

ISABELLA BANK CORP  
Form 10-Q  
November 07, 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 September 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)

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**Michigan**  
(State or other jurisdiction of  
incorporation or organization)

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

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

**48858**  
(Zip code)

**(989) 772-9471**

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

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

Common Stock no par value, 7,620,399 as of October 19, 2012

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**ISABELLA BANK CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**

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

(Dollars in thousands)

	September 30 2012	December 31 2011
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$ 19,202	\$ 24,514
Interest bearing balances due from banks	5,462	4,076
<b>Total cash and cash equivalents</b>	<b>24,664</b>	<b>28,590</b>
Certificates of deposit held in other financial institutions	5,675	8,924
Trading securities	1,788	4,710
Available-for-sale securities (amortized cost of \$452,536 in 2012 and \$414,614 in 2011)	467,414	425,120
Mortgage loans available-for-sale	2,820	3,205
Loans		
Agricultural	83,439	74,645
Commercial	369,366	365,714
Consumer	33,515	31,572
Residential real estate	280,431	278,360
<b>Total loans</b>	<b>766,751</b>	<b>750,291</b>
Less allowance for loan losses	12,062	12,375
<b>Net loans</b>	<b>754,689</b>	<b>737,916</b>
Premises and equipment	25,471	24,626
Corporate owned life insurance	22,594	22,075
Accrued interest receivable	6,565	5,848
Equity securities without readily determinable fair values	17,830	17,189
Goodwill and other intangible assets	46,592	46,792
Other assets	13,036	12,930
<b>TOTAL ASSETS</b>	<b>\$ 1,389,138</b>	<b>\$ 1,337,925</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits		
Noninterest bearing	\$ 126,362	\$ 119,072
NOW accounts	174,350	163,653
Certificates of deposit under \$100 and other savings	453,348	440,123
Certificates of deposit over \$100	235,431	235,316
<b>Total deposits</b>	<b>989,491</b>	<b>958,164</b>
Borrowed funds (\$0 in 2012 and \$5,242 in 2011 at fair value)	226,580	216,136
Accrued interest payable and other liabilities	8,920	8,842
<b>Total liabilities</b>	<b>1,224,991</b>	<b>1,183,142</b>
Shareholders equity		

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Common stock no par value 15,000,000 shares authorized; issued and outstanding 7,611,350 shares (including 25,644 shares held in the Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011	134,973	134,734
Shares to be issued for deferred compensation obligations	4,925	4,524
Retained earnings	18,178	13,036
Accumulated other comprehensive income	6,071	2,489
<b>Total shareholders equity</b>	<b>164,147</b>	<b>154,783</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 1,389,138</b>	<b>\$ 1,337,925</b>

See notes to interim condensed consolidated financial statements.

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

(Dollars in thousands except per share data)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Totals
<b>Balance, January 1, 2011</b>	<b>7,550,074</b>	<b>\$ 133,592</b>	<b>\$ 4,682</b>	<b>\$ 8,596</b>	<b>\$ (1,709)</b>	<b>\$ 145,161</b>
Comprehensive income				7,499	6,608	14,107
Issuance of common stock	90,049	1,891				1,891
Common stock issued for deferred compensation obligations	14,842	266	(254)			12
Share based payment awards under equity compensation plan			486			486
Common stock purchased for deferred compensation obligations		(356)				(356)
Common stock repurchased pursuant to publicly announced repurchase plan	(76,708)	(1,391)				(1,391)
Cash dividends (\$0.57 per share)				(4,331)		(4,331)
<b>Balance, September 30, 2011</b>	<b>7,578,257</b>	<b>\$ 134,002</b>	<b>\$ 4,914</b>	<b>\$ 11,764</b>	<b>\$ 4,899</b>	<b>\$ 155,579</b>
<b>Balance, January 1, 2012</b>	<b>7,589,226</b>	<b>134,734</b>	<b>4,524</b>	<b>13,036</b>	<b>2,489</b>	<b>\$ 154,783</b>
Comprehensive income				9,695	3,582	13,277
Issuance of common stock	85,227	2,025				2,025
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations		95	(95)			
Share based payment awards under equity compensation plan			496			496
Common stock purchased for deferred compensation obligations		(361)				(361)
Common stock repurchased pursuant to publicly announced repurchase plan	(63,103)	(1,520)				(1,520)
Cash dividends (\$0.60 per share)				(4,553)		(4,553)
<b>Balance, September 30, 2012</b>	<b>7,611,350</b>	<b>\$ 134,973</b>	<b>\$ 4,925</b>	<b>\$ 18,178</b>	<b>\$ 6,071</b>	<b>\$ 164,147</b>

See notes to interim condensed consolidated financial statements.

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

(Dollars in thousands except per share data)

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
<b>Interest income</b>				
Loans, including fees	\$ 10,918	\$ 11,365	\$ 32,707	\$ 34,190
Investment securities				
Taxable	1,878	1,800	5,755	5,149
Nontaxable	1,232	1,201	3,652	3,569
Trading account securities	15	45	79	143
Federal funds sold and other	121	121	363	388
<b>Total interest income</b>	<b>14,164</b>	<b>14,532</b>	<b>42,556</b>	<b>43,439</b>
<b>Interest expense</b>				
Deposits	2,203	2,725	7,083	8,286
Borrowings	1,036	1,345	3,289	3,938
<b>Total interest expense</b>	<b>3,239</b>	<b>4,070</b>	<b>10,372</b>	<b>12,224</b>
<b>Net interest income</b>	<b>10,925</b>	<b>10,462</b>	<b>32,184</b>	<b>31,215</b>
Provision for loan losses	200	963	1,100	2,383
<b>Net interest income after provision for loan losses</b>	<b>10,725</b>	<b>9,499</b>	<b>31,084</b>	<b>28,832</b>
<b>Noninterest income</b>				
Service charges and fees	1,543	1,341	4,800	4,434
Gain on sale of mortgage loans	422	111	1,080	293
Net loss on trading securities	(9)	(24)	(41)	(51)
Net gain on borrowings measured at fair value		42	33	159
Gain on sale of available-for-sale investment securities	116		1,119	
Other	687	389	1,853	950
<b>Total noninterest income</b>	<b>2,759</b>	<b>1,859</b>	<b>8,844</b>	<b>5,785</b>
<b>Noninterest expenses</b>				
Compensation and benefits	5,130	4,814	15,663	14,565
Occupancy	649	633	1,889	1,892
Furniture and equipment	1,113	1,151	3,373	3,384
Other	2,236	1,915	6,682	6,038
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	
<b>Total noninterest expenses</b>	<b>9,128</b>	<b>8,513</b>	<b>27,889</b>	<b>25,879</b>
<b>Income before federal income tax expense</b>	<b>4,356</b>	<b>2,845</b>	<b>12,039</b>	<b>8,738</b>
Federal income tax expense	899	334	2,344	1,239

<b>NET INCOME</b>	<b>\$ 3,457</b>	<b>\$ 2,511</b>	<b>\$ 9,695</b>	<b>\$ 7,499</b>
<b>Earnings per share</b>				
<b>Basic</b>	<b>\$ 0.45</b>	<b>\$ 0.33</b>	<b>\$ 1.28</b>	<b>\$ 0.99</b>
<b>Diluted</b>	<b>\$ 0.44</b>	<b>\$ 0.32</b>	<b>\$ 1.24</b>	<b>\$ 0.97</b>
<b>Cash dividends per basic share</b>	<b>\$ 0.20</b>	<b>\$ 0.19</b>	<b>\$ 0.60</b>	<b>\$ 0.57</b>

See notes to interim condensed consolidated financial statements.



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

(Dollars in thousands)

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
<b>Net income</b>	<b>\$ 3,457</b>	<b>\$ 2,511</b>	<b>\$ 9,695</b>	<b>\$ 7,499</b>
Unrealized holding gains on available-for-sale securities:				
Unrealized holding gains arising during the period	2,990	4,721	5,209	10,050
Reclassification adjustment for net realized gains included in net income	(116)		(1,119)	
Reclassification adjustment for impairment loss included in net income			282	
Net unrealized gains	2,874	4,721	4,372	10,050
Tax effect	(763)	(1,835)	(790)	(3,442)
Other comprehensive income, net of tax	2,111	2,886	3,582	6,608
<b>COMPREHENSIVE INCOME</b>	<b>\$ 5,568</b>	<b>\$ 5,397</b>	<b>\$ 13,277</b>	<b>\$ 14,107</b>

See notes to interim condensed consolidated financial statements.

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2012	2011
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 9,695	\$ 7,499
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	1,100	2,383
Impairment of foreclosed assets	17	45
Depreciation	1,802	1,909
Amortization and impairment of originated mortgage servicing rights	582	606
Amortization of acquisition intangibles	200	229
Net amortization of available-for-sale securities	1,683	1,117
Available-for-sale security impairment loss	282	
Gain on sale of available-for-sale securities	(1,119)	
Net unrealized losses on trading securities	41	51
Net gain on sale of mortgage loans	(1,080)	(293)
Net unrealized gains on borrowings measured at fair value	(33)	(159)
Increase in cash value of corporate owned life insurance	(519)	(428)
Share-based payment awards under equity compensation plan	496	486
Origination of loans held for sale	(69,503)	(31,225)
Proceeds from loan sales	70,968	29,724
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	2,881	900
Accrued interest receivable	(717)	(1,067)
Other assets	(1,994)	423
Accrued interest payable and other liabilities	78	792
<b>Net cash provided by operating activities</b>	<b>14,860</b>	<b>12,992</b>
<b>INVESTING ACTIVITIES</b>		
Net change in certificates of deposit held in other financial institutions	3,249	6,159
Activity in available-for-sale securities		
Sales	40,677	3,000
Maturities and calls	58,598	49,117
Purchases	(138,043)	(128,339)
Loan principal originations, net	(19,461)	(18,923)
Proceeds from sales of foreclosed assets	1,446	1,625
Purchases of premises and equipment	(2,647)	(1,576)
Purchases of corporate owned life insurance		(4,000)
<b>Net cash used in investing activities</b>	<b>(56,181)</b>	<b>(92,937)</b>

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2012	2011
<b>FINANCING ACTIVITIES</b>		
Acceptances and withdrawals of deposits, net	31,327	65,102
Increase in other borrowed funds	10,477	22,130
Cash dividends paid on common stock	(4,553)	(4,331)
Proceeds from issuance of common stock	2,025	1,637
Common stock repurchased	(1,520)	(1,125)
Common stock purchased for deferred compensation obligations	(361)	(356)
<b>Net cash provided by financing activities</b>	<b>37,395</b>	<b>83,057</b>
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(3,926)</b>	<b>3,112</b>
Cash and cash equivalents at beginning of period	28,590	18,109
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 24,664</b>	<b>\$ 21,221</b>
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$ 10,526	\$ 12,292
Federal income taxes paid	1,467	672
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$ 1,588	\$ 1,681
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 and Analysis of Financial Condition and Results of Operations, references to Isabella, we, our, us, and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank refers to Isabella Bank Corporation's subsidiary, Isabella Bank.

The acronyms and abbreviations identified below are used in the Notes to the 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	IFRS: International Financial Reporting Standards
ALLL: Allowance for loan and lease losses	IRR: Interest Rate Risk
ASC: FASB Accounting Standards Codification	JOBS Act: Jumpstart our Business Startups Act
ASU: FASB Accounting Standards Update	LIBOR: London Interbank Offered Rate
ATM: Automated Teller Machine	Moody's: Moody's Investors Service, Inc
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	N/A: Not applicable
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	N/M: Not meaningful
FASB: Financial Accounting Standards Board	OCI: Other comprehensive income (loss)
FDIC: Federal Deposit Insurance Corporation	OMSR: Originated mortgage servicing rights
FFIEC: Federal Financial Institutions Examination Council	OREO: Other real estate owned
FRB: Board of Governors of the Federal Reserve System	OTTI: Other-than-temporary impairment
FHLB: Federal Home Loan Bank	PBO: Projected Benefit Obligation
Freddie Mac: Federal Home Loan Mortgage Corporation	Rabbi Trust: A trust established to fund the Directors Plan
FTE: Fully taxable equivalent	SEC: U.S. Securities & Exchange Commission
GAAP: U.S. generally accepted accounting principles	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 nine month periods ended September 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.

**Table of Contents****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 September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Average number of common shares outstanding for basic calculation	7,600,443	7,577,388	7,595,806	7,568,551
Average potential effect of shares in the Directors Plan (1)	206,233	197,937	203,250	195,360
Average number of common shares outstanding used to calculate diluted earnings per common share	7,806,676	7,775,325	7,799,056	7,763,911
Net income	\$ 3,457	\$ 2,511	\$ 9,695	\$ 7,499
<b>Earnings per share</b>				
<b>Basic</b>	<b>\$ 0.45</b>	<b>\$ 0.33</b>	<b>\$ 1.28</b>	<b>\$ 0.99</b>
<b>Diluted</b>	<b>\$ 0.44</b>	<b>\$ 0.32</b>	<b>\$ 1.24</b>	<b>\$ 0.97</b>

(1) Exclusive of shares held in the Rabbi Trust

**NOTE 3 ACCOUNTING STANDARDS UPDATES****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.

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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.

**Pending Accounting Standards Updates***ASU No. 2012-02: Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*

In August, ASU No. 2012-02 amended ASC Topic 350, *Goodwill and Other* to simplify the testing of intangible assets with indefinite lives. This update will allow for a qualitative assessment of intangible assets with indefinite lives to determine whether or not it is necessary to perform the impairment test described in ASC Topic 350. The new authoritative guidance is effective for fiscal years beginning after September 15, 2012 and is not expected to have any impact on our consolidated financial statements.

**NOTE 4 TRADING SECURITIES**

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

	September 30 2012	December 31 2011
States and political subdivisions	\$ 1,788	\$ 4,710

Included in the net trading losses of \$41 during the first nine months of 2012 were \$13 of net unrealized trading losses on securities that were held in our trading portfolio as of September 30, 2012. Included in the net trading losses of \$51 during the first nine months of 2011 were \$45 of net unrealized trading losses on securities that were held in the trading portfolio as of September 30, 2011.

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

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

	Amortized Cost	September 30, 2012		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Government sponsored enterprises	\$ 1,925	\$ 32	\$	\$ 1,957
States and political subdivisions	176,576	9,394	490	185,480
Auction rate money market preferred	3,200		429	2,771
Preferred stocks	6,800	56	496	6,360
Mortgage-backed securities	138,086	4,142		142,228
Collateralized mortgage obligations	125,949	2,773	104	128,618
<b>Total</b>	<b>\$ 452,536</b>	<b>\$ 16,397</b>	<b>\$ 1,519</b>	<b>\$ 467,414</b>

	Amortized Cost	December 31, 2011		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
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
<b>Total</b>	<b>\$ 414,614</b>	<b>\$ 13,522</b>	<b>\$ 3,016</b>	<b>\$ 425,120</b>

The amortized cost and fair value of AFS securities by contractual maturity at September 30, 2012 are as follows:

	Maturing				Securities With Variable Monthly Payments or Continual Call Dates	Total
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years		
Government sponsored enterprises	\$	\$	\$ 72	\$ 1,853	\$	\$ 1,925
States and political subdivisions	7,300	37,147	82,543	49,586		176,576
Auction rate money market preferred					3,200	3,200
Preferred stocks					6,800	6,800
Mortgage-backed securities					138,086	138,086
Collateralized mortgage obligations					125,949	125,949
<b>Total amortized cost</b>	<b>\$ 7,300</b>	<b>\$ 37,147</b>	<b>\$ 82,615</b>	<b>\$ 51,439</b>	<b>\$ 274,035</b>	<b>\$ 452,536</b>
<b>Fair value</b>	<b>\$ 7,302</b>	<b>\$ 38,237</b>	<b>\$ 88,912</b>	<b>\$ 52,986</b>	<b>\$ 279,977</b>	<b>\$ 467,414</b>



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

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

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

Proceeds from sales of securities	\$ 40,677
Gross realized gains	\$ 1,119
Applicable income tax expense	\$ 380

There were no sales of AFS securities in the first nine 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 September 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:

	September 30, 2012				
	Less Than Twelve Months		Over Twelve Months		Total
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
States and political subdivisions	\$ 1	\$ 315	\$ 489	\$ 2,410	\$ 490
Auction rate money market preferred			429	2,771	429
Preferred stocks			496	3,303	496
Mortgage-backed securities					
Collateralized mortgage obligations	104	15,001			104
<b>Total</b>	<b>\$ 105</b>	<b>\$ 15,316</b>	<b>\$ 1,414</b>	<b>\$ 8,484</b>	<b>\$ 1,519</b>
<b>Number of securities in an unrealized loss position:</b>	<b>4</b>		<b>6</b>		<b>10</b>

	December 31, 2011				
	Less Than Twelve Months		Over Twelve Months		Total
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
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
<b>Total</b>	<b>\$ 98</b>	<b>\$ 25,701</b>	<b>\$ 2,918</b>	<b>\$ 7,082</b>	<b>\$ 3,016</b>

**Number of securities in an unrealized loss position:** 6 6 12

As of September 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?

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

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

Has the duration of the investment been extended?

As of September 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 unlikely that we will 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 earnings in the first quarter of 2012.

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

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

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

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

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

September 30, 2012	\$	282	\$	282
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There were no credit losses recognized in earnings 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 it is unlikely that we will have to sell the securities before recovery of their cost basis, we do not believe that the values of any other securities are other-than-temporarily impaired as of September 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 these 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					Total
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	
<b>Allowance for loan losses</b>						
July 1, 2012	\$ 6,008	\$ 433	\$ 3,669	\$ 667	\$ 1,541	\$ 12,318
Loans charged off	(271)		(213)	(127)		(611)
Recoveries	40		34	81		155
Provision for loan losses	1,132	6	(356)	91	(673)	200
<b>September 30, 2012</b>	<b>\$ 6,909</b>	<b>\$ 439</b>	<b>\$ 3,134</b>	<b>\$ 712</b>	<b>\$ 868</b>	<b>\$ 12,062</b>

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	Allowance for Loan Losses					
	Nine Months Ended September 30, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
<b>Allowance for loan losses</b>						
January 1, 2012	\$ 6,284	\$ 1,003	\$ 2,980	\$ 633	\$ 1,475	\$ 12,375
Loans charged off	(957)		(566)	(364)		(1,887)
Recoveries	168		95	211		474
Provision for loan losses	1,414	(564)	625	232	(607)	1,100
<b>September 30, 2012</b>	<b>\$ 6,909</b>	<b>\$ 439</b>	<b>\$ 3,134</b>	<b>\$ 712</b>	<b>\$ 868</b>	<b>\$ 12,062</b>

	Allowance for Loan Losses and Recorded Investment in Loans					
	As of September 30, 2012					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
<b>Allowance for loan losses</b>						
Individually evaluated for impairment	\$ 2,915	\$	\$ 1,354	\$	\$	\$ 4,269
Collectively evaluated for impairment	3,994	439	1,780	712	868	7,793
<b>Total</b>	<b>\$ 6,909</b>	<b>\$ 439</b>	<b>\$ 3,134</b>	<b>\$ 712</b>	<b>\$ 868</b>	<b>\$ 12,062</b>
<b>Loans</b>						
Individually evaluated for impairment	\$ 16,593	\$ 2,281	\$ 8,429	\$ 79		\$ 27,382
Collectively evaluated for impairment	352,773	81,158	272,002	33,436		739,369
<b>Total</b>	<b>\$ 369,366</b>	<b>\$ 83,439</b>	<b>\$ 280,431</b>	<b>\$ 33,515</b>		<b>\$ 766,751</b>

	Allowance for Loan Losses					
	Three Months Ended September 30, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
<b>Allowance for loan losses</b>						
July 1, 2011	\$ 6,738	\$ 764	\$ 2,885	\$ 660	\$ 1,331	\$ 12,378
Loans charged off	(215)		(857)	(98)		(1,170)
Recoveries	75	1	39	87		202
Provision for loan losses	116	(331)	1,148	(3)	33	963
<b>September 30, 2011</b>	<b>\$ 6,714</b>	<b>\$ 434</b>	<b>\$ 3,215</b>	<b>\$ 646</b>	<b>\$ 1,364</b>	<b>\$ 12,373</b>



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	Allowance for Loan Losses Nine Months Ended September 30, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
<b>Allowance for loan losses</b>						
January 1, 2011	\$ 6,048	\$ 1,033	\$ 3,198	\$ 605	\$ 1,489	\$ 12,373
Loans charged off	(1,084)	(1)	(1,735)	(382)		(3,202)
Recoveries	421	1	142	255		819
Provision for loan losses	1,329	(599)	1,610	168	(125)	2,383
<b>September 30, 2011</b>	<b>\$ 6,714</b>	<b>\$ 434</b>	<b>\$ 3,215</b>	<b>\$ 646</b>	<b>\$ 1,364</b>	<b>\$ 12,373</b>

	Allowance for Loan Losses and Recorded Investment in Loans As of December 31, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
<b>Allowance for loan losses</b>						
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
<b>Total</b>	<b>\$ 6,284</b>	<b>\$ 1,003</b>	<b>\$ 2,980</b>	<b>\$ 633</b>	<b>\$ 1,475</b>	<b>\$ 12,375</b>
<b>Loans</b>						
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
<b>Total</b>	<b>\$ 365,714</b>	<b>\$ 74,645</b>	<b>\$ 278,360</b>	<b>\$ 31,572</b>		<b>\$ 750,291</b>

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

Rating	September 30, 2012					
	Real Estate	Commercial Other	Total	Real Estate	Agricultural Other	Total
2 - High quality	\$ 25,824	\$ 16,871	\$ 42,695	\$ 2,591	\$ 2,196	\$ 4,787
3 - High satisfactory	82,108	26,977	109,085	16,293	9,615	25,908
4 - Low satisfactory	126,649	47,965	174,614	25,073	20,704	45,777
5 - Special mention	13,224	2,271	15,495	961	2,751	3,712
6 - Substandard	19,124	2,404	21,528	1,631	1,363	2,994
7 - Vulnerable	2,783	2,358	5,141			
8 - Doubtful	785	23	808		261	261
<b>Total</b>	<b>\$ 270,497</b>	<b>\$ 98,869</b>	<b>\$ 369,366</b>	<b>\$ 46,549</b>	<b>\$ 36,890</b>	<b>\$ 83,439</b>

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Rating	December 31, 2011					
	Real Estate	Commercial Other	Total	Real Estate	Agricultural Other	Total
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
<b>Total</b>	<b>\$ 258,095</b>	<b>\$ 107,619</b>	<b>\$ 365,714</b>	<b>\$ 44,683</b>	<b>\$ 29,962</b>	<b>\$ 74,645</b>

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

**1. EXCELLENT Substantially Risk Free**

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

High liquidity, strong cash flow, low leverage.

Unquestioned ability to meet all obligations when due.

Experienced management, with management succession in place.

Secured by cash.

**2. HIGH QUALITY Limited Risk**

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

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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

Access to alternative financing.

Well defined primary and secondary source of repayment.

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

### 3. **HIGH SATISFACTORY Reasonable Risk**

Credit with satisfactory financial condition and further characterized by:

Working capital adequate to support operations.

Cash flow sufficient to pay debts as scheduled.

Management experience and depth appear favorable.

Loan performing according to terms.

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

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**4. LOW SATISFACTORY Acceptable Risk**

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

Would include most start-up businesses.

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

Management's abilities are apparent, yet unproven.

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

Loan structure generally in accordance with policy.

If secured, loan collateral coverage is marginal.

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

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

**5. SPECIAL MENTION Criticized**

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

Downward trend in sales, profit levels, and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

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

Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Collateral or guaranty offers limited protection.

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

**6. SUBSTANDARD Classified**

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

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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**7. VULNERABLE Classified**

Credit is considered Substandard and warrants placing on nonaccrual. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:

Insufficient cash flow to service debt.

Minimal or no payments being received.

Limited options available to avoid the collection process.

Transition status, expect action will take place to collect loan without immediate progress being made.

**8. DOUBTFUL Workout**

Credit has all the weaknesses inherent in a Substandard loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:

Normal operations are severely diminished or have ceased.

Seriously impaired cash flow.

Original repayment terms materially altered.

Secondary source of repayment is inadequate.

Survivability as a going concern is impossible.

Collection process has begun.

Bankruptcy petition has been filed.

Judgments have been filed.

Portion of the loan balance has been charged-off.

9. **LOSS Charge off**

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

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

Fraudulently overstated assets and/or earnings.

Collateral has marginal or no value.

Debtor cannot be located.

Over 120 days delinquent.

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

	<b>September 30, 2012</b>					
	Accruing Interest and Past Due:			Total		
	30-89 Days	90 Days or More	Nonaccrual	Past Due and Nonaccrual	Current	Total
<b>Commercial</b>						
Commercial real estate	\$ 4,100	\$ 86	\$ 2,939	\$ 7,125	\$ 263,372	\$ 270,497
Commercial other	680	114	2,369	3,163	95,706	98,869
<b>Total commercial</b>	<b>4,780</b>	<b>200</b>	<b>5,308</b>	<b>10,288</b>	<b>359,078</b>	<b>369,366</b>
<b>Agricultural</b>						
Agricultural real estate	36	91		127	46,422	46,549
Agricultural other	328		261	589	36,301	36,890
<b>Total agricultural</b>	<b>364</b>	<b>91</b>	<b>261</b>	<b>716</b>	<b>82,723</b>	<b>83,439</b>
<b>Residential real estate</b>						
Senior liens	2,824	177	1,239	4,240	218,895	223,135
Junior liens	184		32	216	17,233	17,449
Home equity lines of credit	238		185	423	39,424	39,847
<b>Total residential real estate</b>	<b>3,246</b>	<b>177</b>	<b>1,456</b>	<b>4,879</b>	<b>275,552</b>	<b>280,431</b>
<b>Consumer</b>						
Secured	220			220	27,938	28,158
Unsecured	64			64	5,293	5,357
<b>Total consumer</b>	<b>284</b>			<b>284</b>	<b>33,231</b>	<b>33,515</b>
<b>Total</b>	<b>\$ 8,674</b>	<b>\$ 468</b>	<b>\$ 7,025</b>	<b>\$ 16,167</b>	<b>\$ 750,584</b>	<b>\$ 766,751</b>

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



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Total agricultural	2	99	604	705	73,940	74,645
<b>Residential real estate</b>						
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
<b>Total residential real estate</b>	<b>3,424</b>	<b>289</b>	<b>1,584</b>	<b>5,297</b>	<b>273,063</b>	<b>278,360</b>
<b>Consumer</b>						
Secured	158	5		163	26,011	26,174
Unsecured	23			23	5,375	5,398
<b>Total consumer</b>	<b>181</b>	<b>5</b>		<b>186</b>	<b>31,386</b>	<b>31,572</b>
<b>Total</b>	<b>\$ 5,754</b>	<b>\$ 760</b>	<b>\$ 6,389</b>	<b>\$ 12,903</b>	<b>\$ 737,388</b>	<b>\$ 750,291</b>

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

1. There has been a 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 and for the periods ended:

	September 30, 2012			December 31, 2011		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
<b>Impaired loans with a valuation allowance</b>						
Commercial real estate	\$ 6,392	\$ 6,673	\$ 2,259	\$ 5,014	\$ 5,142	\$ 1,881
Commercial other	3,047	3,047	656	734	734	271
Agricultural other				2,689	2,689	822
Residential real estate senior liens	8,089	9,237	1,326	7,271	8,827	1,111
Residential real estate junior liens	152	198	28	195	260	35
<b>Total impaired loans with a valuation allowance</b>	<b>\$ 17,680</b>	<b>\$ 19,155</b>	<b>\$ 4,269</b>	<b>\$ 15,903</b>	<b>\$ 17,652</b>	<b>\$ 4,120</b>
<b>Impaired loans without a valuation allowance</b>						
Commercial real estate	\$ 5,356	\$ 6,128		\$ 7,984	\$ 10,570	
Commercial other	1,798	1,908		365	460	
Agricultural real estate				190	190	
Agricultural other	2,281	2,401		505	625	
Residential real estate senior liens	3	65				
Home equity lines of credit	185	485		198	498	
Consumer secured	79	88		105	114	
<b>Total impaired loans without a valuation allowance</b>	<b>\$ 9,702</b>	<b>\$ 11,075</b>		<b>\$ 9,347</b>	<b>\$ 12,457</b>	
<b>Impaired loans</b>						
Commercial	\$ 16,593	\$ 17,756	\$ 2,915	\$ 14,097	\$ 16,906	\$ 2,152
Agricultural	2,281	2,401		3,384	3,504	822
Residential real estate	8,429	9,985	1,354	7,664	9,585	1,146
Consumer	79	88		105	114	

<b>Total impaired loans</b>	<b>\$ 27,382</b>	<b>\$ 30,230</b>	<b>\$ 4,269</b>	<b>\$ 25,250</b>	<b>\$ 30,109</b>	<b>\$ 4,120</b>
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	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
<b>Impaired loans with a valuation allowance</b>				
Commercial real estate	\$ 6,260	\$ 106	\$ 6,197	\$ 287
Commercial other	1,996	67	1,183	95
Agricultural other	1,023		1,878	73
Residential real estate senior liens	7,992	86	7,802	261
Residential real estate junior liens	158	3	174	7
<b>Total impaired loans with a valuation allowance</b>	<b>\$ 17,429</b>	<b>\$ 262</b>	<b>\$ 17,234</b>	<b>\$ 723</b>
<b>Impaired loans without a valuation allowance</b>				
Commercial real estate	\$ 5,651	\$ 72	\$ 6,749	\$ 251
Commercial other	2,026	15	1,860	80
Agricultural real estate	179		214	
Agricultural other	1,417	34	869	41
Residential real estate senior liens	2	2	1	2
Home equity lines of credit	188	6	194	14
Consumer secured	81	2	90	5
<b>Total impaired loans without a valuation allowance</b>	<b>\$ 9,544</b>	<b>\$ 131</b>	<b>\$ 9,977</b>	<b>\$ 393</b>
<b>Impaired loans</b>				
Commercial	\$ 15,933	\$ 260	\$ 15,989	\$ 713
Agricultural	2,619	34	2,961	114
Residential real estate	8,340	97	8,171	284
Consumer	81	2	90	5
<b>Total impaired loans</b>	<b>\$ 26,973</b>	<b>\$ 393</b>	<b>\$ 27,211</b>	<b>\$ 1,116</b>

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	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
<b>Impaired loans with a valuation allowance</b>				
Commercial real estate	\$ 4,770	\$ 130	\$ 4,402	\$ 250
Commercial other	586	16	577	16
Agricultural real estate	58	3	58	3
Agricultural other	720	(38)	1,140	4
Residential real estate senior liens	6,174	115	5,621	221
Residential real estate junior liens	179	1	165	5
<b>Total impaired loans with a valuation allowance</b>	<b>\$ 12,487</b>	<b>\$ 227</b>	<b>\$ 11,963</b>	<b>\$ 499</b>
<b>Impaired loans without a valuation allowance</b>				
Commercial real estate	\$ 5,743	\$ 124	\$ 3,878	\$ 219
Commercial other	1,941	37	1,076	124
Agricultural real estate	207	2	112	1
Agricultural other	2,411	112	1,770	151
Residential real estate senior liens		1	201	1
Home equity lines of credit	100	10	100	10
Consumer secured	50	2	61	5
<b>Total impaired loans without a valuation allowance</b>	<b>\$ 10,452</b>	<b>\$ 288</b>	<b>\$ 7,198</b>	<b>\$ 511</b>
<b>Impaired loans</b>				
Commercial	\$ 13,040	\$ 307	\$ 9,933	\$ 609
Agricultural	3,396	79	3,080	159
Residential real estate	6,453	127	6,087	237
Consumer	50	2	61	5
<b>Total impaired loans</b>	<b>\$ 22,939</b>	<b>\$ 515</b>	<b>\$ 19,161</b>	<b>\$ 1,010</b>

Impaired loans, which include TDR s, had \$173 and \$68 of unfunded commitments under lines of credit as of September 30, 2012 and 2011, respectively.

**Table of Contents****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, we consider if:

1. The borrower is currently in default on any of their debt.
2. The borrower will likely default on any of their debt if the concession is not granted.
3. The borrower s cash flow is insufficient to service all of their debt if the concession is 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 and nine month periods ended September 30, 2012:

	Loans Restructured in the Three Month Period ended September 30, 2012			Loans Restructured in the Nine Month Period ended September 30, 2012		
	Number of Loans	Pre- Modification Recorded Investment	Post- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Post- Modification Recorded Investment
Commercial other	1	\$ 178	\$ 178	27	\$ 5,069	\$ 5,069
Agricultural other				6	561	561
Residential real estate senior liens				12	1,405	1,405
Residential real estate junior liens	1	22	22	1	22	22
<b>Total</b>	<b>2</b>	<b>\$ 200</b>	<b>\$ 200</b>	<b>46</b>	<b>\$ 7,057</b>	<b>\$ 7,057</b>



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	Loans Restructured in the Three Month Period ended September 30, 2011			Loans Restructured in the Nine Month Period ended September 30, 2011		
	Number of Loans	Pre- Modification Recorded Investment	Post- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Post- Modification Recorded Investment
<b>Commercial</b>						
Commercial real estate	1	\$ 408	\$ 408	1	\$ 408	\$ 408
Commercial other	21	4,069	3,737	42	12,143	11,700
<b>Total commercial</b>	<b>22</b>	<b>4,477</b>	<b>4,145</b>	<b>43</b>	<b>12,551</b>	<b>12,108</b>
Agricultural other	3	143	143	11	1,481	1,481
Residential real estate senior liens	3	165	165	23	2,454	2,424
Consumer secured	3	34	34	5	50	50
<b>Total</b>	<b>31</b>	<b>\$ 4,819</b>	<b>\$ 4,487</b>	<b>82</b>	<b>\$ 16,536</b>	<b>\$ 16,063</b>

	Loans Restructured in the Three Month Period Ended September 30, 2012				Loans Restructured in the Nine Month Period Ended September 30, 2012			
	Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment
Commercial other	1	\$ 178		\$	25	\$ 4,924	2	\$ 145
Agricultural other					6	561		
Residential real estate senior liens					4	324	8	1,081
Residential real estate junior liens			1	22			1	22
<b>Total</b>	<b>1</b>	<b>\$ 178</b>	<b>1</b>	<b>\$ 22</b>	<b>35</b>	<b>\$ 5,809</b>	<b>11</b>	<b>\$ 1,248</b>



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	Loans Restructured in the Three Month Period Ended September 30, 2011					
	Below Market Interest Rate		Extension of Amortization Period		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment
<b>Commercial</b>						
Commercial real estate	1	\$ 408		\$		\$
Commercial other	21	4,069				
<b>Total commercial</b>	<b>22</b>	<b>4,477</b>				
Agricultural other	3	143				
Residential real estate senior liens	1	85	1	7	1	73
Consumer secured	3	34				
<b>Total</b>	<b>29</b>	<b>\$ 4,739</b>	<b>1</b>	<b>\$ 7</b>	<b>1</b>	<b>\$ 73</b>

	Loans Restructured in the Nine Month Period Ended September 30, 2012					
	Below Market Interest Rate		Extension of Amortization Period		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment	Number of Loans	Pre- Modification Recorded Investment
<b>Commercial</b>						
Commercial real estate	1	\$ 408		\$		\$
Commercial other	38	9,500	3	913	1	1,730
<b>Total commercial</b>	<b>39</b>	<b>9,908</b>	<b>3</b>	<b>913</b>	<b>1</b>	<b>1,730</b>
Agricultural other	11	1,481				
Residential real estate senior liens	18	2,083	2	57	3	314
Consumer secured	5	50				
<b>Total</b>	<b>73</b>	<b>\$ 13,522</b>	<b>5</b>	<b>\$ 970</b>	<b>4</b>	<b>\$ 2,044</b>

We did not restructure any loans through the forbearance of principal or accrued interest in the three or nine month periods ended September 30, 2012 or 2011.

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



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

	Three Months Ended September 30, 2012				Nine Months Ended September 30, 2012			
	Number of Loans	Pre-Default Recorded Investment	Charge Off Recorded Upon Default	Post-Default Recorded Investment	Number of Loans	Pre-Default Recorded Investment	Charge Off Recorded Upon Default	Post-Default Recorded Investment
Commercial other	2	\$ 50	\$ 25	\$ 25	3	\$ 132	\$ 66	\$ 66
Residential real estate senior liens					1	47	43	4
Consumer secured	1	8	8		1	8	8	
<b>Total</b>	<b>3</b>	<b>\$ 58</b>	<b>\$ 33</b>	<b>\$ 25</b>	<b>5</b>	<b>\$ 187</b>	<b>\$ 117</b>	<b>\$ 70</b>

We had no loans that defaulted during the first nine 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:

	September 30 2012	December 31 2011
Troubled debt restructurings	\$ 21,061	\$ 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:

	September 30 2012	December 31 2011
Federal Home Loan Bank Stock	\$ 7,700	\$ 7,380
Investment in Corporate Settlement Solutions	6,932	6,611
Federal Reserve Bank Stock	1,879	1,879
Investment in Valley Financial Corporation	1,000	1,000
Other	319	319
<b>Total</b>	<b>\$ 17,830</b>	<b>\$ 17,189</b>

**NOTE 8 BORROWED FUNDS**

Borrowed funds consist of the following obligations as of:

	September 30, 2012		December 31, 2011	
	Amount	Rate	Amount	Rate
Federal Home Loan Bank advances	\$ 152,000	2.15%	\$ 142,242	3.16%
Securities sold under agreements to repurchase without stated maturity dates	57,927	0.20%	57,198	0.25%
Securities sold under agreements to repurchase with stated maturity dates	16,653	3.51%	16,696	3.51%

<b>Total</b>	<b>\$ 226,580</b>	<b>1.75%</b>	<b>\$ 216,136</b>	<b>2.42%</b>
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The FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans and certain mortgage-backed securities and collateralized mortgage obligations. Advances are also secured by our holdings of FHLB stock. We had the ability to borrow up to an additional \$117,035 based on assets currently pledged as collateral as of September 30, 2012. During the first quarter of 2012, we reduced funding costs by modifying the terms of \$60,000 of FHLB advances.

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

	September 30 2012		December 31 2011	
	Amount	Rate	Amount	Rate
Fixed rate advances due 2012	\$		\$ 17,000	2.97%
One year putable fixed rate advances due 2012	5,000	3.48%	15,000	4.10%
Variable rate advances due 2012	5,000	0.50%		
Fixed rate advances due 2013			5,242	4.14%
One year putable fixed rate advances due 2013			5,000	3.15%
Fixed rate advances due 2014			25,000	3.16%
Fixed rate advances due 2015	42,000	1.12%	45,000	3.30%
Fixed rate advances due 2016	10,000	2.15%	10,000	2.15%
Fixed rate advances due 2017	40,000	2.15%	20,000	2.56%
Fixed rate advances due 2018	20,000	2.86%		
Fixed rate advances due 2019	20,000	3.73%		
Fixed rate advances due 2020	10,000	1.98%		
<b>Total</b>	<b>\$ 152,000</b>	<b>2.15%</b>	<b>\$ 142,242</b>	<b>3.16%</b>

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$112,873 and \$99,869 at September 30, 2012 and December 31, 2011, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

The following table provides a summary of short term borrowings for the three and nine month periods ended September 30:

	Three Months Ended September 30					
	2012			2011		
	Maximum Month-End Balance	Quarter to Date Average Balance	Weighted Average Interest Rate During the Period	Maximum Month-End Balance	Quarter to Date Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$ 58,471	\$ 57,983	0.20%	\$ 49,583	\$ 47,871	0.25%
Federal funds purchased	15,000	5,848	0.46%	18,300	2,563	0.46%

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	Nine Months Ended September 30					
	2012			2011		
	Maximum Month-End Balance	YTD Average Balance	Weighted Average Interest Rate During the Period	Maximum Month-End Balance	YTD Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$ 58,584	\$ 55,721	0.20%	\$ 49,583	\$ 42,515	0.25%
Federal funds purchased	17,900	4,327	0.41%	18,300	2,776	0.51%

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

	September 30 2012	December 31 2011
Pledged to secure borrowed funds	\$ 308,797	\$ 292,092
Pledged to secure repurchase agreements	112,873	99,869
Pledged for public deposits and for other purposes necessary or required by law	23,480	26,761
<b>Total</b>	<b>\$ 445,150</b>	<b>\$ 418,722</b>

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

**NOTE 9 OTHER NONINTEREST EXPENSES**

A summary of expenses included in other noninterest expenses are as follows for the three and nine month periods ended:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Marketing and donations	\$ 610	\$ 228	\$ 1,639	\$ 978
FDIC insurance premiums	218	209	646	874
Directors fees	235	203	654	620
Audit fees	179	195	509	518
Education and travel	112	102	378	306
Printing and supplies	91	108	310	297
Postage and freight	105	103	300	299
Foreclosed asset and collection	21	143	100	420
Consulting fees	92	63	350	163
Amortization of deposit premium	67	77	200	229
Legal fees	50	82	193	198
Other Losses	80	23	217	34
All other	376	379	1,186	1,102
<b>Total</b>	<b>\$ 2,236</b>	<b>\$ 1,915</b>	<b>\$ 6,682</b>	<b>\$ 6,038</b>

**Table of Contents****NOTE 10 FEDERAL INCOME TAXES**

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the three and nine month periods ended September 30:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Income taxes at 34% statutory rate	\$ 1,481	\$ 967	\$ 4,093	\$ 2,971
Effect of nontaxable income				
Interest income on tax exempt municipal bonds	(391)	(389)	(1,170)	(1,157)
Earnings on corporate owned life insurance	(58)	(48)	(176)	(146)
Other	(147)	(204)	(439)	(460)
Total effect of nontaxable income	(596)	(641)	(1,785)	(1,763)
Effect of nondeductible expenses	14	8	36	31
<b>Federal income tax expense</b>	<b>\$ 899</b>	<b>\$ 334</b>	<b>\$ 2,344</b>	<b>\$ 1,239</b>

Included in OCI for the three and nine month periods ended September 30, 2012 and 2011 are changes in unrealized holding gains, related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

A summary of OCI follows for the three and nine month periods ended September 30:

	September 30, 2012			September 30, 2011		
	Auction Rate Money Market Preferreds and Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferreds and Preferred Stocks	All Other AFS Securities	Total
Unrealized gains (losses) arising during the period	\$ 630	\$ 2,360	\$ 2,990	\$ (675)	\$ 5,396	\$ 4,721
Reclassification adjustment for net realized gains included in net income		(116)	(116)			
Net unrealized gains	630	2,244	2,874	(675)	5,396	4,721
Tax effect		(763)	(763)		(1,835)	(1,835)
<b>Other comprehensive income (loss), net of tax</b>	<b>\$ 630</b>	<b>\$ 1,481</b>	<b>\$ 2,111</b>	<b>\$ (675)</b>	<b>\$ 3,561</b>	<b>\$ 2,886</b>

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	Nine Months Ended					
	September 30, 2012			September 30, 2011		
	Auction Rate Money Market Preferreds and Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferreds and Preferred Stocks	All Other AFS Securities	Total
Unrealized gains arising during the period	\$ 2,049	\$ 3,160	\$ 5,209	\$ (72)	\$ 10,122	\$ 10,050
Reclassification adjustment for net realized gains included in net income		(1,119)	(1,119)			
Reclassification adjustment for impairment loss included in net income		282	282			
Net unrealized gains	2,049	2,323	4,372	(72)	10,122	10,050
Tax effect		(790)	(790)		(3,442)	(3,442)
<b>Other comprehensive income, net of tax</b>	<b>\$ 2,049</b>	<b>\$ 1,533</b>	<b>\$ 3,582</b>	<b>\$ (72)</b>	<b>\$ 6,680</b>	<b>\$ 6,608</b>

**NOTE 11 DEFINED BENEFIT PENSION PLAN**

We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. As a result of the curtailment, future salary increases are no longer considered and plan benefits are based on years of service and the employees' five highest consecutive years of compensation out of the last ten years of service through March 1, 2007. We contributed \$709 to the pension plan during the nine month period ended September 30, 2012 and contributed \$140 to the plan in the nine month period ended September 30, 2011. We anticipate contributing \$41 to the plan in the fourth quarter of 2012.

Following are the components of net periodic benefit cost for the three and nine month periods ended September 30:

	Three Months Ended		Nine Months Ended	
	September 30 2012	September 30 2011	September 30 2012	September 30 2011
Interest cost on PBO	\$ 118	\$ 126	\$ 353	\$ 380
Expected return on plan assets	(127)	(131)	(381)	(392)
Amortization of unrecognized actuarial net loss	73	38	219	115
<b>Net periodic benefit cost</b>	<b>\$ 64</b>	<b>\$ 33</b>	<b>\$ 191</b>	<b>\$ 103</b>

**NOTE 12 FAIR VALUE**

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

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

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

*Investment securities:* Investment securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques.





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such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

Due to the limited trading activity of certain auction rate money market preferred securities and preferred stocks, we measured these securities using Level 3 inputs as of September 30, 2012. As the markets for these securities normalized and established regular trading patterns, we measured preferred stocks utilizing Level 1 inputs and an auction rate money market preferred security utilizing Level 2 inputs as of December 31, 2011 and continued to measure at these levels as of September 30, 2012.

The table below represents the activity in auction rate money market preferred available-for-sale investment securities measured with Level 3 inputs on a recurring basis for the:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Level 3 inputs at beginning of period	\$ 2,834	\$ 2,865
Net unrealized losses	(371)	(402)
Level 3 inputs September 30	\$ 2,463	\$ 2,463

The table below represents the activity in preferred stock available-for-sale investment securities measured with Level 3 inputs on a recurring basis for the:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Level 3 inputs at beginning of period	\$ 7,570	\$ 6,936
Net unrealized (losses) gains	(304)	330
Level 3 inputs September 30	\$ 7,266	\$ 7,266

We had no financial instruments measured with Level 3 inputs on a recurring basis during 2012.

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

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

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

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, management utilizes independent appraisals, broker price opinions, or internal evaluations. These valuations are reviewed to determine whether an additional discount should be applied given the age of market



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information that may have been considered as well as other factors such as costs to carry and sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any charge offs or specific reserves are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

Impaired loans where an allowance is established based on the net realizable value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, we record the loan as nonrecurring Level 2. When a current appraised value is not available or we determine the fair value of collateral is further impaired below the appraised value, the impaired loan is classified as nonrecurring Level 3.

The table below lists the quantitative information about impaired loans measured utilizing Level 3 fair value measurements as of September 30, 2012:

Valuation Techniques	Fair Value	Unobservable Input	Range
<b>Discounted cash flow</b>	\$ 6,889	Duration of cash flows	17 - 120 Months
		Reduction in interest rate	
		from original loan terms	2.13% - 3.38%
		Discount applied to	
		collateral appraisal:	
		Real Estate	20% -30%
		Equipment	50%
<b>Discounted appraisal value</b>	\$ 16,224	Livestock	50%
		Cash crop inventory	50%
		Other inventory	75%
		Accounts receivable	75%

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

*Goodwill and other intangible assets:* Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Goodwill is typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. Acquisition intangibles are tested for impairment with a cash flow valuation. This valuation method requires a significant degree of judgment. In the event the projected undiscounted net operating cash flows for these intangible assets are less than the carrying value, the asset is recorded at fair value as determined by the valuation model. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2012 and 2011 there were no impairments recorded on goodwill and other acquisition intangibles.

*Equity securities without readily determinable fair values:* We have investments in equity securities without readily determinable fair values as well as investments in joint ventures. The assets are individually reviewed for impairment on an annual basis, or more frequently if an indication of impairment exists, by comparing the carrying value to the estimated fair value. The lack of an independent source to validate fair value estimates, including the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. We classify nonmarketable equity securities and investments in joint ventures subjected to nonrecurring fair value adjustments as Level 3. During 2012 and 2011, there were no impairments recorded on equity securities without readily determinable fair values.

*Foreclosed assets:* Upon transfer from the loan portfolio, foreclosed assets are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral and as such, we classify foreclosed assets as a nonrecurring Level 2. When the net realizable value of the collateral is further impaired below the appraised value but there is no observable market price, we record the foreclosed asset as nonrecurring Level 3.



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

*Deposits:* The fair value of demand, savings, and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts), and are classified as Level 1. Fair values for variable rate certificates of deposit approximate their recorded carrying value. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. As such, certificates of deposit are classified as Level 2.

*Borrowed funds:* The carrying amounts of federal funds purchased, borrowings under overnight repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. The fair values of other borrowed funds are estimated using discounted cash flow analyses based on current incremental borrowing arrangements.

We elected to measure a portion of borrowed funds at fair value as of December 31, 2011. These borrowings were recorded at fair value on a recurring basis, with the fair value measurement estimated using discounted cash flow analysis based on current incremental borrowing rates for similar types of borrowing arrangements. Changes in the fair value of these borrowings are included in noninterest income. As such, other borrowed funds are classified as Level 2.

The activity in borrowings which the Corporation had elected to carry at fair value was as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Borrowings carried at fair value beginning of year	\$	\$ 5,306	\$ 5,242	\$ 10,423
Paydowns and maturities			(5,209)	(5,000)
Net unrealized change in fair value		(42)	(33)	(159)
<b>Borrowings carried at fair value September 30</b>	<b>\$</b>	<b>\$ 5,264</b>	<b>\$</b>	<b>\$ 5,264</b>
<b>Unpaid principal balance September 30</b>	<b>\$</b>	<b>\$ 5,000</b>	<b>\$</b>	<b>\$ 5,000</b>

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

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement.

**Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis**

Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

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The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis on our consolidated balance sheets are as follows as of:

	Carrying Value	Estimated Fair Value	September 30, 2012		
			(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and demand deposits due from banks	\$ 24,664	\$ 24,664	\$ 24,664	\$	\$
Certificates of deposit held in other financial institutions	5,675	5,691		5,691	
Mortgage loans available-for-sale	2,820	2,856		2,856	
Total loans	766,751	780,793		753,411	27,382
Less allowance for loan losses	(12,062)	(12,062)		(7,793)	(4,269)
Net loans	754,689	768,731		745,618	23,113
Accrued interest receivable	6,565	6,565	6,565		
Equity securities without readily determinable fair values (1)	17,830	17,830			
Originated mortgage servicing rights	2,290	2,290		2,290	
<b>LIABILITIES</b>					
Deposits without stated maturities	522,642	522,642	522,642		
Deposits with stated maturities	466,849	475,526		475,526	
Borrowed funds	226,580	234,229		234,229	
Accrued interest payable	813	813	813		

	Carrying Value	Estimated Fair Value	December 31, 2011		
			(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and demand deposits due from banks	\$ 28,590	\$ 28,590	\$ 28,590	\$ -	\$ -
Certificates of deposit held in other financial institutions	8,924	8,977	-	8,977	-
Mortgage loans available-for-sale	3,205	3,252		3,252	
Total loans	750,291	769,177		743,927	25,250
Less allowance for loan losses	(12,375)	(12,375)		(8,255)	(4,120)
Net loans	737,916	756,802		735,672	21,130
Accrued interest receivable	5,848	5,848	5,848		
Equity securities without readily determinable fair values (1)	17,189	17,189			
Originated mortgage servicing rights	2,374	2,374		2,374	
<b>LIABILITIES</b>					
Deposits without stated maturities	476,627	476,627	476,627		
Deposits with stated maturities	481,537	499,644		499,644	
Borrowed funds	210,894	222,538		222,538	
Accrued interest payable	967	967	967		

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

**Table of Contents****Financial Instruments Recorded at Fair Value**

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

Description	Total	September 30, 2012			Total	December 31, 2011		
		(Level 1)	(Level 2)	(Level 3)		(Level 1)	(Level 2)	(Level 3)
<b>Recurring items</b>								
Trading securities								
States and political subdivisions	1,788		1,788		4,710		4,710	
Available-for-sale investment securities								
Government sponsored enterprises	1,957		1,957		397		397	
States and political subdivisions	185,480		185,480		174,938		174,938	
Auction rate money market preferred	2,771		2,771		2,049		2,049	
Preferred stocks	6,360	6,360			5,033	5,033		
Mortgage-backed securities	142,228		142,228		143,602		143,602	
Collateralized mortgage obligations	128,618		128,618		99,101		99,101	
Total available-for-sale investment securities	467,414	6,360	461,054		425,120	5,033	420,087	
Borrowed funds					5,242		5,242	
<b>Nonrecurring items</b>								
Impaired loans (net of the allowance for loan losses)								
	23,113			23,113	21,130			21,130
Originated mortgage servicing rights	2,290		2,290		2,374		2,374	
Foreclosed assets	2,001		2,001		1,876		1,876	
	496,606	6,360	467,133	23,113	460,452	5,033	434,289	21,130
Percent of assets and liabilities measured at fair value		1.28%	94.07%	4.65%		1.09%	94.32%	4.59%

The changes in fair value of assets and liabilities recorded at fair value through earnings on a recurring basis and changes in assets and liabilities recorded at fair value on a nonrecurring basis, for which an impairment, or reduction of an impairment, was recognized in the three and nine month periods ended September 30, 2012 and 2011, are summarized as follows:

Description	Three Months Ended September 30					
	2012			2011		
	Trading Gains and (Losses)	Other Gains and (Losses)	Total	Trading Gains and (Losses)	Other Gains and (Losses)	Total
<b>Recurring Items</b>						
Trading securities	(9)		(9)	(24)		(24)
Borrowed funds					42	42
<b>Nonrecurring Items</b>						
Foreclosed assets					(10)	(10)
Originated mortgage servicing rights		(98)	(98)		(296)	(296)
<b>Total</b>	<b>(9)</b>	<b>(98)</b>	<b>(107)</b>	<b>(24)</b>	<b>(264)</b>	<b>(288)</b>





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Description	Nine Months Ended September 30					
	2012			2011		
	Trading Losses	Other Gains and (Losses)	Total	Trading Losses	Other Gains and (Losses)	Total
<b>Recurring items</b>						
Trading securities	(41)		(41)	(51)		(51)
Borrowed funds		33	33		159	159
<b>Nonrecurring items</b>						
Foreclosed assets		(17)	(17)		(45)	(45)
Originated mortgage servicing rights		(56)	(56)		(314)	(314)
<b>Total</b>	<b>(41)</b>	<b>(40)</b>	<b>(81)</b>	<b>(51)</b>	<b>(200)</b>	<b>(251)</b>

**NOTE 13 OPERATING SEGMENTS**

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of Isabella Bank as of September 30, 2012 and 2011 and each of the three and nine month periods then ended, represented 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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### **Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **ISABELLA BANK CORPORATION FINANCIAL REVIEW**

(All dollars in thousands, except per share data)

This section reviews the financial condition and results of operations of Isabella Bank Corporation and its subsidiaries for the three and nine month periods ended September 30, 2012 and 2011. This analysis should be read in conjunction with our 2011 annual report and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 3 of this report. A comprehensive list of acronyms and abbreviations used throughout this discussion is included in Note 1 Basis of Presentation of our interim condensed consolidated financial statements.

#### **Executive Summary**

Despite the challenges of the current economic environment and increased regulatory compliance costs, we are pleased to report our highest quarterly earnings ever and we anticipate that the year ending December 31, 2012 will be our strongest year. There continues to be slight improvements in the local, regional, and national economies, but a large degree of economic uncertainty remains. Our continued success throughout these challenging times is a direct result of our unwavering focus on community banking principles, prudent underwriting standards, and long term sustainable growth. This focus has enabled us to continue to meet the needs of the communities we serve which translates into increased shareholder value.

As we continue to look to build upon our continued success and our desire to expand into complementary markets, we are excited about the prospects of our new Freeland, Michigan office which was opened in October 2012. The new location will complement our existing office locations, increase our brand awareness in the Freeland area, and provide additional shareholder value for years to come.

#### **Recent Legislation**

The Health Care and Education Act of 2010, the Patient Protection and Affordable Care Act, the Dodd-Frank Act, and the JOBS Act, have already and are expected to continue to have a significant impact on the Corporation's operating results in future periods. While the legislation has been passed for these acts, much of the regulations have yet to be written. As such, the extent of the potential impact on our operations has yet to be determined. Of these three acts, the Dodd-Frank Act has had, and is likely to have, the most significant impact. This particular Act made sweeping changes in the regulation of financial institutions aimed at strengthening the operation of the financial services sector. As a result of the implementation of some of the provisions, we have had increases in compensation costs and this trend is expected to continue.

In June 2012, the FFIEC proposed new capital requirements for all financial institutions. In general, the proposal adds a new capital standard of equity capital to assets and increases the minimum capital ratios to be considered well capitalized. While these proposals are not yet final, they could significantly impact our capital requirements, which could impact our ability to pay dividends.

**Table of Contents****RESULTS OF OPERATIONS****Selected Financial Data**

The following table outlines the results of operations and provides certain performance measures for:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
<b>INCOME STATEMENT DATA</b>				
Interest income	\$ 14,164	\$ 14,532	\$ 42,556	\$ 43,439
Interest expense	3,239	4,070	10,372	12,224
Net interest income	10,925	10,462	32,184	31,215
Provision for loan losses	200	963	1,100	2,383
Noninterest income	2,759	1,859	8,844	5,785
Noninterest expenses	9,128	8,513	27,889	25,879
Federal income tax expense	899	334	2,344	1,239
Net Income	\$ 3,457	\$ 2,511	\$ 9,695	\$ 7,499
<b>PER SHARE</b>				
Basic earnings	\$ 0.45	\$ 0.33	\$ 1.28	\$ 0.99
Diluted earnings	0.44	0.32	1.24	0.97
Dividends	0.20	0.19	0.60	0.57
Market value*	22.50	18.75	22.50	18.75
Tangible book value*	14.65	13.70	14.65	13.70
<b>BALANCE SHEET DATA</b>				
<b>At end of period</b>				
Loans	\$ 766,751	\$ 750,163	\$ 766,751	\$ 750,163
Total assets	1,389,138	1,324,093	1,389,138	1,324,093
Deposits	989,491	942,441	989,491	942,441
Shareholders' equity	164,147	155,579	164,147	155,579
<b>Average balance</b>				
Loans	\$ 761,069	\$ 746,856	\$ 751,071	\$ 741,308
Total assets	1,391,955	1,299,179	1,372,433	1,272,848
Deposits	988,136	932,508	979,934	920,290
Shareholders' equity	152,537	146,514	154,428	146,271
<b>PERFORMANCE RATIOS</b>				
Return on average total assets (annualized)	0.99%	0.77%	0.94%	0.79%
Return on average shareholders' equity (annualized)	9.07%	6.86%	8.37%	6.84%
Return on average tangible equity (annualized)	12.56%	9.97%	11.96%	10.08%
Net interest margin yield (FTE annualized)	3.73%	3.85%	3.72%	3.90%
Loan to deposit*	77.49%	79.60%	77.49%	79.60%
Nonperforming loans to total loans*	0.98%	0.81%	0.98%	0.81%
Nonperforming assets to total assets*	0.68%	0.61%	0.68%	0.61%
ALLL to nonperforming loans*	160.98%	199.24%	160.98%	199.24%
<b>CAPITAL RATIOS</b>				
Shareholders' equity to assets*	11.82%	11.75%	11.82%	11.75%
Tier 1 capital to average assets*	8.27%	8.10%	8.27%	8.10%
Tier 1 risk-based capital*	13.35%	12.43%	13.35%	12.43%
Total risk-based capital*	14.60%	13.68%	14.60%	13.68%

\* At end of period

**Table of Contents****Net Interest Income**

Net interest income is our primary source of income. Interest income includes loan fees of \$846 and \$2,302 for the three and nine month periods ended September 30, 2012, respectively, as compared to \$534 and \$1,755 during the same periods in 2011. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

**AVERAGE BALANCES, INTEREST RATE, AND NET INTEREST INCOME**

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities. This schedule also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a 34% tax rate. Nonaccruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

The following table displays the results for the three month periods ended September 30:

	Average Balance	2012 Tax Equivalent Interest	Average Yield / Rate	Average Balance	2011 Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>						
Loans	\$ 761,069	\$ 10,918	5.74%	\$ 746,856	\$ 11,365	6.09%
Taxable investment securities	316,639	1,878	2.37%	243,123	1,800	2.96%
Nontaxable investment securities	149,390	2,006	5.37%	135,433	1,961	5.79%
Trading account securities	1,862	23	4.94%	4,905	68	5.55%
Other	26,367	121	1.84%	38,412	121	1.26%
<b>Total earning assets</b>	<b>1,255,327</b>	<b>14,946</b>	<b>4.76%</b>	<b>1,168,729</b>	<b>15,315</b>	<b>5.24%</b>
<b>NONEARNING ASSETS</b>						
Allowance for loan losses	(12,484)			(12,496)		
Cash and demand deposits due from banks	19,483			20,459		
Premises and equipment	25,290			24,361		
Accrued income and other assets	104,339			98,126		
<b>Total assets</b>	<b>\$ 1,391,955</b>			<b>\$ 1,299,179</b>		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing demand deposits	\$ 172,931	52	0.12%	\$ 155,385	49	0.13%
Savings deposits	218,028	110	0.20%	192,457	117	0.24%
Time deposits	472,873	2,041	1.73%	469,791	2,559	2.18%
Borrowed funds	232,231	1,036	1.78%	202,451	1,345	2.66%
<b>Total interest bearing liabilities</b>	<b>1,096,063</b>	<b>3,239</b>	<b>1.18%</b>	<b>1,020,084</b>	<b>4,070</b>	<b>1.60%</b>
<b>NONINTEREST BEARING LIABILITIES</b>						
Demand deposits	124,304			114,875		
Other	19,051			17,706		
Shareholders' equity	152,537			146,514		
<b>Total liabilities and shareholders' equity</b>	<b>\$ 1,391,955</b>			<b>\$ 1,299,179</b>		
<b>Net interest income (FTE)</b>		<b>\$ 11,707</b>			<b>\$ 11,245</b>	

**Net yield on interest earning assets (FTE)**

**3.73%**

**3.85%**

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The following table displays the results for the nine month periods ended September 30:

	Average Balance	2012 Tax Equivalent Interest	Average Yield / Rate	Average Balance	2011 Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>						
Loans	\$ 751,071	\$ 32,707	5.81%	\$ 741,308	\$ 34,190	6.15%
Taxable investment securities	306,006	5,755	2.51%	226,104	5,149	3.04%
Nontaxable investment securities	144,170	5,956	5.51%	134,948	5,830	5.76%
Trading account securities	2,925	120	5.47%	5,174	217	5.59%
Other	33,619	363	1.44%	38,407	388	1.35%
<b>Total earning assets</b>	<b>1,237,791</b>	<b>44,901</b>	<b>4.84%</b>	<b>1,145,941</b>	<b>45,774</b>	<b>5.33%</b>
<b>NONEARNING ASSETS</b>						
Allowance for loan losses	(12,559)			(12,544)		
Cash and demand deposits due from banks	19,455			20,111		
Premises and equipment	25,079			24,335		
Accrued income and other assets	102,667			95,005		
<b>Total assets</b>	<b>\$ 1,372,433</b>			<b>\$ 1,272,848</b>		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing demand deposits	\$ 171,079	156	0.12%	\$ 152,436	142	0.12%
Savings deposits	212,040	341	0.21%	192,820	363	0.25%
Time deposits	476,186	6,586	1.84%	463,950	7,781	2.24%
Borrowed funds	223,668	3,289	1.96%	193,021	3,938	2.72%
<b>Total interest bearing liabilities</b>	<b>1,082,973</b>	<b>10,372</b>	<b>1.28%</b>	<b>1,002,227</b>	<b>12,224</b>	<b>1.63%</b>
<b>NONINTEREST BEARING LIABILITIES</b>						
Demand deposits	120,629			111,084		
Other	14,403			13,266		
Shareholders equity	154,428			146,271		
<b>Total liabilities and shareholders equity</b>	<b>\$ 1,372,433</b>			<b>\$ 1,272,848</b>		
<b>Net interest income (FTE)</b>		<b>\$ 34,529</b>			<b>\$ 33,550</b>	
<b>Net yield on interest earning assets (FTE)</b>			<b>3.72%</b>			<b>3.90%</b>



**Table of Contents****VOLUME AND RATE VARIANCE ANALYSIS**

The following table sets forth the effect of volume and rate changes on interest income and expense for the periods indicated. For the purpose of this table, changes in interest due to volume and rate were determined as follows:

Volume Variance change in volume multiplied by the previous year's rate.

Rate Variance change in the FTE rate multiplied by the previous year's volume.

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

	Three Months Ended September 30, 2012 Compared to September 30, 2011			Nine Months Ended September 30, 2012 Compared to September 30, 2011		
	Volume	Rate	Net	Volume	Rate	Net
<b>CHANGES IN INTEREST INCOME</b>						
Loans	\$ 213	\$ (660)	\$ (447)	\$ 446	\$ (1,929)	\$ (1,483)
Taxable investment securities	479	(401)	78	1,607	(1,001)	606
Nontaxable investment securities	193	(148)	45	388	(265)	123
Trading account securities	(38)	(7)	(45)	(92)	(5)	(97)
Other	(45)	45		(51)	26	(25)
Total changes in interest income	802	(1,171)	(369)	2,298	(3,174)	(876)
<b>CHANGES IN INTEREST EXPENSE</b>						
Interest bearing demand deposits	5	(2)	3	17	(3)	14
Savings deposits	14	(21)	(7)	34	(56)	(22)
Time deposits	17	(535)	(518)	201	(1,396)	(1,195)
Borrowed funds	178	(487)	(309)	562	(1,211)	(649)
Total changes in interest expense	214	(1,045)	(831)	814	(2,666)	(1,852)
<b>Net change in interest margin (FTE)</b>	<b>\$ 588</b>	<b>\$ (126)</b>	<b>\$ 462</b>	<b>\$ 1,484</b>	<b>\$ (508)</b>	<b>\$ 976</b>

Our net yield on interest earning assets has leveled off in spite of the persistent low interest rate environment and soft loan demand. This is a direct result of our restructuring of \$60,000 of FHLB advances in the first quarter of 2012, which is anticipated to reduce interest expense by approximately \$450 for 2012.

Given that the historically low interest rate environment is expected to continue for the foreseeable future, the net yield on interest earning assets is likely to decline in future periods. This anticipated decline will be driven by continued reduction in rates earned on loans without a corresponding decline in funding rates. Any additional interest income will be contingent upon increases in volume, which will increase the speed of the rate reductions on interest earning assets.

**Table of Contents****Allowance for Loan Losses**

The viability of any financial institution is ultimately determined by its management of credit risk. Loans outstanding represent our single largest concentration of risk. The ALLL is our estimation of probable losses inherent in the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment allocations, historical losses, internally assigned credit ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a reflection of other qualitative risks within the loan portfolio.

The following tables summarize our charge off and recovery activity for the:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Allowance for loan losses at beginning of period	\$ 12,318	\$ 12,378	\$ 12,375	\$ 12,373
Loans charged off				
Commercial and agricultural	271	215	957	1,085
Residential real estate	213	857	566	1,735
Consumer	127	98	364	382
<b>Total loans charged off</b>	<b>611</b>	<b>1,170</b>	<b>1,887</b>	<b>3,202</b>
Recoveries				
Commercial and agricultural	40	76	168	422
Residential real estate	34	39	95	142
Consumer	81	87	211	255
<b>Total recoveries</b>	<b>155</b>	<b>202</b>	<b>474</b>	<b>819</b>
Provision for loan losses	200	963	1,100	2,383
<b>Allowance for loan losses at end of period</b>	<b>\$ 12,062</b>	<b>\$ 12,373</b>	<b>\$ 12,062</b>	<b>\$ 12,373</b>
Net loans charged off	\$ 456	\$ 968	\$ 1,413	\$ 2,383
Average loans outstanding	761,069	746,856	751,071	741,308
<b>Net loans charged off to average loans outstanding</b>	<b>0.06%</b>	<b>0.13%</b>	<b>0.19%</b>	<b>0.32%</b>
Total amount of loans outstanding at end of period	\$ 766,751	\$ 750,163	\$ 766,751	\$ 750,163
<b>Allowance for loan losses as a % of loans at end of period</b>	<b>1.57%</b>	<b>1.65%</b>	<b>1.57%</b>	<b>1.65%</b>

As shown in the preceding table, the level of net chargeoffs continues to decline. This trend has allowed us to reduce our provision, which has led to a decline in the ALLL in both amount and as a percentage of loans. For further discussion on the allocation of the ALLL, see Note 6 Loans and Allowance for Loan Losses to our interim condensed consolidated financial statements.

**Table of Contents****Loans Past Due and Loans in Nonaccrual Status**

Increases in past due and nonaccrual loans can have a significant impact on the allowance for loan losses. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due 30-89 days, 90 days or more, and nonaccrual loans. Loans past due and in nonaccrual status have increased over prior periods. Part of the increase in accruing loans past due 30-89 days from year end was related to one loan that had a balance of \$1,302 as of September 30, 2012. This loan was also past due 30-89 days as of June 30, 2012. We will continue to closely monitor this loan for indicators of additional deterioration. The increase in nonaccrual loans was primarily the result of the addition of one loan in the three month period ended September 30, 2012 (for further discussion see nonperforming assets below).

A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual loans by type, is included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has allowed certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDR. The implementation of ASU No. 2011-02 *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* has also contributed to the increased level of TDRs. The modifications have been extremely successful for us and our customers as very few of the modified loans have resulted in foreclosures. Troubled debt restructurings that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance.

The following table summarizes our troubled debt restructurings component of impaired loans as of:

	September 30, 2012			December 31, 2011			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$ 17,637	\$ 1,551	\$ 19,188	\$ 16,125	\$ 514	\$ 16,639	\$ 2,549
Past due 30-89 days	594	1,017	1,611	1,614	429	2,043	(432)
Past due 90 days or more	30	232	262		74	74	188
<b>Total troubled debt restructurings</b>	<b>\$ 18,261</b>	<b>\$ 2,800</b>	<b>\$ 21,061</b>	<b>\$ 17,739</b>	<b>\$ 1,017</b>	<b>\$ 18,756</b>	<b>\$ 2,305</b>

Additional disclosures about TDRs are included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

**Table of Contents****Nonperforming Assets**

The following table summarizes our nonperforming assets as of:

	September 30 2012	December 31 2011
Nonaccrual loans	\$ 7,025	\$ 6,389
Accruing loans past due 90 days or more	468	760
<b>Total nonperforming loans</b>	<b>7,493</b>	<b>7,149</b>
OREO	1,986	1,867
Repossessed assets	15	9
<b>Total nonperforming assets</b>	<b>\$ 9,494</b>	<b>\$ 9,025</b>
<b>Nonperforming loans as a % of total loans</b>	<b>0.98%</b>	<b>0.95%</b>
<b>Nonperforming assets as a % of total assets</b>	<b>0.68%</b>	<b>0.67%</b>

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

Included in the nonaccrual loan balances above were credits currently classified as troubled debt restructurings as of:

	September 30 2012	December 31 2011
Commercial and agricultural	\$ 2,608	\$ 520
Residential real estate	192	497
<b>Total</b>	<b>\$2,800</b>	<b>\$1,017</b>

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of September 30, 2012 and December 31, 2011. To be classified as individually significant, the recorded investment in nonaccrual loans to each borrower must have exceeded \$1,000 as of the end of either period.

	September 30, 2012		December 31, 2011	
	Outstanding Balance	Specific Allocation	Outstanding Balance	Specific Allocation
Borrower 1	\$ 1,096	\$ 175	\$	\$
Borrower 2	997	A	1,014	A
Borrower 3			1,900	B
Borrower 4	2,107	390		
Other not individually significant	1,369		1,891	
<b>Total</b>	<b>\$ 5,569</b>		<b>\$ 4,805</b>	

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- A** - No specific allocation as the net realizable value of the loan's underlying collateral value exceeded the loan's carrying balance.
- B** - No specific allocation established for this loan as it was charged down to reflect the current market value of the real estate. This loan was subsequently transferred to OREO and sold in the second quarter of 2012.
- There were no other individually significant credits included in nonaccrual loans as of September 30, 2012 or December 31, 2011.

Additional disclosures about nonaccrual loans are included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

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We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a chargeoff. We believe that all loans deemed to be impaired have been recognized.

We believe that the level of the ALLL is appropriate as of September 30, 2012 and we will continue to closely monitor overall credit quality and our policies and procedures related to the analysis of the ALLL to ensure that the allowance for loan losses remains appropriate.

**NONINTEREST INCOME AND EXPENSES****Noninterest Income**

Noninterest income consists of service charges and fee income, gains from the sale of mortgage loans, gains and losses on trading securities and borrowings measured at fair value, gains from the sale of investment securities, and other. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

	Three Months Ended September 30			
	2012	2011	Change	
			\$	%
<b>Service charges and fees</b>				
NSF and overdraft fees	\$ 628	\$ 653	\$ (25)	-3.8%
ATM and debit card fees	473	455	18	4.0%
Trust fees	279	253	26	10.3%
Freddie Mac servicing fee	185	188	(3)	-1.6%
Service charges on deposit accounts	80	84	(4)	-4.8%
Net originated mortgage servicing rights loss	(135)	(325)	190	N/M
All other	33	33		0.0%
<b>Total service charges and fees</b>	<b>1,543</b>	<b>1,341</b>	<b>202</b>	<b>15.1%</b>
<b>Gain on sale of mortgage loans</b>	<b>422</b>	<b>111</b>	<b>311</b>	<b>280.2%</b>
<b>Net loss on trading securities</b>	<b>(9)</b>	<b>(24)</b>	<b>15</b>	<b>N/M</b>
<b>Net gain on borrowings measured at fair value</b>		<b>42</b>	<b>(42)</b>	<b>-100.0%</b>
<b>Gain on sale of available-for-sale investment securities</b>	<b>116</b>		<b>116</b>	<b>N/M</b>
<b>Other</b>				
Earnings on corporate owned life insurance policies	171	141	30	21.3%
Brokerage and advisory fees	143	122	21	17.2%
Income from investment in Corporate Settlement Solutions	198	3	195	N/M
Gain on sale of OREO	75	32	43	134.4%
All other	100	91	9	9.9%
<b>Total other</b>	<b>687</b>	<b>389</b>	<b>298</b>	<b>76.6%</b>
<b>Total noninterest income</b>	<b>\$ 2,759</b>	<b>\$ 1,859</b>	<b>\$ 900</b>	<b>48.4%</b>

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	Nine Months Ended September 30			
	2012	2011	Change	%
			\$	
<b>Service charges and fees</b>				
NSF and overdraft fees	\$ 1,783	\$ 1,875	\$ (92)	-4.9%
ATM and debit card fees	1,407	1,299	108	8.3%
Trust fees	795	741	54	7.3%
Freddie Mac servicing fee	563	544	19	3.5%
Service charges on deposit accounts	238	242	(4)	-1.7%
Net originated mortgage servicing rights loss	(85)	(375)	290	N/M
All other	99	108	(9)	-8.3%
<b>Total service charges and fees</b>	<b>4,800</b>	<b>4,434</b>	<b>366</b>	<b>8.3%</b>
<b>Gain on sale of mortgage loans</b>	<b>1,080</b>	<b>293</b>	<b>787</b>	<b>268.6%</b>
<b>Net loss on trading securities</b>	<b>(41)</b>	<b>(51)</b>	<b>10</b>	<b>N/M</b>
<b>Net gain on borrowings measured at fair value</b>	<b>33</b>	<b>159</b>	<b>(126)</b>	<b>-79.2%</b>
<b>Gain on sale of available-for-sale investment securities</b>	<b>1,119</b>		<b>1,119</b>	<b>N/M</b>
<b>Other</b>				
Earnings on corporate owned life insurance policies	519	428	91	21.3%
Brokerage and advisory fees	410	405	5	1.2%
Income (Loss) from investment in Corporate Settlement Solutions	397	(281)	678	N/M
Gain on sale of OREO	206	73	133	182.2%
All other	321	325	(4)	-1.2%
<b>Total other</b>	<b>1,853</b>	<b>950</b>	<b>903</b>	<b>95.1%</b>
<b>Total noninterest income</b>	<b>\$ 8,844</b>	<b>\$ 5,785</b>	<b>\$ 3,059</b>	<b>52.9%</b>

Significant changes in noninterest income are detailed below:

We continuously analyze various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, we make any necessary adjustments to ensure that our fee structure is within the range of our competitors, while at the same time making sure that the fees remain fair to deposit customers. NSF and overdraft fees represent the largest single component of service charges and fees. While we have experienced significant increases in deposit accounts, NSF and overdraft fees have declined. This decline has been the result of reduced overdraft activity by our customers as well as changes in banking regulations. We expect this downward trend to continue into the foreseeable future.

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

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

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The recent decline in offering rates on residential real estate loans has led to a significant increase in the level of refinancing activity. This increase in activity has resulted in substantial increases in the gain on sale of mortgage loans, while contributing to fluctuations in the value of our OMSR portfolio. This increased refinancing activity has also contributed to the increase in income from Corporate Settlement. We anticipate this trend to continue for the remainder of 2012.

Fluctuations in the gains and losses related to trading securities and borrowings measured at fair value are caused by interest rate variances. As we do not anticipate any significant changes to interest rates in the foreseeable future, and therefore we do not anticipate any large fluctuations in future periods.

We are continually analyzing our available-for-sale investment portfolio for potential sale opportunities that will improve our long term profitability. During the first quarter of 2012, we identified several pools of mortgage-backed securities with significant unrealized gains. As the interest rates of the underlying mortgages were significantly higher than the current offering rates for similar mortgages, we elected to realize these gains through the sales of such securities as the investments would have likely been paid off in the near term through refinancing activity. In the third quarter of 2012, we elected to sell some additional mortgage-backed securities as their current prepayment characteristics had resulted in less than acceptable yields. We do not anticipate any further significant investment sales during the remainder of 2012.

Earnings on corporate owned life insurance policies have increased from 2011 as a result of the purchase of an additional \$4,000 in policies in the third quarter of 2011. Earnings are expected to approximate current levels for the remainder of 2012.

As market conditions have improved, we have been able to sell some of our OREO properties at gains. As property values and the facts and circumstances surrounding each property vary, this amount will fluctuate from period to period. We do not anticipate any assets currently included in OREO generating significant gains or losses in future periods.

The fluctuation in all other income is spread throughout various categories, none of which are individually significant. We do not anticipate any significant fluctuations from current levels for the remainder of 2012.



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**Noninterest Expenses**

Noninterest expenses include compensation and benefits, occupancy, furniture and equipment, available-for-sale security impairment loss, and other expenses. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations: