Discounted cash flow		Duration of cash flows	11-120 Months
		Reduction in interest rate from original loan terms	5.00% - 6.63%
	\$ 8,752	Discount applied to	
		<u>collateral appraisal:</u>	
		Real Estate	20% - 30%
		Equipment	50%
Discounted appraisal value	\$ 12,878	Livestock	50%
		Cash crop inventory	50%
		Other inventory	75%
		Accounts receivable	75%

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Valuation Techniques	December 31, 2012 Fair Value	Unobservable Input	Range
Discounted cash flow		Duration of cash flows	14-120 Months
		Reduction in interest rate from original loan terms	5.00% - 6.25%
	\$ 10,522	Discount applied to collateral appraisal:	
		Real Estate	20% - 30%
		Equipment	50%
Discounted appraisal value	\$ 11,499	Livestock	50%
		Cash crop inventory	50%
		Other inventory	75%
		Accounts receivable	75%

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

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

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 and Valley Financial Corporation. The investment in Corporate Settlement Solutions, a title insurance company, was made in the 1st quarter 2007. The Corporation is not the managing entity of Corporate Settlement Solutions, LLC, and accounts for its investment in that entity under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a de novo bank that opened in 2005. The Corporation made investments in Valley Financial Corporation in 2004 and in 2007.

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

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

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

Valuation Technique	March 31, 2013 Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
Discounted appraisal value	\$ 1,173	Real Estate	20% - 30%
Valuation Technique	December 31, 2012 Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
Discounted appraisal value	\$ 2,018	Real Estate	20% - 30%

Originated mortgage servicing rights: OMSR is subject to impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used for impairment testing. If the valuation model reflects a value less than the carrying value, originated mortgage servicing rights are adjusted to fair value through a valuation allowance as determined by the model. As such, we classify loan servicing rights 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, 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, other borrowed funds are classified as Level 2.

Commitments to extend credit, standby letters of credit and undisbursed loans: Fair values for off balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into consideration the remaining terms of the agreements and the counterparties' credit standings. As we do not charge fees for lending commitments outstanding, it is not practicable to estimate the fair value of these instruments.

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. Furthermore, 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.

Table of Contents**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.

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, 2013		
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
ASSETS					
Cash and demand deposits due from banks	\$ 19,680	\$ 19,680	\$ 19,680	\$	\$
Certificates of deposit held in other financial institutions	3,505	3,511		3,511	
Mortgage loans available-for-sale	1,026	1,092		1,092	
Total loans	767,522	778,334			778,334
Less allowance for loan losses	(11,909)	(11,909)			(11,909)
Net loans	755,613	766,425			766,425
Accrued interest receivable	6,160	6,160	6,160		
Equity securities without readily determinable fair values (1)	18,123	18,123			
Originated mortgage servicing rights	2,293	2,293		2,293	
LIABILITIES					
Deposits without stated maturities	569,258	569,258	569,258		
Deposits with stated maturities	460,502	467,812		467,812	
Borrowed funds	232,410	239,425		239,425	
Accrued interest payable	730	730	730		

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	Carrying Value	Estimated Fair Value	December 31, 2012		
			(Level 1)	(Level 2)	(Level 3)
ASSETS					
Cash and demand deposits due from banks	\$ 24,920	\$ 24,920	\$ 24,920	\$	\$
Certificates of deposit held in other financial institutions	4,465	4,475		4,475	
Mortgage loans available-for-sale	3,633	3,680		3,680	
Total loans	772,753	784,964			784,964
Less allowance for loan losses	(11,936)	(11,936)			(11,936)
Net loans	760,817	773,028			773,028
Accrued interest receivable	5,227	5,227	5,227		
Equity securities without readily determinable fair values (1)	18,118	18,118			
Originated mortgage servicing rights	2,285	2,285		2,285	
LIABILITIES					
Deposits without stated maturities	553,332	553,332	553,332		
Deposits with stated maturities	464,335	472,630		472,630	
Borrowed funds	241,001	248,822		248,822	
Accrued interest payable	751	751	751		

- (1) Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under 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.

Financial Instruments Recorded at Fair Value

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

Description	Total	March 31, 2013			Total	December 31, 2012		
		(Level 1)	(Level 2)	(Level 3)		(Level 1)	(Level 2)	(Level 3)
Recurring items								
Trading securities								
States and political subdivisions	1,563		1,563		\$ 1,573		1,573	
AFS Securities								
Government-sponsored enterprises	25,491		25,491		25,776		25,776	
States and political subdivisions	192,564		192,564		182,743		182,743	
Auction rate money market preferred	3,091		3,091		2,778		2,778	
Preferred stocks	6,708	6,708			6,363	6,363		
Mortgage-backed securities	163,533		163,533		155,345		155,345	
Collateralized mortgage obligations	129,544		129,544		131,005		131,005	
Total AFS Securities	520,931	6,708	514,223		504,010	6,363	497,647	
Nonrecurring items								
Impaired loans (net of the allowance for loan losses)								
	21,441			21,441	22,021			22,021
OMSR	2,293		2,293		2,285		2,285	
Foreclosed assets	1,173			1,173	2,018			2,018
	547,401	6,708	518,079	22,614	531,907	6,363	501,505	24,039
Percent of assets and liabilities measured at fair value								
		1.23%	94.64%	4.13%		1.20%	94.28%	4.52%

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The changes in fair value of assets and liabilities recorded at fair value through earnings on a recurring basis and changes in assets and liabilities recorded at fair value on a nonrecurring basis, for which an impairment, or reduction of an impairment, was recognized in the:

Description	Three Months Ended March 31					
	2013			2012		
	Trading Losses	Other Gains and (Losses)	Total	Trading Losses	Other Gains and (Losses)	Total
Recurring items						
Trading securities	\$ (10)	\$	\$ (10)	\$ (16)	\$	\$ (16)
Borrowed funds					33	33
Nonrecurring items						
Foreclosed assets		(24)	(24)		(17)	(17)
OMSR		17	17		74	74
Total	\$ (10)	\$ (7)	\$ (17)	\$ (16)	\$ 90	\$ 74

NOTE 13 ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes in accumulated other comprehensive income by component for the three months ended:

	Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan	Total
Balance, January 1, 2012	\$ 5,942	\$ (3,453)	\$ 2,489
OCI before reclassifications	799		799
Amounts reclassified from AOCI	(721)		(721)
Subtotal	78		78
Tax effect	519		519
Other comprehensive loss, net of tax	597		597
Balance, March 31, 2012	\$ 6,539	\$ (3,453)	\$ 3,086
Balance, January 1, 2013	\$ 8,678	\$ (3,671)	\$ 5,007
OCI before reclassifications	(1,961)		(1,961)
Amounts reclassified from AOCI	(99)		(99)
Subtotal	(2,060)		(2,060)
Tax effect	923		923
OCI, net of tax	(1,137)		(1,137)
Balance, March 31, 2013	\$ 7,541	\$ (3,671)	\$ 3,870

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The following table details reclassification adjustments and the related affected line items on our interim condensed consolidated statements of income for the three month periods ended March 31:

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

NOTE 14 PARENT COMPANY ONLY FINANCIAL INFORMATION

Interim Condensed Balance Sheets	March 31 2013	December 31 2012
ASSETS		
Cash on deposit at the Bank	\$ 887	\$ 332
AFS Securities	4,000	3,939
Investments in subsidiaries	116,420	115,781
Premises and equipment	2,091	2,041
Other assets	52,541	52,398
TOTAL ASSETS	\$ 175,939	\$ 174,491
LIABILITIES AND SHAREHOLDERS EQUITY		
Other liabilities	\$ 10,631	\$ 10,002
Shareholders equity	165,308	164,489
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 175,939	\$ 174,491

Interim Condensed Statements of Income	Three Months Ended March 31	
	2013	2012
Income		
Dividends from subsidiaries	\$ 1,500	\$ 1,625