ISABELLA BANK CORP
Form 10-Q
May 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended March 31, 2012

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.

x 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).

x 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	x
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 x 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, 7,600,622 as of April 24, 2012

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ISABELLA BANK CORPORATION

QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

Item 1 Interim Condensed Consolidated Financial Statements (Unaudited)

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	March 31, 2012	December 31 2011
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$ 17,793	$ 24,514
Interest bearing balances due from banks	3,951	4,076
Total cash and cash equivalents	**21,744**	**28,590**
Certificates of deposit held in other financial institutions	6,640	8,924
Trading securities	4,403	4,710
Available-for-sale securities (amortized cost of $461,071 in 2012 and $414,614 in 2011)	471,655	425,120
Mortgage loans available-for-sale	3,396	3,205
Loans		
Agricultural	76,681	74,645
Commercial	361,325	365,714
Consumer	30,459	31,572
Residential real estate	274,667	278,360
Total loans	**743,132**	**750,291**
Less allowance for loan losses	12,375	12,375
Net loans	**730,757**	**737,916**
Premises and equipment	25,054	24,626
Corporate owned life insurance	22,246	22,075
Accrued interest receivable	6,044	5,848
Equity securities without readily determinable fair values	17,220	17,189
Goodwill and other intangible assets	46,726	46,792
Other assets	13,335	12,930
TOTAL ASSETS	**$ 1,369,220**	**$ 1,337,925**
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	$ 122,862	$ 119,072
NOW accounts	170,701	163,653
Certificates of deposit under $100 and other savings	460,815	440,123
Certificates of deposit over $100	234,748	235,316
Total deposits	**989,126**	**958,164**
Borrowed funds ($0 in 2012 and $5,242 in 2011 at fair value)	214,493	216,136
Accrued interest payable and other liabilities	8,294	8,842
Total liabilities	**1,211,913**	**1,183,142**

Shareholders equity		
Common stock no par value		
15,000,000 shares authorized; issued and outstanding 7,596,772 shares (including 16,686 shares held in a Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011	134,868	134,734
Shares to be issued for deferred compensation obligations	4,598	4,524
Retained earnings	14,755	13,036
Accumulated other comprehensive income	3,086	2,489
Total shareholders equity	**157,307**	**154,783**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,369,220**	**$ 1,337,925**

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 data)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Totals
Balance, January 1, 2011	**7,550,074**	**$ 133,592**	**$ 4,682**	**$ 8,596**	**$ (1,709)**	**$ 145,161**
Comprehensive income				2,316	1,358	3,674
Issuance of common stock	30,531	728				728
Common stock issued for deferred compensation obligations	12,037	215	(182)			33
Share based payment awards under equity compensation plan			180			180
Common stock purchased for deferred compensation obligations		(164)				(164)
Common stock repurchased pursuant to publicly announced repurchase plan	(31,739)	(577)				(577)
Cash dividends ($0.19 per share)				(1,434)		(1,434)
Balance, March 31, 2011	**7,560,903**	**$ 133,794**	**$ 4,680**	**$ 9,478**	**$ (351)**	**$ 147,601**
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**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands except per share data)

	Three Months Ended March 31	
	2012	2011
Interest income		
Loans, including fees	$ 10,940	$ 11,361
Investment securities		
Taxable	1,889	1,513
Nontaxable	1,204	1,179
Trading account securities	42	51
Federal funds sold and other	129	134
Total interest income	**14,204**	**14,238**
Interest expense		
Deposits	2,512	2,785
Borrowings	1,192	1,268
Total interest expense	**3,704**	**4,053**
Net interest income	**10,500**	**10,185**
Provision for loan losses	461	817
Net interest income after provision for loan losses	**10,039**	**9,368**
Noninterest income		
Service charges and fees	1,629	1,476
Gain on sale of mortgage loans	379	129
Net loss on trading securities	(16)	(19)
Net gain on borrowings measured at fair value	33	80
Gain on sale of available-for-sale investment securities	1,003	
Other	513	282
Total noninterest income	**3,541**	**1,948**
Noninterest expenses		
Compensation and benefits	5,301	5,005
Occupancy	641	646
Furniture and equipment	1,090	1,106
Available-for-sale impairment loss		
Total other-than-temporary impairment loss	486	
Portion of loss reported in other comprehensive income	(204)	
Net available-for-sale impairment loss	282	
Other	2,259	1,830
Total noninterest expenses	**9,573**	**8,587**
Income before federal income tax expense	**4,007**	**2,729**
Federal income tax expense	773	413

NET INCOME	**$ 3,234**	**$ 2,316**
Earnings per share		
Basic	**$ 0.43**	**$ 0.31**
Diluted	**$ 0.41**	**$ 0.30**
Cash dividends per basic share	**$ 0.20**	**$ 0.19**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

	Three Months Ended March 31	
	2012	2011
Net income	**$ 3,234**	**$ 2,316**
Unrealized holding gains on available-for-sale securities:		
Unrealized holding gains arising during the period	799	1,753
Reclassification adjustment for net realized gains included in net income	(1,003)	
Reclassification adjustment for impairment loss included in net income	282	
Net unrealized gains	78	1,753
Tax effect	519	(395)
Other comprehensive income, net of tax	597	1,358
COMPREHENSIVE INCOME	**$ 3,831**	**$ 3,674**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Three Months Ended March 31 2012	Three Months Ended March 31 2011
OPERATING ACTIVITIES		
Net income	$ 3,234	$ 2,316
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	461	817
Impairment of foreclosed assets	17	10
Depreciation	597	647
Amortization and impairment of originated mortgage servicing rights	121	89
Amortization of acquisition intangibles	66	76
Net amortization of available-for-sale securities	528	362
Available-for-sale security impairment loss	282	
Gain on sale of available-for-sale securities	(1,003)	
Net unrealized losses on trading securities	16	19
Net gain on sale of mortgage loans	(379)	(129)
Net unrealized gains on borrowings measured at fair value	(33)	(80)
Increase in cash value of corporate owned life insurance	(171)	(142)
Share-based payment awards under equity compensation plan	169	180
Origination of loans held for sale	(25,966)	(8,830)
Proceeds from loan sales	26,154	9,889
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	291	385
Accrued interest receivable	(196)	(802)
Other assets	(195)	(24)
Accrued interest payable and other liabilities	(548)	(323)
Net cash provided by operating activities	**3,445**	**4,460**
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	2,284	1,940
Activity in available-for-sale securities		
Sales	24,241	
Maturities and calls	19,789	15,597
Purchases	(90,294)	(45,442)
Loan principal collections and (originations), net	6,510	(4,315)
Proceeds from sales of foreclosed assets	328	302
Purchases of premises and equipment	(1,025)	(239)
Net cash used in investing activities	**(38,167)**	**(32,157)**

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31	
	2012	2011
FINANCING ACTIVITIES		
Acceptances and withdrawals of deposits, net	$ 30,962	$ 45,908
Decrease in other borrowed funds	(1,610)	(11,574)
Cash dividends paid on common stock	(1,515)	(1,434)
Proceeds from issuance of common stock	609	546
Common stock repurchased	(426)	(362)
Common stock purchased for deferred compensation obligations	(144)	(164)
Net cash provided by financing activities	**27,876**	**32,920**
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	**(6,846)**	**5,223**
Cash and cash equivalents at beginning of period	28,590	18,109
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$ 21,744**	**$ 23,332**
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	$ 3,784	$ 4,025
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	$ 188	$ 833
Common stock issued for deferred compensation obligations		182
Common stock repurchased from an associated Rabbi Trust		(215)

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

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 generally accepted accounting principles for complete financial statements. In management s opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation s annual report for the year ended December 31, 2011.

The accounting policies are the same as those discussed in Note 1 to the Consolidated Financial Statements included in the Corporation s annual report for the year ended December 31, 2011.

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, as well as any adjustments to income that would result from the assumed issuance. Potential common shares that may be issued by the Corporation relate solely to outstanding shares in the Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (the Directors Plan).

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

	Three Months Ended March 31	
	2012	2011
Average number of common shares outstanding for basic calculation	7,594,257	7,557,293
Average potential effect of shares in the Directors Plan (1)	199,882	193,128
Average number of common shares outstanding used to calculate diluted earnings per common share	7,794,139	7,750,421
Net income	$ 3,234	$ 2,316
Earnings per share		
Basic	**$ 0.43**	**$ 0.31**
Diluted	**$ 0.41**	**$ 0.30**

(1) Exclusive of shares held in the Rabbi Trust

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NOTE 3 RECENTLY ADOPTED ACCOUNTING STANDARDS UPDATES

ASU No. 2011-03: Reconsideration of Effective Control for Repurchase Agreements

In April 2011, ASU No. 2011-03 amended ASC Topic 310, Transfers and Servicing to eliminate from the assessment of effective control, the criteria calling for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed upon terms, even in the event of the transferee s default. The assessment of effective control should instead focus on the transferor s contractual rights and obligations. The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not impact the Corporation s consolidated financial statements.

ASU No. 2011-04: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS

In May 2011, ASU No. 2011-04 amended ASC Topic 820, Fair Value Measurement to align fair value measurements and disclosures in U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The ASU changes the wording used to describe the requirements in GAAP for measuring fair value and disclosures about fair value.

The ASU clarifies the application of existing fair value measurements and disclosure requirements related to:

- The application of highest and best use and valuation premise concepts.
- Measuring the fair value of an instrument classified in a reporting entity s stockholders equity.
- Disclosure about fair value measurements within Level 3 of the fair value hierarchy.

The ASU also changes particular principles or requirements for measuring fair value and disclosing information measuring fair value and disclosures related to:

- Measuring the fair value of financial instruments that are managed within a portfolio.
- Application of premiums and discounts in a fair value measurement.

The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not have a financial impact but increased the level of disclosures related to fair value measurements in the Corporation s interim condensed consolidated financial statements in 2012.

ASU No. 2011-05: Presentation of Comprehensive Income

In June 2011, ASU No. 2011-05 amended ASC Topic 220, Comprehensive Income to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. In addition, to increase the prominence of items reported in other comprehensive income, and to facilitate the convergence of GAAP and IFRS, the FASB eliminated the option to present components of other comprehensive income as part of the statement of changes in shareholders equity.

The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not have an impact on Corporation s consolidated financial statements as the Corporation has historically elected to present a separate statement of comprehensive income.

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NOTE 4 TRADING SECURITIES

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

	March 31 2012	December 31 2011
States and political subdivisions	$ 4,403	$ 4,710

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 Corporation s trading portfolio as of March 31, 2012. Included in the net trading losses of $19 during the first three months of 2011 were $17 of net unrealized trading losses on securities that were held in the Corporation s trading portfolio as of March 31, 2011.

NOTE 5 AVAILABLE-FOR-SALE SECURITIES

The amortized cost and fair value of available-for-sale securities, with gross unrealized gains and losses, are as follows at:

	March 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 2,450	$ 24	$	$ 2,474
States and political subdivisions	169,341	7,893	348	176,886
Auction rate money market preferred	3,200		579	2,621
Preferred stocks	6,800		735	6,065
Mortgage-backed securities	154,643	1,976	180	156,439
Collateralized mortgage obligations	124,637	2,533		127,170
Total	**$ 461,071**	**$ 12,426**	**$ 1,842**	**$ 471,655**

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 395	$ 2	$	$ 397
States and political subdivisions	166,832	8,157	51	174,938
Auction rate money market preferred	3,200		1,151	2,049
Preferred stocks	6,800		1,767	5,033
Mortgage-backed securities	140,842	2,807	47	143,602
Collateralized mortgage obligations	96,545	2,556		99,101
Total	**$ 414,614**	**$ 13,522**	**$ 3,016**	**$ 425,120**

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The amortized cost and fair value of available-for-sale securities by contractual maturity at March 31, 2012 are as follows:

	Maturing				Securities With Variable Monthly Payments or Continual Call Dates	
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years		Total
Government sponsored enterprises	$	$	$ 72	$ 2,378	$	$ 2,450
States and political subdivisions	8,898	35,262	85,647	39,534		169,341
Auction rate money market preferred					3,200	3,200
Preferred stocks					6,800	6,800
Mortgage-backed securities					154,643	154,643
Collateralized mortgage obligations					124,637	124,637
Total amortized cost	**$ 8,898**	**$ 35,262**	**$ 85,719**	**$ 41,912**	**$ 289,280**	**$ 461,071**
Fair value	**$ 8,928**	**$ 36,518**	**$ 91,022**	**$ 42,892**	**$ 292,295**	**$ 471,655**

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 preferreds 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 available-for-sale securities was as follows for the three month period ended March 31, 2012:

Proceeds from sales of securities	$ 24,241
Gross realized gains	$ 1,003
Applicable income tax expense	$ 341

There were no sales of available-for-sale securities in the first three months of 2011. 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.

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Information pertaining to available-for-sale securities with gross unrealized losses at March 31, 2012 and December 31, 2011 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	March 31, 2012				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	F air Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 348	$ 5,783	$	$	$ 348
Auction rate money market preferred			579	2,621	579
Preferred stocks			735	6,066	735
Mortgage-backed securities	180	34,854			180
Total	**$ 528**	**$ 40,637**	**$ 1,314**	**$ 8,687**	**$ 1,842**
Number of securities in an unrealized loss position:		**21**		**6**	**27**

	December 31, 2011				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 51	$ 1,410	$	$	$ 51
Auction rate money market preferred			1,151	2,049	1,151
Preferred stocks			1,767	5,033	1,767
Mortgage-backed securities	47	24,291			47
Total	**$ 98**	**$ 25,701**	**$ 2,918**	**$ 7,082**	**$ 3,016**
Number of securities in an unrealized loss position:		**6**		**6**	**12**

As of March 31, 2012 and December 31, 2011, management conducted an analysis to determine whether all securities currently in an unrealized loss position should be considered other-than-temporarily-impaired (OTTI). 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 issuer s investment credit rating below investment grade?

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

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

Has the duration of the investment been extended?

As of March 31, 2012, the Corporation held an auction rate money market preferred security and preferred stocks which continued to be in an unrealized loss position as a result of the securities interest rates, as they are currently lower than the offering rates of securities with similar characteristics. Management has determined that any declines in the fair value of these securities are the result of changes in interest rates and not risks related to the underlying credit quality of the security. Additionally, none of the issuers of these securities are deemed to be below investment grade, management does not intend to sell the securities in an unrealized loss position, and it is more likely than not that the Corporation will not have to sell the securities before recovery of their cost basis.

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During the three month period ended March 31, 2012, the Corporation had one state issued student loan auction rate available-for-sale 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, the Corporation 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 bifurcation methods were then weighted, with a higher weighting applied to the Estimated Cash Flow Method, to arrive at the estimated credit related impairment of $282 due to a decline in projected cash flows and credit rating downgrade.

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%

The total other-than-temporary impairment loss recognized in accumulated other comprehensive income as of March 31, 2012 was $204 related to the student loan auction rate security. A roll forward of credit related impairment recognized in earnings on available-for-sale securities in the three months ended March 31, 2012 was as follows:

January 1, 2012	$
Additions to credit losses for which no previous OTTI was recognized	282
March 31, 2012	**$ 282**

There were no credit losses recognized in earnings or OTTI impairment losses recognized in accumulated other comprehensive income on available-for-sale securities in the three months ended March 31, 2011.

Based on the Corporation s analysis using the above criteria, the fact that management has asserted that it does not have the intent to sell these securities in an unrealized loss position, and that it is more likely than not the Corporation will not have to sell the securities before recovery of their cost basis, management does not believe that the values of any other securities are other-than-temporarily impaired as of as of March 31, 2012 or December 31, 2011.

NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES (ALLL)

The Corporation grants 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 management has the intent and ability to hold in its portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the allowance for loans losses, 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 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 state 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. The Corporation minimizes its 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, the Corporation 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, the Corporation requires annual financial statements, prepares cash flow analyses, and reviews credit reports as deemed necessary.

The Corporation offers 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 the Federal Home Loan Mortgage Corporation. Fixed rate residential real estate loans with an amortization of 15 years or less may be held in the Corporation s portfolio, held for future sale, or sold upon origination. Factors used in determining when to sell these mortgages include management s judgment about the direction of interest rates, the Corporation s need for fixed rate assets in the management of its interest rate sensitivity, and overall loan demand.

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 a mortgage loan committee or through a secondary market automated underwriting system; loans in excess of $400 require the approval of the Corporation s Internal Loan Committee, Board of Directors, or the Board of Director s Loan Committee.

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 management believes the uncollectibility of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The ALLL is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility 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 its recorded investment. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding three years. An unallocated component is maintained to cover uncertainties that management believes affect its 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.

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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, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
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 March 31, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
Individually evaluated for impairment	$ 2,232	$ 531	$ 1,287	$	$	$ 4,050
Collectively evaluated for impairment	3,496	328	2,415	625	1,461	8,325
Total	**$ 5,728**	**$ 859**	**$ 3,702**	**$ 625**	**$ 1,461**	**$ 12,375**
Loans						
Individually evaluated for impairment	$ 17,350	$ 3,095	$ 8,214	$ 95		$ 28,754
Collectively evaluated for impairment	343,975	73,586	266,453	30,364		714,378
Total	**$ 361,325**	**$ 76,681**	**$ 274,667**	**$ 30,459**		**$ 743,132**

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	Allowance for Loan Losses Three Months Ended March 31, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
January 1, 2011	$ 6,048	$ 1,033	$ 3,198	$ 605	$ 1,489	$ 12,373
Loans charged off	(655)		(323)	(145)		(1,123)
Recoveries	137		74	103		314
Provision for loan losses	716	(257)	473	59	(174)	817
March 31, 2011	**$ 6,246**	**$ 776**	**$ 3,422**	**$ 622**	**$ 1,315**	**$ 12,381**

	Allowance for Loan Losses and Recorded Investment in Loans As of December 31, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
Individually evaluated for impairment	$ 2,152	$ 822	$ 1,146	$	$	$ 4,120
Collectively evaluated for impairment	4,132	181	1,834	633	1,475	8,255
Total	**$ 6,284**	**$ 1,003**	**$ 2,980**	**$ 633**	**$ 1,475**	**$ 12,375**
Loans						
Individually evaluated for impairment	$ 14,097	$ 3,384	$ 7,664	$ 105		$ 25,250
Collectively evaluated for impairment	351,617	71,261	270,696	31,467		725,041
Total	**$ 365,714**	**$ 74,645**	**$ 278,360**	**$ 31,572**		**$ 750,291**

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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:

	March 31, 2012					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$ 9,938	$ 16,472	$ 26,410	$ 2,465	$ 1,739	$ 4,204
3 - High satisfactory	95,563	26,385	121,948	14,972	5,569	20,541
4 - Low satisfactory	114,175	53,308	167,483	24,918	17,678	42,596
5 - Special mention	15,318	2,136	17,454	1,763	1,200	2,963
6 - Substandard	19,692	3,717	23,409	1,874	4,027	5,901
7 - Vulnerable	1,802	101	1,903			
8 - Doubtful	2,681	37	2,718	190	286	476
Total	**$ 259,169**	**$ 102,156**	**$ 361,325**	**$ 46,182**	**$ 30,499**	**$ 76,681**

	December 31, 2011					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$ 11,113	$ 11,013	$ 22,126	$ 3,583	$ 1,390	$ 4,973
3 - High satisfactory	90,064	29,972	120,036	11,154	5,186	16,340
4 - Low satisfactory	118,611	57,572	176,183	24,253	15,750	40,003
5 - Special mention	15,482	4,200	19,682	3,863	2,907	6,770
6 - Substandard	19,017	4,819	23,836	1,640	4,314	5,954
7 - Vulnerable	187		187			
8 - Doubtful	3,621	43	3,664	190	415	605
Total	**$ 258,095**	**$ 107,619**	**$ 365,714**	**$ 44,683**	**$ 29,962**	**$ 74,645**

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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.

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.

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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 the Corporation 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**

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

	March 31, 2012					
	Accruing Interest and Past Due:			Total Past Due and		
	30-89 Days	90 Days or More	Nonaccrual	Nonaccrual	Current	Total
Commercial						
Commercial real estate	$ 1,350	$ 189	$ 4,661	$ 6,200	$ 252,969	$ 259,169
Commercial other	448		101	549	101,607	102,156
Total commercial	1,798	189	4,762	6,749	354,576	361,325
Agricultural						
Agricultural real estate	302	99	189	590	45,592	46,182
Agricultural other	186		286	472	30,027	30,499
Total agricultural	488	99	475	1,062	75,619	76,681
Residential real estate						
Senior liens	2,538	35	1,130	3,703	212,442	216,145
Junior liens	103	38	85	226	19,557	19,783
Home equity lines of credit	133		199	332	38,407	38,739
Total residential real estate	2,774	73	1,414	4,261	270,406	274,667
Consumer						
Secured	76			76	25,345	25,421
Unsecured	22			22	5,016	5,038
Total consumer	98			98	30,361	30,459
Total	**$ 5,158**	**$ 361**	**$ 6,651**	**$ 12,170**	**$ 730,962**	**$ 743,132**

	December 31, 2011					
	Accruing Interest and Past Due:			Total Past Due and		
	30-89 Days	90 Days or More	Nonaccrual	Nonaccrual	Current	Total
Commercial						
Commercial real estate	$ 1,721	$ 364	$ 4,176	$ 6,261	$ 251,834	$ 258,095
Commercial other	426	3	25	454	107,165	107,619
Total commercial	2,147	367	4,201	6,715	358,999	365,714
Agricultural						
Agricultural real estate		99	189	288	44,395	44,683
Agricultural other	2		415	417	29,545	29,962
Total agricultural	2	99	604	705	73,940	74,645

Residential real estate						
Senior liens	3,004	124	1,292	4,420	213,181	217,601
Junior liens	235	40	94	369	20,877	21,246
Home equity lines of credit	185	125	198	508	39,005	39,513
Total residential real estate	3,424	289	1,584	5,297	273,063	278,360
Consumer						
Secured	158	5		163	26,011	26,174
Unsecured	23			23	5,375	5,398
Total consumer	181	5		186	31,386	31,572
Total	**$ 5,754**	**$ 760**	**$ 6,389**	**$ 12,903**	**$ 737,388**	**$ 750,291**

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Impaired Loans

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

1. There has been a chargeoff of its principal balance (in whole or in part);

2. The loan has been classified as a Troubled Debt Restructuring (TDR); or

3. The loan is in nonaccrual status.

Impairment is measured on a loan by loan basis for commercial, commercial real estate, agricultural, or agricultural real estate loans by either 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.

Interest income is recognized on impaired loans in nonaccrual status on the cash basis, but only after all principal has been collected. For impaired loans not in nonaccrual status, interest income is recognized daily as earned according to the terms of the loan agreement.

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

	March 31, 2012			December 31, 2011		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	$ 6,759	$ 6,969	$ 1,941	$ 5,014	$ 5,142	$ 1,881
Commercial other	714	714	291	734	734	271
Agricultural other	2,243	2,243	531	2,689	2,689	822
Residential real estate senior liens	7,830	9,165	1,253	7,271	8,827	1,111
Residential real estate junior liens	185	251	34	195	260	35
Total impaired loans with a valuation allowance	**$ 17,731**	**$ 19,342**	**$ 4,050**	**$ 15,903**	**$ 17,652**	**$ 4,120**
Impaired loans without a valuation allowance						
Commercial real estate	$ 7,632	$ 10,521		$ 7,984	$ 10,570	
Commercial other	2,245	2,339		365	460	
Agricultural real estate	190	190		190	190	
Agricultural other	662	782		505	625	
Home equity lines of credit	199	499		198	498	
Consumer secured	95	104		105	114	
Total impaired loans without a valuation allowance	**$ 11,023**	**$ 14,435**		**$ 9,347**	**$ 12,457**	
Impaired loans						
Commercial	$ 17,350	$ 20,543	$ 2,232	$ 14,097	$ 16,906	$ 2,152
Agricultural	3,095	3,215	531	3,384	3,504	822
Residential real estate	8,214	9,915	1,287	7,664	9,585	1,146
Consumer	95	104		105	114	
Total impaired loans	**$ 28,754**	**$ 33,777**	**$ 4,050**	**$ 25,250**	**$ 30,109**	**$ 4,120**

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	Three Months Ended			
	March 31, 2012		March 31, 2011	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	$ 5,887	$ 98	$ 2,091	$ 24
Commercial other	724	12	9	
Agricultural other	2,466	37	2,196	33
Residential real estate senior liens	7,550	83	4,427	36
Residential real estate junior liens	190	2	170	1
Total impaired loans with a valuation allowance	**$ 16,817**	**$ 232**	**$ 8,893**	**$ 94**
Impaired loans without a valuation allowance				
Commercial real estate	$ 7,808	$ 67	$ 2,676	$ 33
Commercial other	1,305	31	981	60
Agricultural real estate	190		95	
Agricultural other	584	4		
Residential real estate senior liens	1		537	6
Home equity lines of credit	199	4	1	
Consumer secured	100	2	47	2
Total impaired loans without a valuation allowance	**$ 10,187**	**$ 108**	**$ 4,337**	**$ 101**
Impaired loans				
Commercial	$ 15,724	$ 208	$ 5,757	$ 117
Agricultural	3,240	41	2,291	33
Residential real estate	7,940	89	5,135	43
Consumer	100	2	47	2
Total impaired loans	**$ 27,004**	**$ 340**	**$ 13,230**	**$ 195**

The Corporation had pledged to advance $359 in connection with impaired loans, which include TDR s, as of March 31, 2012.

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Troubled Debt Restructurings

Loan modifications are considered to be TDR s when a concession has been granted 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, the Corporation considers if:

1. The borrower is currently in default on any of their debt.
2. It is likely that the borrower would default on any of their debt if the concession was not granted.
3. The borrower s cash flow was sufficient 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 for the three month period ended March 31, 2012:

	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	21	$ 4,586	$ 4,586
Agricultural other	6	561	561
Residential real estate senior liens	5	721	721
Total	**32**	**$ 5,868**	**$ 5,868**

The following tables summarize concessions granted by the Corporation to borrowers in financial difficulties in the three month period ended March 31, 2012:

	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
Commercial other	21	$ 4,586		$
Agricultural other	6	561		
Residential real estate senior liens			5	721
Total	**27**	**$ 5,147**	**5**	**$ 721**

The Corporation did not restructure any loans through the forbearance of principal or accrued interest in the three month period ended March 31, 2012.

Based on the Corporation s 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.

The following is a summary of loans that defaulted in the first three months of 2012, which were modified within 12 months prior to the default date.

	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
Total	**2**	**$ 129**	**$ 85**	**$ 44**

The Corporation had no loans that defaulted during the first three months of 2011, which were modified within 12 months prior to the default date.

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

	March 31 2012	December 31 2011
Troubled debt restructurings	$ 23,102	$ 18,756

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 2012	December 31 2011
Federal Home Loan Bank Stock	$ 7,380	$ 7,380