ISABELLA BANK CORP
Form 10-Q
August 08, 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 June 30, 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	**(I.R.S. Employer**
incorporation or organization)	**identification No.)**
401 N. Main St, Mt. Pleasant, MI	**48858**
(Address of principal executive offices)	**(Zip code)**

(989) 772-9471

(Registrant s telephone number, including area code)

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. 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, 7,617,345 as of July 23, 2012

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)

	June 30, 2012	December 31 2011
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$ 19,492	$ 24,514
Interest bearing balances due from banks	759	4,076
Total cash and cash equivalents	**20,251**	**28,590**
Certificates of deposit held in other financial institutions	6,880	8,924
Trading securities	1,998	4,710
Available-for-sale securities (amortized cost of $464,931 in 2012 and $414,614 in 2011)	476,935	425,120
Mortgage loans available-for-sale	2,347	3,205
Loans		
Agricultural	81,222	74,645
Commercial	368,371	365,714
Consumer	31,357	31,572
Residential real estate	274,002	278,360
Total loans	**754,952**	**750,291**
Less allowance for loan losses	12,318	12,375
Net loans	**742,634**	**737,916**
Premises and equipment	24,729	24,626
Corporate owned life insurance	22,423	22,075
Accrued interest receivable	5,217	5,848
Equity securities without readily determinable fair values	17,708	17,189
Goodwill and other intangible assets	46,659	46,792
Other assets	13,715	12,930
TOTAL ASSETS	**$ 1,381,496**	**$ 1,337,925**
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	$ 124,230	$ 119,072
NOW accounts	163,000	163,653
Certificates of deposit under $100 and other savings	450,159	440,123
Certificates of deposit over $100	241,439	235,316
Total deposits	**978,828**	**958,164**
Borrowed funds ($0 in 2012 and $5,242 in 2011 at fair value)	234,132	216,136
Accrued interest payable and other liabilities	8,681	8,842
Total liabilities	**1,221,641**	**1,183,142**
Shareholders equity		

Common stock no par value		
15,000,000 shares authorized; issued and outstanding 7,602,545 shares (including 19,990 shares held in the Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011	134,931	134,734
Shares to be issued for deferred compensation obligations	4,724	4,524
Retained earnings	16,240	13,036
Accumulated other comprehensive income	3,960	2,489
Total shareholders equity	**159,855**	**154,783**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,381,496**	**$ 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				4,988	3,722	8,710
Issuance of common stock	61,218	1,346				1,346
Common stock issued for deferred compensation obligations	14,842	266	(254)			12
Share based payment awards under equity compensation plan			307			307
Common stock purchased for deferred compensation obligations		(227)				(227)
Common stock repurchased pursuant to publicly announced repurchase plan	(50,458)	(914)				(914)
Cash dividends ($0.38 per share)				(2,881)		(2,881)
Balance, June 30, 2011	**7,575,676**	**$ 134,063**	**$ 4,735**	**$ 10,703**	**$ 2,013**	**$ 151,514**
Balance, January 1, 2012	**7,589,226**	**$ 134,734**	**$ 4,524**	**$ 13,036**	**$ 2,489**	**$ 154,783**
Comprehensive income				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**

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 June 30		Six Months Ended June 30	
	2012	2011	2012	2011
Interest income				
Loans, including fees	$ 10,849	$ 11,464	$ 21,789	$ 22,825
Investment securities				
Taxable	1,988	1,836	3,877	3,349
Nontaxable	1,216	1,189	2,420	2,368
Trading account securities	22	47	64	98
Federal funds sold and other	113	133	242	267
Total interest income	**14,188**	**14,669**	**28,392**	**28,907**
Interest expense				
Deposits	2,368	2,776	4,880	5,561
Borrowings	1,061	1,325	2,253	2,593
Total interest expense	**3,429**	**4,101**	**7,133**	**8,154**
Net interest income	**10,759**	**10,568**	**21,259**	**20,753**
Provision for loan losses	439	603	900	1,420
Net interest income after provision for loan losses	**10,320**	**9,965**	**20,359**	**19,333**
Noninterest income				
Service charges and fees	1,628	1,617	3,257	3,093
Gain on sale of mortgage loans	279	53	658	182
Net loss on trading securities	(16)	(8)	(32)	(27)
Net gain on borrowings measured at fair value		37	33	117
Gain on sale of available-for-sale investment securities			1,003	
Other	653	279	1,166	561
Total noninterest income	**2,544**	**1,978**	**6,085**	**3,926**
Noninterest expenses				
Compensation and benefits	5,232	4,746	10,533	9,751
Occupancy	599	613	1,240	1,259
Furniture and equipment	1,170	1,127	2,260	2,233
Other	2,187	2,293	4,446	4,123
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	
Total noninterest expenses	**9,188**	**8,779**	**18,761**	**17,366**
Income before federal income tax expense	**3,676**	**3,164**	**7,683**	**5,893**
Federal income tax expense	672	492	1,445	905

NET INCOME	**$ 3,004**	**$ 2,672**	**$ 6,238**	**$ 4,988**
Earnings per share				
Basic	**$ 0.40**	**$ 0.35**	**$ 0.82**	**$ 0.66**
Diluted	**$ 0.39**	**$ 0.34**	**$ 0.80**	**$ 0.64**
Cash dividends per basic share	**$ 0.20**	**$ 0.19**	**$ 0.40**	**$ 0.38**

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 June 30		Six Months Ended June 30	
	2012	2011	2012	2011
Net income	**$ 3,004**	**$ 2,672**	**$ 6,238**	**$ 4,988**
Unrealized holding gains on available-for-sale securities:				
Unrealized holding gains arising during the period	1,420	3,576	2,219	5,329
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	1,420	3,576	1,498	5,329
Tax effect	(546)	(1,212)	(27)	(1,607)
Other comprehensive income, net of tax	874	2,364	1,471	3,722
COMPREHENSIVE INCOME	**$ 3,878**	**$ 5,036**	**$ 7,709**	**$ 8,710**

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 2012	Six Months Ended June 30 2011
OPERATING ACTIVITIES		
Net income	$ 6,238	$ 4,988
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	900	1,420
Impairment of foreclosed assets	17	35
Depreciation	1,195	1,282
Amortization and impairment of originated mortgage servicing rights	287	193
Amortization of acquisition intangibles	133	152
Net amortization of available-for-sale securities	1,076	693
Available-for-sale security impairment loss	282	
Gain on sale of available-for-sale securities	(1,003)	
Net unrealized losses on trading securities	32	27
Net gain on sale of mortgage loans	(658)	(182)
Net unrealized gains on borrowings measured at fair value	(33)	(117)
Increase in cash value of corporate owned life insurance	(348)	(287)
Share-based payment awards under equity compensation plan	295	307
Origination of loans held for sale	(46,386)	(17,247)
Proceeds from loan sales	47,902	17,847
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	2,680	900
Accrued interest receivable	631	(123)
Other assets	(1,132)	653
Accrued interest payable and other liabilities	(161)	684
Net cash provided by operating activities	**11,947**	**11,225**
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	2,044	4,934
Activity in available-for-sale securities		
Sales	24,241	
Maturities and calls	37,922	33,799
Purchases	(112,835)	(78,664)
Loan principal originations, net	(6,768)	(13,462)
Proceeds from sales of foreclosed assets	647	859
Purchases of premises and equipment	(1,298)	(884)
Net cash used in investing activities	**(56,047)**	**(53,418)**

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

	Six Months Ended June 30	
	2012	2011
FINANCING ACTIVITIES		
Acceptances and withdrawals of deposits, net	20,664	$ 46,860
Increase in other borrowed funds	18,029	1,680
Cash dividends paid on common stock	(3,034)	(2,881)
Proceeds from issuance of common stock	1,322	1,092
Common stock repurchased	(995)	(648)
Common stock purchased for deferred compensation obligations	(225)	(227)
Net cash provided by financing activities	**35,761**	**45,876**
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	**(8,339)**	**3,683**
Cash and cash equivalents at beginning of period	28,590	18,109
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$ 20,251**	**$ 21,792**
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	$ 7,291	$ 8,156
Federal income taxes paid	836	365
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	$ 1,150	$ 1,057
Common stock issued for deferred compensation obligations		254
Common stock repurchased from the Rabbi Trust		(266)

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 the Management s Discussion & Analysis of Financial Condition & 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 Ban Corporation refers solely to the parent holding company, and Isabella Bank refers to Isabella Bank Corporation s subsidiary, Isabella Bank.

The acronyms and abbreviations identified below are used in the Notes to Interim Condensed Consolidated Financial Statements as well as in the Management s Discussion and Analysis of Financial Condition and Results of Operations. You may find it helpful to refer back to this page as you read this report.

AFS: Available-for-sale
ALLL: Allowance for loan and lease losses
ASC: FASB Accounting Standards Codification
ASU: FASB Accounting Standards Update
ATM: Automated Teller Machine
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors

Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

FASB: Financial Accounting Standards Board
FDIC: Federal Deposit Insurance Corporation
FFIEC: Federal Financial Institutions Council

FRB: Board of Governors of the Federal Reserve System
FHLB: Federal Home Loan Bank
Freddie Mac: Federal Home Loan Mortgage Corporation
FTE: Fully taxable equivalent
GAAP: U.S. generally accepted accounting principles

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
OCI: Other comprehensive income (loss)

OMSR: Originated mortgage servicing rights
OTTI: Other-than-temporary impairment
PBO: Projected Benefit Obligation
Rabbi Trust: A trust established to fund the Directors Plan

SEC: U.S. Securities & Exchange Commission
SOX: Sarbanes-Oxley Act of 2002
TDR: Troubled debt restructuring
XBRL: eXtensible Business Reporting Language

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, 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 our annual report for the year ended December 31, 2011.

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

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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 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	
	2012	2011	2012	2011
Average number of common shares outstanding for basic calculation	7,592,668	7,570,752	7,593,462	7,564,060
Average potential effect of shares in the Directors Plan (1)	203,603	194,964	201,743	194,051
Average number of common shares outstanding used to calculate diluted earnings per common share	7,796,271	7,765,716	7,795,205	7,758,111
Net income	$ 3,004	$ 2,672	$ 6,238	$ 4,988
Earnings per share				
Basic	**$ 0.40**	**$ 0.35**	**$ 0.82**	**$ 0.66**
Diluted	**$ 0.39**	**$ 0.34**	**$ 0.80**	**$ 0.64**

(1) Exclusive of shares held in the Rabbi Trust

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 our 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 GAAP and 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.

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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 our 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 our consolidated financial statements as we have historically elected to present a separate statement of comprehensive income.

NOTE 4 TRADING SECURITIES

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

	June 30 2012	December 31 2011
States and political subdivisions	$ 1,998	$ 4,710

Included in the 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. Included in the net trading losses of $27 during the first six months of 2011 were $32 of net unrealized trading losses on securities that were held in the trading portfolio as of June 30, 2011.

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NOTE 5 AVAILABLE-FOR-SALE SECURITIES

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

	June 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 2,197	$ 34	$	$ 2,231
States and political subdivisions	170,958	8,243	547	178,654
Auction rate money market preferred	3,200		626	2,574
Preferred stocks	6,800		873	5,927
Mortgage-backed securities	161,521	2,991	15	164,497
Collateralized mortgage obligations	120,255	2,844	47	123,052
Total	**$ 464,931**	**$ 14,112**	**$ 2,108**	**$ 476,935**

	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**

The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2012 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 Continual Call Dates	Total
Government sponsored enterprises	$	$	$ 72	$ 2,125	$	$ 2,197
States and political subdivisions	7,573	34,073	85,055	44,257		170,958
Auction rate money market preferred					3,200	3,200
Preferred stocks					6,800	6,800
Mortgage-backed securities					161,521	161,521

Collateralized mortgage obligations					120,255	120,255
Total amortized cost	**$ 7,573**	**$ 34,073**	**$ 85,127**	**$ 46,382**	**$ 291,776**	**$ 464,931**
Fair value	**$ 7,589**	**$ 35,243**	**$ 90,845**	**$ 47,208**	**$ 296,050**	**$ 476,935**

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

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

A summary of the activity related to sales of AFS securities was as follows for the six month period ended June 30, 2012:

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

There were no sales of AFS securities in the first six 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.

Information pertaining to AFS securities with gross unrealized losses at June 30, 2012 and December 31, 2011 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	June 30, 2012				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 55	$ 6,768	$ 492	$ 2,482	$ 547
Auction rate money market preferred			626	2,574	626
Preferred stocks			873	5,927	873
Mortgage-backed securities	15	15,283			15
Collateralized mortgage obligations	47	4,686			47
Total	**$ 117**	**$ 26,737**	**$ 1,991**	**$ 10,983**	**$ 2,108**
Number of securities in an unrealized loss position:		**24**		**8**	**32**

	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 June 30, 2012 and December 31, 2011, 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 issuer s investment credit rating below investment grade?

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

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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?

As of June 30, 2012, we 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. We 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, we do not intend to sell the securities in an unrealized loss position, and it is more likely than not that we will not have to sell the securities before recovery of their cost basis.

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

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

	Discounted Cash Flow Method
Ratings	
Fitch	Not Rated
Moody s	Caa3
S&P	A
Seniority	Senior
Discount rate	LIBOR + 6.35%

	Credit Yield Analysis Method
Credit discount rate	LIBOR + 4.00%
Average observed discounts based on closed transactions	14.00%

To test for additional impairment of this security during the three months ended June 30, 2012, we obtained another investment valuation (from the same firm engaged to perform the March 31, 2012 valuation) as of June 30, 2012. Based on the results of this valuation, no additional OTTI was observed as of June 30, 2012.

A rollforward of credit related impairment recognized in earnings on available-for-sale securities in the three and six months ended June 30, 2012 was as follows:

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

June 30, 2012	**$**	**282**	**$**	**282**

There were no credit losses recognized in on available-for-sale securities during 2011.

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 that it is more likely than not that we will not 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 as of June 30, 2012 or December 31, 2011.

NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

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

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

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

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

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

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

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectibility 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 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 our recorded investment. Historical loss allocations were calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding four years. An unallocated component is maintained to cover uncertainties that we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

	Allowance for Loan Losses Three Months Ended June 30, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
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**

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	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
	Allowance for Loan Losses Six Months Ended June 30, 2012					
Allowance for loan losses						
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**

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
	Allowance for Loan Losses and Recorded Investment in Loans As of June 30, 2012					
Allowance for loan losses						
Individually evaluated for impairment	$ 2,115	$ 133	$ 1,308	$	$	$ 3,556
Collectively evaluated for impairment	3,893	300	2,361	667	1,541	8,762
Total	**$ 6,008**	**$ 433**	**$ 3,669**	**$ 667**	**$ 1,541**	**$ 12,318**
Loans						
Individually evaluated for impairment	15,271	2,955	8,248	82		26,556
Collectively evaluated for impairment	353,100	78,267	265,754	31,275		728,396
Total	**$ 368,371**	**$ 81,222**	**$ 274,002**	**$ 31,357**		**$ 754,952**

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
	Allowance for Loan Losses Three Months Ended June 30, 2011					
Allowance for loan losses						
April 1, 2011	$ 6,246	$ 776	$ 3,422	$ 622	$ 1,315	$ 12,381
Loans charged off	(214)	(1)	(555)	(139)		(909)
Recoveries	209		29	65		303
Provision for loan losses	497	(11)	(11)	112	16	603
June 30, 2011	**$ 6,738**	**$ 764**	**$ 2,885**	**$ 660**	**$ 1,331**	**$ 12,378**

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	Allowance for Loan Losses Six Months Ended June 30, 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	(869)	(1)	(878)	(284)		(2,032)
Recoveries	346		103	168		617
Provision for loan losses	1,213	(268)	462	171	(158)	1,420
June 30, 2011	**$ 6,738**	**$ 764**	**$ 2,885**	**$ 660**	**$ 1,331**	**$ 12,378**