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

FORM 10-Q

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended June 30, 2013
or
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period from to
Commission File Number: 0-18415

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes ý No
APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
Common Stock no par value, 7,711,460 as of 7/25/2013

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

GAAP: U.S. generally accepted accounting principles	XBRL: eXtensible Business Reporting Language

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PART I – FINANCIAL INFORMATION
Item 1 – Interim Condensed Consolidated Financial Statements (Unaudited)

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

	June 30 2013	December 31 2012
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$21,289	$22,634
Interest bearing balances due from banks	77	2,286
Total cash and cash equivalents	21,366	24,920
Certificates of deposit held in other financial institutions	1,810	4,465
Trading securities	950	1,573
AFS securities (amortized cost of $499,891 in 2013 and $490,420 in 2012)	499,424	504,010
Mortgage loans AFS	743	3,633
Loans		
Commercial	389,044	371,505
Agricultural	87,516	83,606
Residential real estate	293,158	284,148
Consumer	33,734	33,494
Total loans	803,452	772,753
Less allowance for loan and lease losses	11,700	11,936
Net loans	791,752	760,817
Premises and equipment	25,852	25,787
Corporate owned life insurance policies	24,101	22,773
Accrued interest receivable	5,232	5,227
Equity securities without readily determinable fair values	18,242	18,118
Goodwill and other intangible assets	46,418	46,532
Other assets	15,525	12,784
TOTAL ASSETS	$1,451,415	$1,430,639
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing	$139,942	$143,735
NOW accounts	173,184	181,259
Certificates of deposit under $100 and other savings	468,094	455,546
Certificates of deposit over $100	240,204	237,127
Total deposits	1,021,424	1,017,667
Borrowed funds	262,460	241,001
Accrued interest payable and other liabilities	8,243	7,482
Total liabilities	1,292,127	1,266,150
Shareholders' equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,703,589 shares (including 4,742 shares held in the Rabbi Trust) in 2013 and 7,671,846 shares (including 5,130 shares held in the Rabbi Trust) in 2012	137,321	136,580
Shares to be issued for deferred compensation obligations	3,871	3,734
Retained earnings	22,244	19,168
Accumulated other comprehensive income (loss)	(4,148)	5,007
Total shareholders' equity	159,288	164,489

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

See notes to interim condensed consolidated financial statements.

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

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

See notes to interim condensed consolidated financial statements.

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

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

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

See notes to interim condensed consolidated financial statements.

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

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2012	7,589,226	$134,734	$ 4,524	$13,036	$ 2,489	$154,783
Comprehensive income (loss)	—	—	—	6,238	1,471	7,709
Issuance of common stock	54,900	1,322	—	—	—	1,322
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	95	(95)	—	—	—
Share-based payment awards under equity compensation plan	—	—	295	—	—	295
Common stock purchased for deferred compensation obligations	—	(225)	—	—	—	(225)
Common stock repurchased pursuant to publicly announced repurchase plan	(41,581)	(995)	—	—	—	(995)
Cash dividends ($0.40 per share)	—	—	—	(3,034)	—	(3,034)
Balance, June 30, 2012	7,602,545	$134,931	$ 4,724	$16,240	$ 3,960	$159,855
Balance, January 1, 2013	7,671,846	$136,580	$ 3,734	$19,168	$ 5,007	$164,489
Comprehensive income (loss)	—	—	—	6,300	(9,155)	(2,855)
Issuance of common stock	77,568	1,900	—	—	—	1,900
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	121	(121)	—	—	—
Share-based payment awards under equity compensation plan	—	—	258	—	—	258
Common stock purchased for deferred compensation obligations	—	(166)	—	—	—	(166)
Common stock repurchased pursuant to publicly announced repurchase plan	(45,825)	(1,114)	—	—	—	(1,114)
Cash dividends ($0.42 per share)	—	—	—	(3,224)	—	(3,224)
Balance, June 30, 2013	7,703,589	$137,321	$ 3,871	$22,244	$ (4,148)	$159,288

See notes to interim condensed consolidated financial statements.

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

	Six Months Ended June 30	
	2013	2012
OPERATING ACTIVITIES		
Net income	$6,300	$6,238
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	515	900
Impairment of foreclosed assets	92	17
Depreciation	1,249	1,195
Amortization and impairment of OMSRs	210	287
Amortization of acquisition intangibles	114	133
Net amortization of AFS securities	1,131	1,076
AFS security impairment loss	—	282
(Gain) loss on sale of AFS securities	(99)	(1,003)
Net unrealized (gains) losses on trading securities	18	32
Net gain on sale of mortgage loans	(607)	(658)
Net unrealized (gains) losses on borrowings measured at fair value	—	(33)
Increase in cash value of corporate owned life insurance policies	(359)	(348)
Share-based payment awards under equity compensation plan	258	295
Origination of loans held-for-sale	(35,014)	(46,386)
Proceeds from loan sales	38,511	47,902
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	605	2,680
Accrued interest receivable	(5)	631
Other assets	914	(1,132)
Accrued interest payable and other liabilities	761	(161)
Net cash provided by (used in) operating activities	14,594	11,947
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	2,655	2,044
Activity in AFS securities		
Sales	9,857	24,241
Maturities and calls	46,780	37,922
Purchases	(67,140)	(112,835)
Loan principal originations, net	(32,185)	(6,768)
Proceeds from sales of foreclosed assets	1,556	647
Purchases of premises and equipment	(1,314)	(1,298)
Purchases of corporate owned life insurance policies	(1,092)	—
Proceeds from redemption of corporate owned life insurance policies	123	—
Net cash provided by (used in) investing activities	(40,760)	(56,047)

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

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

See notes to interim condensed consolidated financial statements.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands except per share amounts)

Note 1 – Basis of Presentation

As used in these notes as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to "Isabella," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank refers to Isabella Bank Corporation's subsidiary, Isabella Bank.

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. For further information, refer to the consolidated financial statements and footnotes thereto included in our annual report for the year ended December 31, 2012.

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

Note 2 – Computation of Earnings Per Share

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

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

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

(1) Exclusive of shares held in the Rabbi Trust

Note 3 – Recently Adopted Accounting Standards Update

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

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

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Note 4 – Trading Securities

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

	June 30 2013	December 31 2012
States and political subdivisions	$950	$1,573

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

Note 5 – AFS Securities

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

	June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$25,184	$16	$951	$24,249
States and political subdivisions	184,157	5,567	2,422	187,302
Auction rate money market preferred	3,200	—	257	2,943
Preferred stocks	6,800	66	307	6,559
Mortgage-backed securities	151,530	862	2,985	149,407
Collateralized mortgage obligations	129,020	1,445	1,501	128,964
Total	$499,891	$7,956	$8,423	$499,424

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

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

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

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

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

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

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

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

Information pertaining to AFS securities with gross unrealized losses at June 30, 2013 and December 31, 2012 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

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

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

As of June 30, 2013 and December 31, 2012, we conducted an analysis to determine whether any securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

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

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

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

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

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

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

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

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

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

Note 6 – Loans and ALLL

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

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

The accrual of interest on commercial, agricultural, and residential real estate loans is typically discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. The interest on these loans is accounted for on the cash basis, until qualifying for return to accrual status. Loans are typically returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

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

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

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 95% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan-to-value ratios in excess of 80%. Substantially all loans upon origination have a loan to value ratio of less than 80%. Underwriting criteria for residential real estate loans include: evaluation of the borrower's ability to make monthly payments,

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the value of the property securing the loan, ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower's gross income, all debt servicing does not exceed 36% of income, acceptable credit reports, verification of employment, income, and financial information. Appraisals are performed by independent appraisers and reviewed internally. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market automated underwriting system; loans in excess of $400 require the approval of our Internal Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

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

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

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

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

A summary of changes in the ALLL and the recorded investment in loans by segments follows:

	Allowance for Loan Losses Three Months Ended June 30, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2013	$6,897	$321	$3,634	$732	$325	$11,909
Loans charged-off	(234)	—	(397)	(88)	—	(719)
Recoveries	166	—	61	68	—	295
Provision for loan losses	(357)	14	378	(65)	245	215
June 30, 2013	$6,472	$335	$3,676	$647	$570	$11,700

	Allowance for Loan Losses Six Months Ended June 30, 2013					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2013	$6,862	$407	$3,627	$666	$374	$11,936
Loans charged-off	(445)	—	(587)	(209)	—	(1,241)
Recoveries	223	—	114	153	—	490
Provision for loan losses	(168)	(72)	522	37	196	515
June 30, 2013	$6,472	$335	$3,676	$647	$570	$11,700

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Allowance for Loan Losses and Recorded Investment in Loans
June 30, 2013

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$1,642	$31	$1,744	$—	$—	$3,417
Collectively evaluated for impairment	4,830	304	1,932	647	570	8,283
Total	$6,472	$335	$3,676	$647	$570	$11,700
Loans						
Individually evaluated for impairment	$13,639	$576	$10,720	$54		$24,989
Collectively evaluated for impairment	375,405	86,940	282,438	33,680		778,463
Total	$389,044	$87,516	$293,158	$33,734		$803,452

Allowance for Loan Losses
Three Months Ended June 30, 2012

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2012	$5,728	$859	$3,702	$625	$1,461	$12,375
Loans charged-off	(237)	—	(238)	(146)	—	(621)
Recoveries	42	—	20	63	—	125
Provision for loan losses	475	(426)	185	125	80	439
June 30, 2012	$6,008	$433	$3,669	$667	$1,541	$12,318

Allowance for Loan Losses
Six Months Ended June 30, 2012

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2012	$6,284	$1,003	$2,980	$633	$1,475	$12,375
Loans charged-off	(686)	—	(353)	(237)	—	(1,276)
Recoveries	128	—	61	130	—	319
Provision for loan losses	282	(570)	981	141	66	900
June 30, 2012	$6,008	$433	$3,669	$667	$1,541	$12,318

Allowance for Loan Losses and Recorded Investment in Loans
December 31, 2012

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$2,050	$91	$1,796	$—	$—	$3,937
Collectively evaluated for impairment	4,812	316	1,831	666	374	7,999
Total	$6,862	$407	$3,627	$666	$374	$11,936
Loans						
Individually evaluated for impairment	$14,456	$723	$10,704	$75		$25,958
Collectively evaluated for impairment	357,049	82,883	273,444	33,419		746,795

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

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

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

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

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

1. EXCELLENT – Substantially Risk Free

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

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

2. HIGH QUALITY – Limited Risk

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

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

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3. HIGH SATISFACTORY – Reasonable Risk
Credit with satisfactory financial condition and further characterized by:
- Working capital adequate to support operations.
- Cash flow sufficient to pay debts as scheduled.
- Management experience and depth appear favorable.
- Loan performing according to terms.
- If loan is secured, collateral is acceptable and loan is fully protected.

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

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

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

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

- Borrower is uncooperative with loan officer.

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7. VULNERABLE – Classified
Credit is considered "Substandard" and warrants placing on nonaccrual. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:
- Insufficient cash flow to service debt.
- Minimal or no payments being received.
- Limited options available to avoid the collection process.
- Transition status, expect action will take place to collect loan without immediate progress being made.

8. DOUBTFUL – Workout
Credit has all the weaknesses inherent in a "Substandard" loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:
- Normal operations are severely diminished or have ceased.
- Seriously impaired cash flow.
- Original repayment terms materially altered.
- Secondary source of repayment is inadequate.
- Survivability as a "going concern" is impossible.
- Collection process has begun.
- Bankruptcy petition has been filed.
- Judgments have been filed.
- Portion of the loan balance has been charged-off.

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

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

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

Impaired Loans

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

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

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

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

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

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

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

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

Troubled Debt Restructurings

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

Typical concessions granted include, but are not limited to:

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

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

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

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

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	7	$ 3,153	$ 2,957	7	$ 3,153	$ 2,957
Agricultural other	—	—	—	1	134	134
Residential real estate senior liens	7	635	635	15	1,435	1,418
Total	14	$ 3,788	$ 3,592	23	$ 4,722	$ 4,509

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	5	$ 305	$ 305	26	$ 4,891	$ 4,891
Agricultural other	—	—	—	6	561	561
Residential real estate senior liens	7	684	684	12	1,405	1,405
Total	12	$ 989	$ 989	44	$ 6,857	$ 6,857

	Three Months Ended June 30, 2013				Six Months Ended June 30, 2013			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	3	$ 1,357	4	$ 1,796	3	$ 1,357	4	$ 1,796
Agricultural other	—	—	—	—	1	134	—	—
Residential real estate senior liens	4	414	3	221	7	625	8	810
Total	7	$ 1,771	7	$ 2,017	11	$ 2,116	12	$ 2,606

	Three Months Ended June 30, 2012				Six Months Ended June 30, 2012			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	3	$ 160	2	$ 145	24	$ 4,746	2	$ 145
Agricultural other	—	—	—	—	6	561	—	—
Residential real estate senior liens	4	324	3	360	4	324	8	1,081
Total	7	$ 484	5	$ 505	34	$ 5,631	10	$ 1,226

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

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

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

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

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

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

	June 30 2013	December 31 2012
TDRs	$ 20,857	$ 19,355

Note 7 – Equity Securities Without Readily Determinable Fair Values

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

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

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

Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

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

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

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

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

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of $122,362 and $143,322 at June 30, 2013 and December 31, 2012, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

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

	Three Months Ended June 30, 2013			Three Months Ended June 30, 2012		
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	$71,668	$69,692	0.15 %	$58,584	$58,045	0.20 %
Federal funds purchased	13,700	6,022	0.57 %	17,900	7,025	0.47 %

	Six Months Ended June 30, 2013			Six Months Ended June 30, 2012		
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	$71,668	$65,363	0.15 %	$58,584	$55,436	0.11 %
Federal funds purchased	13,700	3,646	0.56 %	17,900	3,552	0.23 %

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

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

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

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Note 9 – Other Noninterest Expenses

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

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

Note 10 – Federal Income Taxes

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

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

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

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A summary of OCI follows for the:

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

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

Note 11 – Defined Benefit Pension Plan

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

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

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

Note 12 – Fair Value

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

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

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

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

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

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

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

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

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

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

	December 31, 2012		
Valuation Techniques	Fair Value	Unobservable Input	Range
Discounted cash flow	$8,726	Duration of cash flows:	14-120 Months
		Reduction in interest rate from original loan terms:	5.00% - 6.25%