

INDEPENDENT BANK CORP /MI/  
Form 10-Q  
November 04, 2015

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2015

Commission file number 0-7818

INDEPENDENT BANK CORPORATION

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(Exact name of registrant as specified in its charter)

|  |   |
|--|---|
| Michigan   | 38-2032782                              |
| (State or jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |

4200 East Beltline, Grand Rapids, Michigan 49525

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(Address of principal executive offices)

(616) 527-5820  
(Registrant's telephone number, including area code)

NONE

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Former name, address and fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has filed all documents and reports required to be filed by Sections 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 (§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, non-accelerated filer or smaller reporting company.

Large accelerated filer Accelerated filer Non-accelerated filer 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

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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 | 22,297,545                      |
| Class                      | Outstanding at November 3, 2015 |

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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FORWARD-LOOKING STATEMENTS

Statements in this report that are not statements of historical fact, including statements that include terms such as “will,” “may,” “should,” “believe,” “expect,” “forecast,” “anticipate,” “estimate,” “project,” “intend,” “likely,” “optimistic” and “plan” about future or projected financial and operating results, plans, projections, objectives, expectations, and intentions, are forward-looking statements. Forward-looking statements include, but are not limited to, descriptions of plans and objectives for future operations, products or services; projections of our future revenue, earnings or other measures of economic performance; forecasts of credit losses and other asset quality trends; statements about our business and growth strategies; and expectations about economic and market conditions and trends. These forward-looking statements express our current expectations, forecasts of future events, or long-term goals. They are based on assumptions, estimates, and forecasts that, although believed to be reasonable, may turn out to be incorrect. Actual results could differ materially from those discussed in the forward-looking statements for a variety of reasons, including:

- economic, market, operational, liquidity, credit, and interest rate risks associated with our business;
- economic conditions generally and in the financial services industry, particularly economic conditions within Michigan and the regional and local real estate markets in which our bank operates;
- the failure of assumptions underlying the establishment of, and provisions made to, our allowance for loan losses;
- the failure of assumptions underlying our estimate of probable incurred losses from vehicle service contract payment plan counterparty contingencies, including our assumptions regarding future cancellations of vehicle service contracts, the value to us of collateral that may be available to recover funds due from our counterparties, and our ability to enforce the contractual obligations of our counterparties to pay amounts owing to us;
- increased competition in the financial services industry, either nationally or regionally;
- our ability to achieve loan and deposit growth;
- volatility and direction of market interest rates;
- the continued services of our management team; and
- implementation of new legislation, which may have significant effects on us and the financial services industry.

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all-inclusive. The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

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Part I - Item 1.

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Financial Condition

|  | September<br>30,<br>2015<br>(unaudited) | December<br>31,<br>2014<br>(unaudited) |
|--|---|--|
| (In thousands, except share amounts)                           |   |  |
| Assets   |   |  |
| Cash and due from banks  | \$52,146                                | \$48,326                               |
| Interest bearing deposits                                      | 53,051                                  | 25,690                                 |
| Cash and Cash Equivalents                                      | 105,197                                 | 74,016                                 |
| Interest bearing deposits - time                               | 13,029                                  | 13,561                                 |
| Trading securities   | 225                                     | 203                                    |
| Securities available for sale                                  | 604,662                                 | 533,178                                |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 15,286                                  | 19,919                                 |
| Loans held for sale, carried at fair value                     | 25,462                                  | 23,662                                 |
| Loans  |   |  |
| Commercial   | 726,356                                 | 690,955                                |
| Mortgage   | 468,578                                 | 472,628                                |
| Installment  | 235,627                                 | 206,378                                |
| Payment plan receivables                                       | 37,438                                  | 40,001                                 |
| Total Loans  | 1,467,999                               | 1,409,962                              |
| Allowance for loan losses                                      | (24,604 )                               | (25,990 )                              |
| Net Loans  | 1,443,395                               | 1,383,972                              |
| Other real estate and repossessed assets                       | 3,851                                   | 6,454                                  |
| Property and equipment, net                                    | 43,359                                  | 45,948                                 |
| Bank-owned life insurance                                      | 54,098                                  | 53,625                                 |
| Deferred tax assets, net                                       | 41,422                                  | 48,632                                 |
| Capitalized mortgage loan servicing rights                     | 11,630                                  | 12,106                                 |
| Vehicle service contract counterparty receivables, net         | 7,324                                   | 7,237                                  |
| Other intangibles  | 2,366                                   | 2,627                                  |
| Accrued income and other assets                                | 23,555                                  | 23,590                                 |
| Total Assets   | \$2,394,861                             | \$2,248,730                            |
| Liabilities and Shareholders' Equity                           |   |  |
| Deposits   |   |  |
| Non-interest bearing   | \$640,208                               | \$576,882                              |
| Savings and interest-bearing checking                          | 987,146                                 | 943,734                                |
| Reciprocal   | 47,918                                  | 53,668                                 |
| Time   | 385,690                                 | 350,018                                |
| Total Deposits   | 2,060,962                               | 1,924,302                              |
| Other borrowings   | 12,070                                  | 12,470                                 |
| Subordinated debentures  | 35,569                                  | 35,569                                 |
| Vehicle service contract counterparty payables                 | 1,950                                   | 1,977                                  |
| Accrued expenses and other liabilities                         | 31,330                                  | 24,041                                 |
| Total Liabilities  | 2,141,881                               | 1,998,359                              |

Shareholders' Equity

|  |             |             |
|--|-------------|-------------|
| Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding   | -           | -           |
| Common stock, no par value, 500,000,000 shares authorized; issued and outstanding:<br>22,548,562 shares at September 30, 2015 and 22,957,323 shares at December 31, 2014 | 343,601     | 352,462     |
| Accumulated deficit  | (86,125 )   | (96,455 )   |
| Accumulated other comprehensive loss   | (4,496 )    | (5,636 )    |
| Total Shareholders' Equity   | 252,980     | 250,371     |
| Total Liabilities and Shareholders' Equity   | \$2,394,861 | \$2,248,730 |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

|   | Three months<br>ended<br>September 30,<br>2015 |          | Nine months<br>ended<br>September 30,<br>2015 |          |
|---|--|----------|---|----------|
|   | 2014   | 2015     | 2014  | 2015     |
|   | (unaudited)                                    |          | (unaudited)                                   |          |
|   | (In thousands, except per share<br>amounts)    |          |   |          |
| Interest Income                                     |  |          |   |          |
| Interest and fees on loans                          | \$17,869                                       | \$17,818 | \$52,859                                      | \$54,179 |
| Interest on securities                              |  |          |   |          |
| Taxable   | 1,901  | 1,644    | 5,528   | 4,623    |
| Tax-exempt  | 228  | 281      | 667   | 830      |
| Other investments                                   | 295  | 325      | 922   | 1,076    |
| Total Interest Income                               | 20,293   | 20,068   | 59,976  | 60,708   |
| Interest Expense                                    |  |          |   |          |
| Deposits  | 987  | 1,236    | 2,961   | 3,789    |
| Other borrowings                                    | 465  | 649      | 1,382   | 1,720    |
| Total Interest Expense                              | 1,452  | 1,885    | 4,343   | 5,509    |
| Net Interest Income                                 | 18,841   | 18,183   | 55,633  | 55,199   |
| Provision for loan losses                           | (244 )   | (632 )   | (1,037 )                                      | (2,049 ) |
| Net Interest Income After Provision for Loan Losses | 19,085   | 18,815   | 56,670  | 57,248   |
| Non-interest Income                                 |  |          |   |          |
| Service charges on deposit accounts                 | 3,294  | 3,579    | 9,261   | 10,166   |
| Interchange income                                  | 2,169  | 1,984    | 6,551   | 5,992    |
| Net gains (losses) on assets                        |  |          |   |          |
| Mortgage loans                                      | 1,812  | 1,490    | 5,735   | 4,139    |
| Securities  | 45   | 168      | 97  | 334      |
| Other than temporary impairment loss on securities  |  |          |   |          |
| Total impairment loss                               | -  | (9 )     | -   | (9 )     |
| Loss recognized in other comprehensive income       | -  | -        | -   | -        |
| Net impairment loss recognized in earnings          | -  | (9 )     | -   | (9 )     |
| Mortgage loan servicing                             | (556 )   | 932      | 476   | 1,389    |
| Title insurance fees                                | 281  | 243      | 874   | 734      |
| Net gain on branch sale                             | 1,193  | -        | 1,193   | -        |
| Other   | 1,881  | 2,156    | 5,881   | 6,829    |
| Total Non-interest Income                           | 10,119   | 10,543   | 30,068  | 29,574   |
| Non-Interest Expense                                |  |          |   |          |
| Compensation and employee benefits                  | 12,029   | 11,718   | 35,605  | 34,774   |
| Occupancy, net                                      | 1,940  | 2,079    | 6,399   | 6,715    |
| Data processing                                     | 2,001  | 1,790    | 5,958   | 5,653    |
| Loan and collection                                 | 816  | 1,391    | 2,938   | 4,283    |
| Furniture, fixtures and equipment                   | 998  | 1,005    | 2,915   | 3,127    |
| Communications                                      | 754  | 712      | 2,184   | 2,212    |
| Legal and professional                              | 519  | 559      | 1,352   | 1,380    |
| Advertising   | 406  | 427      | 1,338   | 1,547    |
| FDIC deposit insurance                              | 350  | 396      | 1,044   | 1,235    |
| Interchange expense                                 | 279  | 368      | 859   | 1,112    |

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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| Credit card and bank service fees                              | 197     | 226     | 602      | 734      |
| Vehicle service contract counterparty contingencies            | 30      | 28      | 89       | 169      |
| Costs related to unfunded lending commitments                  | 26      | 12      | 46       | 27       |
| Provision for loss reimbursement on sold loans                 | (35 )   | -       | (59 )    | (466 )   |
| Net (gains) losses on other real estate and repossessed assets | 5       | (285 )  | (173 )   | (410 )   |
| Other  | 1,564   | 1,658   | 4,512    | 4,952    |
| Total Non-interest Expense                                     | 21,879  | 22,084  | 65,609   | 67,044   |
| Income Before Income Tax                                       | 7,325   | 7,274   | 21,129   | 19,778   |
| Income tax expense   | 2,278   | 2,345   | 6,682    | 5,659    |
| Net Income   | \$5,047 | \$4,929 | \$14,447 | \$14,119 |
| Net Income Per Common Share                                    |         |         |          |          |
| Basic  | \$0.22  | \$0.21  | \$0.63   | \$0.62   |
| Diluted  | \$0.22  | \$0.21  | \$0.62   | \$0.60   |
| Dividends Per Common Share                                     |         |         |          |          |
| Declared   | \$0.06  | \$0.06  | \$0.18   | \$0.12   |
| Paid   | \$0.06  | \$0.06  | \$0.18   | \$0.12   |

See notes to interim condensed consolidated financial statements (unaudited)



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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

|   | Three months<br>ended<br>September 30,<br>2015 2014<br>(unaudited)<br>(In thousands) |         | Nine months<br>ended<br>September 30,<br>2015 2014<br>(unaudited) |          |
|---|--|---------|---|----------|
| Net income  | \$5,047  | \$4,929 | \$14,447  | \$14,119 |
| Other comprehensive income, before tax  |  |         |   |          |
| Available for sale securities   |  |         |   |          |
| Unrealized gains arising during period  | 1,366  | 253     | 1,830   | 4,262    |
| Change in unrealized gains for which a portion of other than temporary impairment has been recognized in earnings | 10   | 94      | -   | 432      |
| Reclassification adjustment for other than temporary impairment included in earnings                              | -  | 9       | -   | 9        |
| Reclassification adjustments for gains included in earnings   | -  | (121 )  | (75 )   | (123 )   |
| Unrealized gains recognized in other comprehensive income on available for sale securities                        | 1,376  | 235     | 1,755   | 4,580    |
| Income tax expense  | 482  | 82      | 615   | 1,603    |
| Unrealized gains recognized in other comprehensive income on available for sale securities, net of tax            | 894  | 153     | 1,140   | 2,977    |
| Derivative instruments  |  |         |   |          |
| Reclassification adjustment for accretion on settled derivatives  | -  | 95      | -   | 285      |
| Unrealized gains recognized in other comprehensive income on derivative instruments                               | -  | 95      | -   | 285      |
| Income tax expense  | -  | 33      | -   | 100      |
| Unrealized gains recognized in other comprehensive income on derivative instruments, net of tax                   | -  | 62      | -   | 185      |
| Other comprehensive income  | 894  | 215     | 1,140   | 3,162    |
| Comprehensive income  | \$5,941  | \$5,144 | \$15,587  | \$17,281 |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

|   | Nine months ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2015                               | 2014      |
|   | (unaudited - In<br>thousands)      |           |
| Net Income  | \$ 14,447                          | \$ 14,119 |
| Adjustments to Reconcile Net Income to Net Cash From Operating Activities                                       |                                    |           |
| Proceeds from sales of loans held for sale  | 227,381                            | 160,102   |
| Disbursements for loans held for sale   | (223,446)                          | (158,410) |
| Provision for loan losses   | (1,037 )                           | (2,049 )  |
| Deferred federal income tax expense   | 7,210                              | 7,218     |
| Net deferred loan costs   | (1,189 )                           | (846 )    |
| Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities and loans | 3,345                              | 1,856     |
| Net gains on mortgage loans   | (5,735 )                           | (4,139 )  |
| Net gains on securities   | (97 )                              | (334 )    |
| Securities impairment recognized in earnings  | -                                  | 9         |
| Net gains on other real estate and repossessed assets   | (173 )                             | (410 )    |
| Vehicle service contract counterparty contingencies   | 89                                 | 169       |
| Share based compensation  | 1,153                              | 891       |
| Gain on branch sale   | (1,193 )                           | -         |
| Net gain on sale of fixed assets  | (152 )                             | -         |
| Increase in accrued income and other assets   | (359 )                             | (6,034 )  |
| Decrease in accrued expenses and other liabilities  | (684 )                             | (5,874 )  |
| Total Adjustments   | 5,113                              | (7,851 )  |
| Net Cash From Operating Activities  | 19,560                             | 6,268     |
| Cash Flow Used in Investing Activities  |                                    |           |
| Proceeds from the sale of securities available for sale   | 11,786                             | 7,630     |
| Proceeds from the maturity of securities available for sale   | 25,458                             | 48,624    |
| Principal payments received on securities available for sale  | 94,333                             | 62,400    |
| Purchases of securities available for sale  | (195,623)                          | (184,726) |
| Purchases of interest bearing deposits  | (4,100 )                           | (750 )    |
| Proceeds from the maturity of interest bearing deposits   | 4,576                              | 4,050     |
| Purchase of Federal Reserve Bank stock  | (272 )                             | (151 )    |
| Redemption of Federal Reserve Bank stock  | 391                                | 226       |
| Redemption of Federal Home Loan Bank stock  | 4,514                              | -         |
| Net increase in portfolio loans (loans originated, net of principal payments)                                   | (56,407 )                          | (23,447 ) |
| Net cash paid in branch sale  | (7,229 )                           | -         |
| Proceeds from the collection of vehicle service contract counterparty receivables                               | 255                                | 366       |
| Proceeds from the sale of other real estate and repossessed assets  | 5,619                              | 12,435    |
| Proceeds from the sale of property and equipment  | 490                                | -         |
| Capital expenditures  | (2,925 )                           | (2,660 )  |
| Net Cash Used in Investing Activities   | (119,134)                          | (76,003 ) |
| Cash Flow From Financing Activities   |                                    |           |
| Net increase in total deposits  | 145,313                            | 11,089    |
| Net increase (decrease) in other borrowings   | (1 )                               | 13,649    |
| Payments of Federal Home Loan Bank advances   | (399 )                             | (4,609 )  |

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|   |           |           |
|---|-----------|-----------|
| Net decrease in vehicle service contract counterparty payables                            | (27 )     | (1,301 )  |
| Dividends paid  | (4,118 )  | (2,752 )  |
| Proceeds from issuance of common stock  | 103       | 66        |
| Repurchase of common stock  | (9,025 )  | -         |
| Share based compensation withholding obligation   | (1,091 )  | -         |
| Net Cash From Financing Activities  | 130,755   | 16,142    |
| Net Increase (Decrease) in Cash and Cash Equivalents                                      | 31,181    | (53,593 ) |
| Cash and Cash Equivalents at Beginning of Period  | 74,016    | 119,081   |
| Cash and Cash Equivalents at End of Period  | \$105,197 | \$65,488  |
| Cash paid during the period for   |           |           |
| Interest  | \$4,302   | \$5,450   |
| Income taxes  | 229       | 116       |
| Transfers to other real estate and repossessed assets                                     | 2,843     | 3,118     |
| Transfer of payment plan receivables to vehicle service contract counterparty receivables | 431       | 105       |
| Purchase of securities available for sale not yet settled                                 | 7,717     | 1,827     |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

|   | Nine months ended<br>September 30,<br>2015      2014<br>(unaudited)<br>(In thousands) |           |
|---|---|-----------|
| Balance at beginning of period  | \$250,371   | \$231,581 |
| Net income  | 14,447  | 14,119    |
| Cash dividends declared   | (4,118 )  | (2,752 )  |
| Issuance of common stock  | 103   | 66        |
| Share based compensation  | 1,153   | 891       |
| Share based compensation withholding obligation                               | (1,091 )  | -         |
| Repurchase of common stock  | (9,025 )  | -         |
| Net change in accumulated other comprehensive loss, net of related tax effect | 1,140   | 3,162     |
| Balance at end of period  | \$252,980   | \$247,067 |

See notes to interim condensed consolidated financial statements (unaudited)

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Preparation of Financial Statements

The condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2014 included in our Annual Report on Form 10-K.

In our opinion, the accompanying unaudited condensed consolidated financial statements contain all the adjustments necessary to present fairly our consolidated financial condition as of September 30, 2015 and December 31, 2014, and the results of operations for the three and nine-month periods ended September 30, 2015 and 2014. The results of operations for the three and nine-month periods ended September 30, 2015, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the assessment for other than temporary impairment (“OTTI”) on investment securities, the determination of the allowance for loan losses, the determination of vehicle service contract counterparty contingencies, the valuation of originated mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2014 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-04, “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure”. The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. This amendment is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014, with early adoption and retrospective or prospective application permitted. This amended guidance became effective for us on January 1, 2015, and did not have a material impact on our consolidated operating results or financial condition.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers (Topic 606)”. This ASU supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this ASU specifies the accounting for some costs to obtain or fulfill a contract with a customer. This amended guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption for fiscal years beginning after December 15, 2016, permitted. This amended guidance is not expected to have a material impact on our consolidated operating results or financial condition.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In June 2014, the FASB issued ASU 2014-12, "Compensation – Stock Compensation (Topic 718) – Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period". This ASU amends existing guidance related to the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. These amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. This amended guidance is effective for us on January 1, 2016, and is not expected to have a material impact on our consolidated operating results or financial condition.

3. Securities

Securities available for sale consist of the following:

|  | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|---------------------|----------------------|---------------|
| (In thousands)                                   |                   |                     |                      |               |
| September 30, 2015                               |                   |                     |                      |               |
| U.S. agency                                      | \$50,447          | \$344               | \$56                 | \$50,735      |
| U.S. agency residential mortgage-backed          | 206,387           | 2,116               | 213                  | 208,290       |
| U.S. agency commercial mortgage-backed           | 35,109            | 246                 | 17                   | 35,338        |
| Private label residential mortgage-backed        | 5,295             | 176                 | 342                  | 5,129         |
| Other asset backed                               | 131,911           | 110                 | 249                  | 131,772       |
| Obligations of states and political subdivisions | 136,508           | 1,161               | 937                  | 136,732       |
| Corporate  | 34,088            | 52                  | 34                   | 34,106        |
| Trust preferred                                  | 2,914             | -                   | 354                  | 2,560         |
| Total  | \$602,659         | \$4,205             | \$2,202              | \$604,662     |
| December 31, 2014                                |                   |                     |                      |               |
| U.S. agency                                      | \$34,936          | \$133               | \$63                 | \$35,006      |
| U.S. agency residential mortgage-backed          | 256,387           | 1,838               | 667                  | 257,558       |
| U.S. agency commercial mortgage-backed           | 33,779            | 68                  | 119                  | 33,728        |
| Private label residential mortgage-backed        | 6,216             | 187                 | 390                  | 6,013         |
| Other asset backed                               | 32,314            | 77                  | 38                   | 32,353        |
| Obligations of states and political subdivisions | 143,698           | 961                 | 1,244                | 143,415       |
| Corporate  | 22,690            | 53                  | 79                   | 22,664        |
| Trust preferred                                  | 2,910             | -                   | 469                  | 2,441         |
| Total  | \$532,930         | \$3,317             | \$3,069              | \$533,178     |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our investments' gross unrealized losses and fair values aggregated by investment type and length of time that individual securities have been at a continuous unrealized loss position follows:

|  | Less Than Twelve Months |                   | Twelve Months or More |                   | Total      |                   |
|--|-------------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|  | Fair Value              | Unrealized Losses | Fair Value            | Unrealized Losses | Fair Value | Unrealized Losses |
| (In thousands)                                   |                         |                   |                       |                   |            |                   |
| September 30, 2015                               |                         |                   |                       |                   |            |                   |
| U.S. agency                                      | \$ 19,021               | \$ 50             | \$ 1,170              | \$ 6              | \$ 20,191  | \$ 56             |
| U.S. agency residential mortgage-backed          | 26,884                  | 94                | 16,024                | 119               | 42,908     | 213               |
| U.S. agency commercial mortgage-backed           | 4,389                   | 16                | 1,396                 | 1                 | 5,785      | 17                |
| Private label residential mortgage-backed        | -                       | -                 | 3,542                 | 342               | 3,542      | 342               |
| Other asset backed                               | 57,799                  | 131               | 5,414                 | 118               | 63,213     | 249               |
| Obligations of states and political subdivisions | 27,995                  | 422               | 12,393                | 515               | 40,388     | 937               |
| Corporate  | 11,098                  | 34                | -                     | -                 | 11,098     | 34                |
| Trust preferred                                  | -                       | -                 | 2,560                 | 354               | 2,560      | 354               |
| Total  | \$ 147,186              | \$ 747            | \$ 42,499             | \$ 1,455          | \$ 189,685 | \$ 2,202          |
| December 31, 2014                                |                         |                   |                       |                   |            |                   |
| U.S. agency                                      | \$ 12,851               | \$ 58             | \$ 606                | \$ 5              | \$ 13,457  | \$ 63             |
| U.S. agency residential mortgage-backed          | 89,547                  | 531               | 15,793                | 136               | 105,340    | 667               |
| U.S. agency commercial mortgage-backed           | 21,325                  | 119               | -                     | -                 | 21,325     | 119               |
| Private label residential mortgage-backed        | 208                     | 1                 | 4,013                 | 389               | 4,221      | 390               |
| Other asset backed                               | 2,960                   | 15                | 8,729                 | 23                | 11,689     | 38                |
| Obligations of states and political subdivisions | 28,114                  | 106               | 37,540                | 1,138             | 65,654     | 1,244             |
| Corporate  | 8,660                   | 79                | -                     | -                 | 8,660      | 79                |
| Trust preferred                                  | -                       | -                 | 2,441                 | 469               | 2,441      | 469               |
| Total  | \$ 163,665              | \$ 909            | \$ 69,122             | \$ 2,160          | \$ 232,787 | \$ 3,069          |

Our portfolio of available-for-sale securities is reviewed quarterly for impairment in value. In performing this review management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet the aforementioned recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income or loss.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at September 30, 2015, we had 29 U.S. agency, 49 U.S. agency residential mortgage-backed and 9 U.S. agency commercial mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to rises in term interest rates since acquisition and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label residential mortgage backed securities — at September 30, 2015, we had five of this type of security whose fair value is less than amortized cost. Two of the five issues are rated by a major rating agency as investment grade, two are rated below investment grade and one is split rated. Two of these bonds have an impairment in excess of 10% and all five of these holdings have been impaired for more than 12 months. The unrealized losses are largely attributable to credit spread widening on these securities since their acquisition.

All of these securities are receiving principal and interest payments. Most of these transactions are pass-through structures, receiving pro rata principal and interest payments from a dedicated collateral pool. The nonreceipt of interest cash flows is not expected and thus not presently considered in our discounted cash flow methodology discussed below.

All private label residential mortgage-backed securities are reviewed for OTTI utilizing a cash flow projection. The cash flow analysis forecasts cash flow from the underlying loans in each transaction and then applies these cash flows to the bonds in the securitization. Our cash flow analysis forecasts complete recovery of our cost basis for four of the five securities whose fair value is less than amortized cost while the fifth security had credit related OTTI and is discussed in further detail below.

As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no other declines discussed above are deemed to be other than temporary.

Other asset backed — at September 30, 2015, we had 65 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at September 30, 2015, we had 57 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at September 30, 2015, we had eight corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Trust preferred securities — at September 30, 2015, we had three trust preferred securities whose fair value is less than amortized cost. All of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities has suffered from credit spread widening.

One of the three securities is rated by two major rating agencies as investment grade, while one (a Bank of America issuance) is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.8 million as of September 30, 2015, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of September 30, 2015 and December 31, 2014:

| September 30, 2015 |                     | December 31, 2014 |                     |
|--------------------|---------------------|-------------------|---------------------|
| Fair Value         | Net Unrealized Loss | Fair Value        | Net Unrealized Loss |
| (In thousands)     |                     |                   |                     |

## Trust preferred securities

|                |         |           |         |           |
|----------------|---------|-----------|---------|-----------|
| Rated issues   | \$1,788 | \$ (127 ) | \$1,643 | \$ (267 ) |
| Unrated issues | 772     | (227 )    | 798     | (202 )    |

As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

We recorded no credit related OTTI charges in earnings on securities available for sale during the three or nine month periods ended September 30, 2015. We recorded \$0.009 million of credit related OTTI charges in earnings on securities available for sale during the three and nine month periods ended September 30, 2014.

At September 30, 2015, three private label residential mortgage-backed securities had credit related OTTI and are summarized as follows:

|                                | Senior Security | Super Senior Security | Senior Support Security | Total   |
|--------------------------------|-----------------|-----------------------|-------------------------|---------|
| (In thousands)                 |                 |                       |                         |         |
| As of September 30, 2015       |                 |                       |                         |         |
| Fair value                     | \$1,690         | \$1,394               | \$91                    | \$3,175 |
| Amortized cost                 | 1,722           | 1,309                 | -                       | 3,031   |
| Non-credit unrealized loss     | 32              | -                     | -                       | 32      |
| Unrealized gain                | -               | 85                    | 91                      | 176     |
| Cumulative credit related OTTI | 757             | 457                   | 380                     | 1,594   |

Credit related OTTI recognized in our Condensed Consolidated Statements of Operations

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For the three months ended September 30,

|      |     |     |      |     |
|------|-----|-----|------|-----|
| 2015 | \$- | \$- | \$ - | \$- |
| 2014 | 9   | -   | -    | 9   |

For the nine months ended September 30,

|      |   |   |   |   |
|------|---|---|---|---|
| 2015 | - | - | - | - |
| 2014 | 9 | - | - | 9 |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. Two of these securities have unrealized gains and one has an unrealized loss at September 30, 2015. Prior to the second quarter of 2013, all three of these securities had an unrealized loss. The original amortized cost for each of these securities has been permanently adjusted downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for two of these securities is now less than previously recorded credit related OTTI amounts. The remaining non-credit related unrealized loss in the senior security is attributed to other factors and is reflected in other comprehensive income during those same periods.

A roll forward of credit losses recognized in earnings on securities available for sale for the three and nine month periods ending September 30, follows:

|  | Three months<br>ended<br>September 30,<br>2015 |         | Nine months<br>ended<br>September 30,<br>2014 |         |
|--|--|---------|---|---------|
|  | 2015   | 2014    | 2015  | 2014    |
|  | (In thousands)                                 |         |   |         |
| Balance at beginning of period   | \$1,844  | \$1,835 | \$1,844                                       | \$1,835 |
| Additions to credit losses on securities for which no previous OTTI was recognized | -  | -       | -   | -       |
| Increases to credit losses on securities for which OTTI was previously recognized  | -  | 9       | -   | 9       |
| Balance at end of period   | \$1,844  | \$1,844 | \$1,844                                       | \$1,844 |

The amortized cost and fair value of securities available for sale at September 30, 2015, by contractual maturity, follow:

|  | Amortized Fair<br>Cost Value<br>(In thousands) |           |
|--|--|-----------|
| Maturing within one year                       | \$29,195                                       | \$29,231  |
| Maturing after one year but within five years  | 69,021   | 69,252    |
| Maturing after five years but within ten years | 45,618   | 45,985    |
| Maturing after ten years                       | 80,123   | 79,665    |
|  | 223,957  | 224,133   |
| U.S. agency residential mortgage-backed        | 206,387  | 208,290   |
| U.S. agency commercial mortgage-backed         | 35,109   | 35,338    |
| Private label residential mortgage-backed      | 5,295  | 5,129     |
| Other asset backed                             | 131,911  | 131,772   |
| Total  | \$602,659                                      | \$604,662 |

The actual maturity may differ from the contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Gains and losses realized on the sale of securities available for sale are determined using the specific identification method and are recognized on a trade-date basis. A summary of proceeds from the sale of securities available for sale and gains and losses for the nine month periods ending September 30, follows:

Proceeds Realized Losses

|      | Gains          |       |      |
|------|----------------|-------|------|
|      | (1)            |       |      |
|      | (In thousands) |       |      |
| 2015 | \$ 11,786      | \$ 75 | \$ - |
| 2014 | 7,630          | 123   | -    |

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(1) Gains in 2014 exclude \$0.179 million of unrealized gain related to a U.S. Treasury short position.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During 2015 and 2014, our trading securities consisted of various preferred stocks. During the first nine months of 2015 and 2014, we recognized gains on trading securities of \$0.022 million and \$0.032 million, respectively, that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. Both of these amounts relate to gains (losses) recognized on trading securities still held at each respective period end.

4. Loans

Our assessment of the allowance for loan losses is based on an evaluation of the loan portfolio, recent loss experience, current economic conditions and other pertinent factors.

An analysis of the allowance for loan losses by portfolio segment for the three months ended September 30, follows:

|                                     | Commercial     | Mortgage | Installment | Payment<br>Plan<br>Receivables | Subjective<br>Allocation | Total    |
|-------------------------------------|----------------|----------|-------------|--------------------------------|--------------------------|----------|
|                                     | (In thousands) |          |             |                                |                          |          |
| 2015                                |                |          |             |                                |                          |          |
| Balance at beginning of period      | \$6,707        | \$11,465 | \$1,461     | \$65                           | \$4,888                  | \$24,586 |
| Additions (deductions)              |                |          |             |                                |                          |          |
| Provision for loan losses           | (26 )          | (47 )    | (49 )       | (5 )                           | (117 )                   | (244 )   |
| Recoveries credited to allowance    | 637            | 286      | 250         | -                              | -                        | 1,173    |
| Loans charged against the allowance | (190 )         | (379 )   | (342 )      | -                              | -                        | (911 )   |
| Balance at end of period            | \$7,128        | \$11,325 | \$1,320     | \$60                           | \$4,771                  | \$24,604 |
| 2014                                |                |          |             |                                |                          |          |
| Balance at beginning of period      | \$5,175        | \$15,542 | \$1,988     | \$80                           | \$5,412                  | \$28,197 |
| Additions (deductions)              |                |          |             |                                |                          |          |
| Provision for loan losses           | (601 )         | (9 )     | 32          | (8 )                           | (46 )                    | (632 )   |
| Recoveries credited to allowance    | 999            | 197      | 283         | -                              | -                        | 1,479    |
| Loans charged against the allowance | (385 )         | (729 )   | (422 )      | -                              | -                        | (1,536 ) |
| Balance at end of period            | \$5,188        | \$15,001 | \$1,881     | \$72                           | \$5,366                  | \$27,508 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An analysis of the allowance for loan losses by portfolio segment for the nine months ended September 30, follows:

|                                     | Commercial     | Mortgage  | Installment | Payment<br>Plan<br>Receivables | Subjective<br>Allocation | Total    |
|-------------------------------------|----------------|-----------|-------------|--------------------------------|--------------------------|----------|
|                                     | (In thousands) |           |             |                                |                          |          |
| 2015                                |                |           |             |                                |                          |          |
| Balance at beginning of period      | \$5,445        | \$ 13,444 | \$ 1,814    | \$ 64                          | \$ 5,223                 | \$25,990 |
| Additions (deductions)              |                |           |             |                                |                          |          |
| Provision for loan losses           | 479            | (881 )    | (179 )      | (4 )                           | (452 )                   | (1,037 ) |
| Recoveries credited to allowance    | 1,722          | 843       | 853         | -                              | -                        | 3,418    |
| Loans charged against the allowance | (518 )         | (2,081 )  | (1,168 )    | -                              | -                        | (3,767 ) |
| Balance at end of period            | \$7,128        | \$ 11,325 | \$ 1,320    | \$ 60                          | \$ 4,771                 | \$24,604 |
| 2014                                |                |           |             |                                |                          |          |
| Balance at beginning of period      | \$6,827        | \$ 17,195 | \$ 2,246    | \$ 97                          | \$ 5,960                 | \$32,325 |
| Additions (deductions)              |                |           |             |                                |                          |          |
| Provision for loan losses           | (1,164)        | (395 )    | 132         | (28 )                          | (594 )                   | (2,049 ) |
| Recoveries credited to allowance    | 3,492          | 1,055     | 886         | 5                              | -                        | 5,438    |
| Loans charged against the allowance | (3,967)        | (2,854 )  | (1,383 )    | (2 )                           | -                        | (8,206 ) |
| Balance at end of period            | \$5,188        | \$ 15,001 | \$ 1,881    | \$ 72                          | \$ 5,366                 | \$27,508 |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Allowance for loan losses and recorded investment in loans by portfolio segment follows:

|  | Commercial     | Mortgage  | Installment | Payment<br>Plan<br>Receivables | Subjective<br>Allocation | Total       |
|--|----------------|-----------|-------------|--------------------------------|--------------------------|-------------|
|  | (In thousands) |           |             |                                |                          |             |
| September 30, 2015                               |                |           |             |                                |                          |             |
| Allowance for loan losses                        |                |           |             |                                |                          |             |
| Individually evaluated for impairment            | \$4,048        | \$8,244   | \$484       | \$ -                           | \$ -                     | \$12,776    |
| Collectively evaluated for impairment            | 3,080          | 3,081     | 836         | 60                             | 4,771                    | 11,828      |
| Total ending allowance balance                   | \$7,128        | \$11,325  | \$1,320     | \$60                           | \$4,771                  | \$24,604    |
| Loans  |                |           |             |                                |                          |             |
| Individually evaluated for impairment            | \$30,328       | \$67,871  | \$6,005     | \$ -                           |                          | \$104,204   |
| Collectively evaluated for impairment            | 697,528        | 402,934   | 230,310     | 37,438                         |                          | 1,368,210   |
| Total loans recorded investment                  | 727,856        | 470,805   | 236,315     | 37,438                         |                          | 1,472,414   |
| Accrued interest included in recorded investment | 1,500          | 2,227     | 688         | -                              |                          | 4,415       |
| Total loans                                      | \$726,356      | \$468,578 | \$235,627   | \$37,438                       |                          | \$1,467,999 |
| December 31, 2014                                |                |           |             |                                |                          |             |
| Allowance for loan losses                        |                |           |             |                                |                          |             |
| Individually evaluated for impairment            | \$3,194        | \$9,311   | \$728       | \$ -                           | \$ -                     | \$13,233    |
| Collectively evaluated for impairment            | 2,251          | 4,133     | 1,086       | 64                             | 5,223                    | 12,757      |
| Total ending allowance balance                   | \$5,445        | \$13,444  | \$1,814     | \$64                           | \$5,223                  | \$25,990    |
| Loans  |                |           |             |                                |                          |             |
| Individually evaluated for impairment            | \$34,147       | \$72,340  | \$6,679     | \$ -                           |                          | \$113,166   |
| Collectively evaluated for impairment            | 658,423        | 402,458   | 200,368     | 40,001                         |                          | 1,301,250   |
| Total loans recorded investment                  | 692,570        | 474,798   | 207,047     | 40,001                         |                          | 1,414,416   |
| Accrued interest included in recorded investment | 1,615          | 2,170     | 669         | -                              |                          | 4,454       |
| Total loans                                      | \$690,955      | \$472,628 | \$206,378   | \$40,001                       |                          | \$1,409,962 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans on non-accrual status and past due more than 90 days (“Non-performing Loans”) follow:

|   | 90+<br>and<br>Still Non-<br>Accrual<br>(In thousands) | Total Non-<br>Performing<br>Loans |
|---|---|-----------------------------------|
| September 30, 2015                                    |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$5,135   | \$ 5,135                          |
| Land, land development and construction - real estate | - 533   | 533                               |
| Commercial and industrial                             | - 2,318   | 2,318                             |
| Mortgage  |   |                                   |
| 1-4 family  | - 5,095   | 5,095                             |
| Resort lending  | - 1,301   | 1,301                             |
| Home equity - 1st lien                                | - 191   | 191                               |
| Home equity - 2nd lien                                | - 189   | 189                               |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 175   | 175                               |
| Home equity - 2nd lien                                | - 445   | 445                               |
| Loans not secured by real estate                      | - 430   | 430                               |
| Other   | - 2   | 2                                 |
| Payment plan receivables                              |   |                                   |
| Full refund   | - 6   | 6                                 |
| Partial refund  | - 10  | 10                                |
| Other   | - 4   | 4                                 |
| Total recorded investment                             | \$- \$15,834  | \$ 15,834                         |
| Accrued interest included in recorded investment      | \$- \$-   | \$ -                              |
| December 31, 2014                                     |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$1,233   | \$ 1,233                          |
| Land, land development and construction - real estate | - 594   | 594                               |
| Commercial and industrial                             | - 2,746   | 2,746                             |
| Mortgage  |   |                                   |
| 1-4 family  | 7 5,945   | 5,952                             |
| Resort lending  | - 2,168   | 2,168                             |
| Home equity - 1st lien                                | - 331   | 331                               |
| Home equity - 2nd lien                                | - 605   | 605                               |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 576   | 576                               |
| Home equity - 2nd lien                                | - 517   | 517                               |
| Loans not secured by real estate                      | - 454   | 454                               |
| Other   | - 48  | 48                                |
| Payment plan receivables                              |   |                                   |
| Full refund   | - 2   | 2                                 |
| Partial refund  | - 12  | 12                                |
| Other   | - -   | -                                 |



|  |     |          |          |
|--|-----|----------|----------|
| Total recorded investment                        | \$7 | \$15,231 | \$15,238 |
| Accrued interest included in recorded investment | \$- | \$-      | \$-      |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An aging analysis of loans by class follows:

|   | Loans Past Due |               |             | Total    | Loans not<br>Past Due | Total<br>Loans |
|---|----------------|---------------|-------------|----------|-----------------------|----------------|
|   | 30-59<br>days  | 60-89<br>days | 90+<br>days |          |                       |                |
| (In thousands)  |                |               |             |          |                       |                |
| September 30, 2015                                    |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$183          | \$-           | \$660       | \$843    | \$274,107             | \$274,950      |
| Land, land development and construction - real estate | -              | 119           | 204         | 323      | 41,899                | 42,222         |
| Commercial and industrial                             | 2,315          | 320           | 368         | 3,003    | 407,681               | 410,684        |
| Mortgage  |                |               |             |          |                       |                |
| 1-4 family  | 2,513          | 662           | 5,095       | 8,270    | 271,130               | 279,400        |
| Resort lending  | 309            | 150           | 1,301       | 1,760    | 116,528               | 118,288        |
| Home equity - 1st lien                                | 39             | 23            | 191         | 253      | 22,252                | 22,505         |
| Home equity - 2nd lien                                | 331            | -             | 189         | 520      | 50,092                | 50,612         |
| Installment   |                |               |             |          |                       |                |
| Home equity - 1st lien                                | 286            | 65            | 175         | 526      | 17,954                | 18,480         |
| Home equity - 2nd lien                                | 191            | 53            | 445         | 689      | 21,616                | 22,305         |
| Loans not secured by real estate                      | 474            | 132           | 430         | 1,036    | 192,321               | 193,357        |
| Other   | 6              | 2             | 2           | 10       | 2,163                 | 2,173          |
| Payment plan receivables                              |                |               |             |          |                       |                |
| Full refund   | 563            | 115           | 6           | 684      | 22,848                | 23,532         |
| Partial refund  | 710            | 249           | 10          | 969      | 7,459                 | 8,428          |
| Other   | 112            | 16            | 4           | 132      | 5,346                 | 5,478          |
| Total recorded investment                             | \$8,032        | \$1,906       | \$9,080     | \$19,018 | \$1,453,396           | \$1,472,414    |
| Accrued interest included in recorded investment      | \$113          | \$18          | \$-         | \$131    | \$4,284               | \$4,415        |
| December 31, 2014                                     |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$89           | \$-           | \$214       | \$303    | \$252,763             | \$253,066      |
| Land, land development and construction - real estate | 131            | -             | 223         | 354      | 33,984                | 34,338         |
| Commercial and industrial                             | 2,391          | 279           | 209         | 2,879    | 402,287               | 405,166        |
| Mortgage  |                |               |             |          |                       |                |
| 1-4 family  | 1,877          | 1,638         | 5,952       | 9,467    | 269,719               | 279,186        |
| Resort lending  | 226            | -             | 2,168       | 2,394    | 126,342               | 128,736        |
| Home equity - 1st lien                                | 39             | 50            | 331         | 420      | 19,782                | 20,202         |
| Home equity - 2nd lien                                | 711            | 89            | 605         | 1,405    | 45,269                | 46,674         |
| Installment   |                |               |             |          |                       |                |
| Home equity - 1st lien                                | 466            | 37            | 576         | 1,079    | 20,995                | 22,074         |
| Home equity - 2nd lien                                | 369            | 81            | 517         | 967      | 28,125                | 29,092         |
| Loans not secured by real estate                      | 589            | 231           | 454         | 1,274    | 152,115               | 153,389        |
| Other   | 15             | 3             | 48          | 66       | 2,426                 | 2,492          |
| Payment plan receivables                              |                |               |             |          |                       |                |
| Full refund   | 838            | 214           | 2           | 1,054    | 26,799                | 27,853         |

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|  |         |         |          |          |             |             |
|--|---------|---------|----------|----------|-------------|-------------|
| Partial refund                                   | 409     | 123     | 12       | 544      | 6,550       | 7,094       |
| Other  | 96      | 24      | -        | 120      | 4,934       | 5,054       |
| Total recorded investment                        | \$8,246 | \$2,769 | \$11,311 | \$22,326 | \$1,392,090 | \$1,414,416 |
| Accrued interest included in recorded investment | \$55    | \$29    | \$-      | \$84     | \$4,370     | \$4,454     |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans are as follows :

|  | September<br>30,<br>2015 | December<br>31,<br>2014 |
|--|--------------------------|-------------------------|
|  | (In thousands)           |                         |
| Impaired loans with no allocated allowance             |                          |                         |
| TDR  | \$6,416                  | \$9,325                 |
| Non - TDR  | 204                      | 299                     |
| Impaired loans with an allocated allowance             |                          |                         |
| TDR - allowance based on collateral                    | 3,970                    | 5,879                   |
| TDR - allowance based on present value cash flow       | 86,985                   | 94,970                  |
| Non - TDR - allowance based on collateral              | 6,281                    | 2,296                   |
| Non - TDR - allowance based on present value cash flow | -                        | -                       |
| Total impaired loans                                   | \$103,856                | \$112,769               |
| Amount of allowance for loan losses allocated          |                          |                         |
| TDR - allowance based on collateral                    | \$1,575                  | \$2,025                 |
| TDR - allowance based on present value cash flow       | 8,952                    | 10,188                  |
| Non - TDR - allowance based on collateral              | 2,249                    | 1,020                   |
| Non - TDR - allowance based on present value cash flow | -                        | -                       |
| Total amount of allowance for loan losses allocated    | \$12,776                 | \$13,233                |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows (1):

|   | September 30, 2015  |                          |                   | December 31, 2014   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| (In thousands)                                    |                     |                          |                   |                     |                          |                   |
| With no related allowance recorded:               |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | \$4,778             | \$4,977                  | \$ -              | \$5,868             | \$6,077                  | \$ -              |
| Land, land development & construction-real estate | 851                 | 1,425                    | -                 | 1,051               | 1,606                    | -                 |
| Commercial and industrial                         | 985                 | 982                      | -                 | 2,685               | 2,667                    | -                 |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 23                  | 166                      | -                 | -                   | 49                       | -                 |
| Resort lending                                    | -                   | -                        | -                 | 48                  | 397                      | -                 |
| Home equity - 1st lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity - 2nd lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | -                   | 36                       | -                 | -                   | 40                       | -                 |
| Home equity - 2nd lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Loans not secured by real estate                  | -                   | -                        | -                 | -                   | -                        | -                 |
| Other   | -                   | -                        | -                 | -                   | -                        | -                 |
|   | 6,637               | 7,586                    | -                 | 9,652               | 10,836                   | -                 |
| With an allowance recorded:                       |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 16,414              | 17,414                   | 1,357             | 12,836              | 13,797                   | 689               |
| Land, land development & construction-real estate | 2,061               | 2,140                    | 421               | 3,456               | 3,528                    | 499               |
| Commercial and industrial                         | 5,239               | 5,549                    | 2,270             | 8,251               | 8,486                    | 2,006             |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 49,245              | 51,392                   | 5,437             | 53,206              | 56,063                   | 6,195             |
| Resort lending                                    | 18,328              | 18,591                   | 2,786             | 18,799              | 18,963                   | 3,075             |
| Home equity - 1st lien                            | 155                 | 172                      | 11                | 162                 | 177                      | 14                |
| Home equity - 2nd lien                            | 120                 | 201                      | 10                | 125                 | 205                      | 27                |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | 2,434               | 2,610                    | 145               | 2,744               | 2,930                    | 219               |
| Home equity - 2nd lien                            | 2,931               | 2,942                    | 285               | 3,212               | 3,215                    | 419               |
| Loans not secured by real estate                  | 631                 | 689                      | 53                | 711                 | 835                      | 89                |
| Other   | 9                   | 9                        | 1                 | 12                  | 12                       | 1                 |
|   | 97,567              | 101,709                  | 12,776            | 103,514             | 108,211                  | 13,233            |
| Total   |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 21,192              | 22,391                   | 1,357             | 18,704              | 19,874                   | 689               |
| Land, land development & construction-real estate | 2,912               | 3,565                    | 421               | 4,507               | 5,134                    | 499               |
| Commercial and industrial                         | 6,224               | 6,531                    | 2,270             | 10,936              | 11,153                   | 2,006             |
| Mortgage  |                     |                          |                   |                     |                          |                   |

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|                                  |           |           |          |           |           |          |
|----------------------------------|-----------|-----------|----------|-----------|-----------|----------|
| 1-4 family                       | 49,268    | 51,558    | 5,437    | 53,206    | 56,112    | 6,195    |
| Resort lending                   | 18,328    | 18,591    | 2,786    | 18,847    | 19,360    | 3,075    |
| Home equity - 1st lien           | 155       | 172       | 11       | 162       | 177       | 14       |
| Home equity - 2nd lien           | 120       | 201       | 10       | 125       | 205       | 27       |
| Installment                      |           |           |          |           |           |          |
| Home equity - 1st lien           | 2,434     | 2,646     | 145      | 2,744     | 2,970     | 219      |
| Home equity - 2nd lien           | 2,931     | 2,942     | 285      | 3,212     | 3,215     | 419      |
| Loans not secured by real estate | 631       | 689       | 53       | 711       | 835       | 89       |
| Other                            | 9         | 9         | 1        | 12        | 12        | 1        |
| Total                            | \$104,204 | \$109,295 | \$12,776 | \$113,166 | \$119,047 | \$13,233 |

Accrued interest included in recorded investment

\$348

\$397

(1) There were no impaired payment plan receivables at September 30, 2015 or December 31, 2014.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Average recorded investment in and interest income earned on impaired loans by class for the three month periods ending September 30, follows (1):

|   | 2015                              |                                  | 2014                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|   | (In thousands)                    |                                  |                                   |                                  |
| With no related allowance recorded:               |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | \$5,133                           | \$ 45                            | \$8,255                           | \$ 103                           |
| Land, land development & construction-real estate | 932                               | 14                               | 859                               | 15                               |
| Commercial and industrial                         | 1,922                             | 68                               | 3,397                             | 63                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 24                                | 3                                | 66                                | -                                |
| Resort lending                                    | -                                 | -                                | 42                                | 1                                |
| Home equity - 1st lien                            | -                                 | -                                | -                                 | -                                |
| Home equity - 2nd lien                            | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | -                                 | -                                | -                                 | -                                |
| Home equity - 2nd lien                            | -                                 | -                                | -                                 | -                                |
| Loans not secured by real estate                  | -                                 | -                                | -                                 | -                                |
| Other   | -                                 | -                                | -                                 | -                                |
|   | 8,011                             | 130                              | 12,619                            | 182                              |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 14,655                            | 154                              | 11,486                            | 136                              |
| Land, land development & construction-real estate | 1,993                             | 2                                | 4,092                             | 38                               |
| Commercial and industrial                         | 6,431                             | 37                               | 7,936                             | 51                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 49,706                            | 554                              | 55,633                            | 558                              |
| Resort lending                                    | 18,414                            | 163                              | 19,351                            | 195                              |
| Home equity - 1st lien                            | 157                               | 2                                | 165                               | 2                                |
| Home equity - 2nd lien                            | 185                               | -                                | 39                                | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | 2,474                             | 47                               | 2,801                             | 43                               |
| Home equity - 2nd lien                            | 2,999                             | 47                               | 3,375                             | 46                               |
| Loans not secured by real estate                  | 645                               | 10                               | 699                               | 9                                |
| Other   | 10                                | -                                | 14                                | -                                |
|   | 97,669                            | 1,016                            | 105,591                           | 1,078                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 19,788                            | 199                              | 19,741                            | 239                              |
| Land, land development & construction-real estate | 2,925                             | 16                               | 4,951                             | 53                               |
| Commercial and industrial                         | 8,353                             | 105                              | 11,333                            | 114                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 49,730                            | 557                              | 55,699                            | 558                              |
| Resort lending                                    | 18,414                            | 163                              | 19,393                            | 196                              |

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|                                  |           |          |           |          |
|----------------------------------|-----------|----------|-----------|----------|
| Home equity - 1st lien           | 157       | 2        | 165       | 2        |
| Home equity - 2nd lien           | 185       | -        | 39        | -        |
| Installment                      |           |          |           |          |
| Home equity - 1st lien           | 2,474     | 47       | 2,801     | 43       |
| Home equity - 2nd lien           | 2,999     | 47       | 3,375     | 46       |
| Loans not secured by real estate | 645       | 10       | 699       | 9        |
| Other                            | 10        | -        | 14        | -        |
| Total                            | \$105,680 | \$ 1,146 | \$118,210 | \$ 1,260 |

(1) There were no impaired payment plan receivables during the three month periods ended September 30, 2015 and 2014, respectively.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Average recorded investment in and interest income earned on impaired loans by class for the nine month periods ending September 30, follows (1):

|   | 2015                              |                                  | 2014                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|   | (In thousands)                    |                                  |                                   |                                  |
| With no related allowance recorded:               |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | \$5,490                           | \$ 170                           | \$8,109                           | \$ 289                           |
| Land, land development & construction-real estate | 986                               | 57                               | 1,168                             | 43                               |
| Commercial and industrial                         | 2,345                             | 195                              | 3,517                             | 129                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 18                                | 5                                | 37                                | -                                |
| Resort lending                                    | 15                                | -                                | 38                                | 1                                |
| Home equity line of credit - 1st lien             | -                                 | -                                | -                                 | -                                |
| Home equity line of credit - 2nd lien             | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | -                                 | 1                                | -                                 | 1                                |
| Home equity installment - 2nd lien                | -                                 | -                                | -                                 | -                                |
| Loans not secured by real estate                  | -                                 | -                                | -                                 | -                                |
| Other   | -                                 | -                                | -                                 | -                                |
|   | 8,854                             | 428                              | 12,869                            | 463                              |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 13,752                            | 452                              | 12,756                            | 417                              |
| Land, land development & construction-real estate | 2,351                             | 35                               | 4,059                             | 120                              |
| Commercial and industrial                         | 7,304                             | 117                              | 8,562                             | 209                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 51,078                            | 1,644                            | 56,545                            | 1,777                            |
| Resort lending                                    | 18,523                            | 507                              | 19,623                            | 581                              |
| Home equity line of credit - 1st lien             | 159                               | 6                                | 159                               | 5                                |
| Home equity line of credit - 2nd lien             | 154                               | 6                                | 40                                | 1                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | 2,582                             | 141                              | 2,860                             | 132                              |
| Home equity installment - 2nd lien                | 3,086                             | 147                              | 3,396                             | 143                              |
| Loans not secured by real estate                  | 669                               | 29                               | 721                               | 26                               |
| Other   | 11                                | 1                                | 15                                | 1                                |
|   | 99,669                            | 3,085                            | 108,736                           | 3,412                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 19,242                            | 622                              | 20,865                            | 706                              |
| Land, land development & construction-real estate | 3,337                             | 92                               | 5,227                             | 163                              |
| Commercial and industrial                         | 9,649                             | 312                              | 12,079                            | 338                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 51,096                            | 1,649                            | 56,582                            | 1,777                            |
| Resort lending                                    | 18,538                            | 507                              | 19,661                            | 582                              |

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|                                       |           |          |           |          |
|---------------------------------------|-----------|----------|-----------|----------|
| Home equity line of credit - 1st lien | 159       | 6        | 159       | 5        |
| Home equity line of credit - 2nd lien | 154       | 6        | 40        | 1        |
| Installment                           |           |          |           |          |
| Home equity installment - 1st lien    | 2,582     | 142      | 2,860     | 133      |
| Home equity installment - 2nd lien    | 3,086     | 147      | 3,396     | 143      |
| Loans not secured by real estate      | 669       | 29       | 721       | 26       |
| Other                                 | 11        | 1        | 15        | 1        |
| Total                                 | \$108,523 | \$ 3,513 | \$121,605 | \$ 3,875 |

(1) There were no impaired payment plan receivables during the nine month periods ended September 30, 2015 and 2014, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our average investment in impaired loans was approximately \$105.7 million and \$118.2 million for the three-month periods ended September 30, 2015 and 2014, respectively and \$108.5 million and \$121.6 million for the nine-month periods ended September 30, 2015 and 2014, respectively. Cash receipts on impaired loans on non-accrual status are generally applied to the principal balance. Interest income recognized on impaired loans during the three months ending September 30, 2015 and 2014, was approximately \$1.1 million and \$1.3 million, respectively, and was approximately \$3.5 million and \$3.9 million during the nine months ending September 30, 2015 and 2014, respectively.

Troubled debt restructurings follow:

|                        | September 30, 2015 |                      |           |
|------------------------|--------------------|----------------------|-----------|
|                        | Commercial         | Retail               | Total     |
|                        | (In thousands)     |                      |           |
| Performing TDRs        | \$22,257           | \$69,726             | \$91,983  |
| Non-performing TDRs(1) | 1,501              | 3,887 <sup>(2)</sup> | 5,388     |
| Total                  | \$23,758           | \$73,613             | \$97,371  |
|                        | December 31, 2014  |                      |           |
|                        | Commercial         | Retail               | Total     |
|                        | (In thousands)     |                      |           |
| Performing TDRs        | \$29,475           | \$73,496             | \$102,971 |
| Non-performing TDRs(1) | 1,978              | 5,225 <sup>(2)</sup> | 7,203     |
| Total                  | \$31,453           | \$78,721             | \$110,174 |

(1) Included in non-performing loans table above.

(2) Also includes loans on non-accrual at the time of modification until six payments are received on a timely basis.

We allocated \$10.5 million and \$12.2 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2015 and December 31, 2014, respectively.

During the nine months ended September 30, 2015 and 2014, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan have generally been for periods ranging from 9 months to 36 months but have extended to as much as 480 months in certain circumstances. Modifications involving an extension of the maturity date have generally been for periods ranging from 1 month to 60 months but have extended to as much as 230 months in certain circumstances.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the three-month periods ended September 30 follow:

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
|   |                           | (Dollars in thousands)                  |  |
| 2015  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -                                    | \$ -                                     |
| Land, land development & construction-real estate | -                         | -                                       | -  |
| Commercial and industrial                         | 1                         | 48                                      | 26                                       |
| Mortgage  |                           |   |  |
| 1-4 family  | 3                         | 343                                     | 344                                      |
| Resort lending                                    | -                         | -                                       | -  |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Loans not secured by real estate                  | 1                         | 19                                      | 19                                       |
| Other   | -                         | -                                       | -  |
| Total   | 5                         | \$ 410                                  | \$ 389                                   |
| 2014  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -                                    | \$ -                                     |
| Land, land development & construction-real estate | 1                         | 40                                      | 36                                       |
| Commercial and industrial                         | 5                         | 716                                     | 693                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 1                         | 87                                      | 87                                       |
| Resort lending                                    | 1                         | 378                                     | 367                                      |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 3                         | 118                                     | 96                                       |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Loans not secured by real estate                  | 1                         | 55                                      | 53                                       |
| Other   | -                         | -                                       | -  |
| Total   | 12                        | \$ 1,394                                | \$ 1,332                                 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the nine-month periods ended September 30 follow:

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
| (Dollars in thousands)                            |                           |   |  |
| 2015  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | 2                         | \$ 229                                  | \$ 234                                   |
| Land, land development & construction-real estate | -                         | -                                       | -  |
| Commercial and industrial                         | 4                         | 301                                     | 273                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 9                         | 1,373                                   | 1,189                                    |
| Resort lending                                    | 1                         | 313                                     | 309                                      |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 5                         | 190                                     | 164                                      |
| Home equity - 2nd lien                            | 3                         | 58                                      | 58                                       |
| Loans not secured by real estate                  | 2                         | 19                                      | 25                                       |
| Other   | -                         | -                                       | -  |
| Total   | 26                        | \$ 2,483                                | \$ 2,252                                 |
| 2014  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | 3                         | \$ 354                                  | \$ 326                                   |
| Land, land development & construction-real estate | 2                         | 55                                      | 50                                       |
| Commercial and industrial                         | 11                        | 2,083                                   | 1,524                                    |
| Mortgage  |                           |   |  |
| 1-4 family  | 8                         | 1,037                                   | 1,049                                    |
| Resort lending                                    | 4                         | 1,011                                   | 997                                      |
| Home equity - 1st lien                            | 1                         | 17                                      | 13                                       |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 8                         | 538                                     | 465                                      |
| Home equity - 2nd lien                            | 5                         | 294                                     | 284                                      |
| Loans not secured by real estate                  | 3                         | 88                                      | 80                                       |
| Other   | -                         | -                                       | -  |
| Total   | 45                        | \$ 5,477                                | \$ 4,788                                 |

The troubled debt restructurings described above for 2015 decreased the allowance for loan losses by \$0.05 million and resulted in zero charge offs during the three months ended September 30, 2015, and increased the allowance by \$0.05 million and resulted in zero charge offs during the nine months ended September 30, 2015.

The troubled debt restructurings described above for 2014 increased the allowance for loan losses by \$0.2 million and resulted in zero charge offs during the three months ended September 30, 2014 and increased the allowance by \$0.2

million and resulted in \$0.01 million of charge offs during the nine months ended September 30, 2014.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the past twelve months and that have subsequently defaulted during the three-month periods ended September 30 follow:

|   | Number<br>of Recorded<br>Contracts<br>(Dollars in<br>thousands) | Balance |
|---|---|---------|
| 2015  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | -   | -       |
| Mortgage  |   |         |
| 1-4 family  | 1   | 54      |
| Resort lending                                    | -   | -       |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 1   | \$ 54   |
| 2014  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | 1   | 66      |
| Mortgage  |   |         |
| 1-4 family  | 1   | 125     |
| Resort lending                                    | -   | -       |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 2   | \$ 191  |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the past twelve months and that have subsequently defaulted during the nine-month periods ended September 30 follow:

|   | Number<br>of Recorded<br>Contracts<br>(Dollars in<br>thousands) | Balance |
|---|---|---------|
| 2015  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | 2   | 157     |
| Mortgage  |   |         |
| 1-4 family  | 1   | 54      |
| Resort lending                                    | -   | -       |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | 1   | 4       |
| Other   | -   | -       |
|   | 4   | \$ 215  |
| 2014  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | 2   | 319     |
| Mortgage  |   |         |
| 1-4 family  | 1   | 125     |
| Resort lending                                    | -   | -       |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 3   | \$ 444  |

A loan is considered to be in payment default generally once it is 90 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted described above for 2015 decreased the allowance for loan losses by \$0.01 million and resulted in zero charge offs during the three months ended September 30, 2015 and



had no impact on the allowance for loan losses and resulted in zero charge offs during the nine months ended September 30, 2015.

The troubled debt restructurings that subsequently defaulted described above for 2014 had no impact on the allowance for loan losses and resulted in no charge offs during the three months ended September 30, 2014 and increased the allowance for loan losses by \$0.01 million and resulted in no charge offs during the nine months ended September 30, 2014.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The terms of certain other loans were modified during the nine months ended September 30, 2015 and 2014 in a manner that did not meet the definition of a troubled debt restructuring. The modification of these loans could have included modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

In order to determine whether a borrower is experiencing financial difficulty, we perform an evaluation of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under our internal underwriting policy.

Credit Quality Indicators – As part of our on-going monitoring of the credit quality of our loan portfolios, we track certain credit quality indicators including (a) weighted-average risk grade of commercial loans, (b) the level of classified commercial loans, (c) credit scores of mortgage and installment loan borrowers, (d) financial performance of certain counterparties for payment plan receivables and (e) delinquency history and non-performing loans.

For commercial loans, we use a loan rating system that is similar to those employed by state and federal banking regulators. Loans are graded on a scale of 1 to 12. A description of the general characteristics of the ratings follows:

Rating 1 through 6: These loans are generally referred to as our “non-watch” commercial credits that include very high or exceptional credit fundamentals through acceptable credit fundamentals.

Rating 7 and 8: These loans are generally referred to as our “watch” commercial credits. This rating includes loans to borrowers that exhibit potential credit weakness or downward trends. If not checked or cured these trends could weaken our asset or credit position. While potentially weak, no loss of principal or interest is envisioned with these ratings.

Rating 9: These loans are generally referred to as our “substandard accruing” commercial credits. This rating includes loans to borrowers that exhibit a well-defined weakness where payment default is probable and loss is possible if deficiencies are not corrected. Generally, loans with this rating are considered collectible as to both principal and interest primarily due to collateral coverage.

Rating 10 and 11: These loans are generally referred to as our “substandard - non-accrual” and “doubtful” commercial credits. This rating includes loans to borrowers with weaknesses that make collection of debt in full, on the basis of current facts, conditions and values at best questionable and at worst improbable. All of these loans are placed in non-accrual.

Rating 12: These loans are generally referred to as our “loss” commercial credits. This rating includes loans to borrowers that are deemed incapable of repayment and are charged-off.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table summarizes loan ratings by loan class for our commercial loan segment:

|  | Commercial       |              |   | Non-<br>Accrual<br>10-11 | Total     |
|--|------------------|--------------|---|--------------------------|-----------|
|  | Non-watch<br>1-6 | Watch<br>7-8 | Substandard<br>Accrual<br>9<br>(In thousands) |                          |           |
| September 30, 2015                                       |                  |              |   |                          |           |
| Income producing - real estate                           | \$261,676        | \$7,013      | \$1,126                                       | \$5,135                  | \$274,950 |
| Land, land development and<br>construction - real estate | 38,135           | 3,307        | 247   | 533                      | 42,222    |
| Commercial and industrial                                | 371,193          | 29,285       | 7,888   | 2,318                    | 410,684   |
| Total  | \$671,004        | \$39,605     | \$9,261                                       | \$7,986                  | \$727,856 |
| Accrued interest included in total                       | \$1,304          | \$189        | \$7   | \$-                      | \$1,500   |
| December 31, 2014  |                  |              |   |                          |           |
| Income producing - real estate                           | \$241,266        | \$8,649      | \$1,918                                       | \$1,233                  | \$253,066 |
| Land, land development and<br>construction - real estate | 30,869           | 2,485        | 390   | 594                      | 34,338    |
| Commercial and industrial                                | 372,947          | 23,475       | 5,998   | 2,746                    | 405,166   |
| Total  | \$645,082        | \$34,609     | \$8,306                                       | \$4,573                  | \$692,570 |
| Accrued interest included in total                       | \$1,479          | \$111        | \$25  | \$-                      | \$1,615   |

For each of our mortgage and installment segment classes we generally monitor credit quality based on the credit scores of the borrowers. These credit scores are generally updated semi-annually.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables summarize credit scores by loan class for our mortgage and installment loan segments:

|                                    | Mortgage (1)   |           | Home     | Home     |           |
|------------------------------------|----------------|-----------|----------|----------|-----------|
|                                    | 1-4            | Resort    | Equity   | Equity   |           |
|                                    | Family         | Lending   | 1st Lien | 2nd      | Total     |
|                                    | (In thousands) |           |          |          |           |
| September 30, 2015                 |                |           |          |          |           |
| 800 and above                      | \$27,538       | \$12,627  | \$4,859  | \$6,717  | \$51,741  |
| 750-799                            | 77,238         | 42,522    | 6,280    | 16,387   | 142,427   |
| 700-749                            | 50,309         | 33,785    | 4,076    | 11,985   | 100,155   |
| 650-699                            | 52,898         | 16,771    | 3,565    | 8,022    | 81,256    |
| 600-649                            | 28,698         | 5,666     | 1,872    | 3,639    | 39,875    |
| 550-599                            | 16,809         | 2,546     | 647      | 1,957    | 21,959    |
| 500-549                            | 13,983         | 1,253     | 758      | 1,089    | 17,083    |
| Under 500                          | 4,098          | 992       | 210      | 404      | 5,704     |
| Unknown                            | 7,829          | 2,126     | 238      | 412      | 10,605    |
| Total                              | \$279,400      | \$118,288 | \$22,505 | \$50,612 | \$470,805 |
| Accrued interest included in total | \$1,427        | \$508     | \$92     | \$200    | \$2,227   |
| December 31, 2014                  |                |           |          |          |           |
| 800 and above                      | \$27,918       | \$14,484  | \$3,863  | \$6,225  | \$52,490  |
| 750-799                            | 72,674         | 45,950    | 6,128    | 14,323   | 139,075   |
| 700-749                            | 52,843         | 32,660    | 3,054    | 9,642    | 98,199    |
| 650-699                            | 51,664         | 20,250    | 3,257    | 8,194    | 83,365    |
| 600-649                            | 27,770         | 6,538     | 1,704    | 3,862    | 39,874    |
| 550-599                            | 21,361         | 3,639     | 994      | 1,721    | 27,715    |
| 500-549                            | 14,575         | 2,156     | 699      | 1,401    | 18,831    |
| Under 500                          | 6,306          | 875       | 261      | 632      | 8,074     |
| Unknown                            | 4,075          | 2,184     | 242      | 674      | 7,175     |
| Total                              | \$279,186      | \$128,736 | \$20,202 | \$46,674 | \$474,798 |
| Accrued interest included in total | \$1,311        | \$562     | \$88     | \$209    | \$2,170   |

(1) Credit scores have been updated within the last twelve months.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|                                    | Installment (1)      |                      | Loans not Secured by Real Estate |         | Total     |
|------------------------------------|----------------------|----------------------|----------------------------------|---------|-----------|
|                                    | Home Equity 1st Lien | Home Equity 2nd Lien | Other                            |         |           |
|                                    | (In thousands)       |                      |                                  |         |           |
| September 30, 2015                 |                      |                      |                                  |         |           |
| 800 and above                      | \$1,953              | \$1,840              | \$40,348                         | \$59    | \$44,200  |
| 750-799                            | 4,411                | 6,624                | 89,310                           | 568     | 100,913   |
| 700-749                            | 2,685                | 4,667                | 38,237                           | 617     | 46,206    |
| 650-699                            | 3,783                | 4,138                | 15,224                           | 479     | 23,624    |
| 600-649                            | 2,161                | 2,254                | 4,758                            | 260     | 9,433     |
| 550-599                            | 1,919                | 1,547                | 2,080                            | 124     | 5,670     |
| 500-549                            | 760                  | 851                  | 976                              | 50      | 2,637     |
| Under 500                          | 744                  | 280                  | 461                              | 11      | 1,496     |
| Unknown                            | 64                   | 104                  | 1,963                            | 5       | 2,136     |
| Total                              | \$18,480             | \$22,305             | \$193,357                        | \$2,173 | \$236,315 |
| Accrued interest included in total | \$70                 | \$82                 | \$519                            | \$17    | \$688     |
| December 31, 2014                  |                      |                      |                                  |         |           |
| 800 and above                      | \$2,272              | \$2,835              | \$31,507                         | \$60    | \$36,674  |
| 750-799                            | 5,677                | 8,557                | 66,558                           | 583     | 81,375    |
| 700-749                            | 3,111                | 6,358                | 28,179                           | 689     | 38,337    |
| 650-699                            | 3,963                | 5,477                | 16,152                           | 615     | 26,207    |
| 600-649                            | 3,434                | 2,408                | 5,128                            | 255     | 11,225    |
| 550-599                            | 2,019                | 1,913                | 1,896                            | 134     | 5,962     |
| 500-549                            | 1,128                | 1,036                | 1,672                            | 84      | 3,920     |
| Under 500                          | 393                  | 427                  | 455                              | 28      | 1,303     |
| Unknown                            | 77                   | 81                   | 1,842                            | 44      | 2,044     |
| Total                              | \$22,074             | \$29,092             | \$153,389                        | \$2,492 | \$207,047 |
| Accrued interest included in total | \$93                 | \$112                | \$445                            | \$19    | \$669     |

(1) Credit scores have been updated within the last twelve months.

Mepco Finance Corporation (“Mepco”) is a wholly-owned subsidiary of our Bank that operates a vehicle service contract payment plan business throughout the United States. See Note #14 for more information about Mepco’s business. As of September 30, 2015, approximately 62.9% of Mepco’s outstanding payment plan receivables relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the full refund owing upon cancellation of the related service contract (including with respect to both the portion funded to the service contract seller and the portion funded to the administrator). These receivables are shown as “Full Refund” in the table below. Another approximately 22.5% of Mepco’s outstanding payment plan receivables as of September 30, 2015, relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the refund owing upon cancellation only with respect to the unearned portion previously funded by Mepco to the administrator (but not to the service contract seller). These receivables are shown as “Partial Refund” in the table below. The balance of Mepco’s outstanding payment plan receivables relate to programs in which there is no insurer or risk retention group that has

any contractual liability to Mepco for any portion of the refund amount. These receivables are shown as “Other” in the table below. For each class of our payment plan receivables we monitor financial information on the counterparties as we evaluate the credit quality of this portfolio.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table summarizes credit ratings of insurer or risk retention group counterparties by class of payment plan receivable:

|                    | Payment Plan Receivables |                |         |          |
|--------------------|--------------------------|----------------|---------|----------|
|                    | Full Refund              | Partial Refund | Other   | Total    |
| (In thousands)     |                          |                |         |          |
| September 30, 2015 |                          |                |         |          |
| AM Best rating     |                          |                |         |          |
| A+                 | \$-                      | \$8            | \$-     | \$8      |
| A                  | 3,711                    | 7,572          | -       | 11,283   |
| A-                 | 3,226                    | 753            | 5,470   | 9,449    |
| Not rated          | 16,595                   | 95             | 8       | 16,698   |
| Total              | \$23,532                 | \$8,428        | \$5,478 | \$37,438 |
| December 31, 2014  |                          |                |         |          |
| AM Best rating     |                          |                |         |          |
| A+                 | \$-                      | \$43           | \$-     | \$43     |
| A                  | 10,007                   | 6,190          | -       | 16,197   |
| A-                 | 1,989                    | 685            | 5,054   | 7,728    |
| Not rated          | 15,857                   | 176            | -       | 16,033   |
| Total              | \$27,853                 | \$7,094        | \$5,054 | \$40,001 |

Although Mepco has contractual recourse against various counterparties for refunds owing upon cancellation of vehicle service contracts, see Note #14 below regarding certain risks and difficulties associated with collecting these refunds.

Foreclosed residential real estate properties included in other real estate and repossessed assets on our Condensed Consolidated Statements of Financial Condition totaled \$2.8 million and \$2.9 million at September 30, 2015 and December 31, 2014, respectively. Retail mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements totaled \$1.1 million and \$2.5 million at September 30, 2015 and December 31, 2014, respectively.

5. Segments

Our reportable segments are based upon legal entities. We currently have two reportable segments: Independent Bank ("IB" or "Bank") and Mepco. These business segments are also differentiated based on the products and services provided. We evaluate performance based principally on net income (loss) of the respective reportable segments.

In the normal course of business, our IB segment provides funding to our Mepco segment through an intercompany line of credit priced at the prime rate of interest as published in the Wall Street Journal. Our IB segment also provides certain administrative services to our Mepco segment which are reimbursed at an agreed upon rate. These intercompany transactions are eliminated upon consolidation. The only other material intersegment balances and transactions are investments in subsidiaries at the parent entities and cash balances on deposit at our IB segment.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A summary of selected financial information for our reportable segments follows:

|  | IB             | Mepco    | Other (1) | Elimination<br>(2) | Total       |
|--|----------------|----------|-----------|--------------------|-------------|
|  | (In thousands) |          |           |                    |             |
| Total assets                                     |                |          |           |                    |             |
| September 30, 2015                               | \$2,323,629    | \$60,018 | \$288,708 | \$(277,494 )       | \$2,394,861 |
| December 31, 2014                                | 2,174,536      | 63,378   | 286,158   | (275,342 )         | 2,248,730   |
| For the three months ended September 30,<br>2015 |                |          |           |                    |             |
| Interest income                                  | \$18,973       | \$1,320  | \$20      | \$(20 )            | \$20,293    |
| Net interest income                              | 17,964         | 1,115    | (238 )    | -                  | 18,841      |
| Provision for loan losses                        | (238 )         | (6 )     | -         | -                  | (244 )      |
| Income (loss) before income tax                  | 7,961          | (254 )   | (358 )    | (24 )              | 7,325       |
| Net income (loss)                                | 5,455          | (168 )   | (224 )    | (16 )              | 5,047       |
| 2014   |                |          |           |                    |             |
| Interest income                                  | \$18,444       | \$1,624  | \$25      | \$(25 )            | \$20,068    |
| Net interest income                              | 17,254         | 1,338    | (409 )    | -                  | 18,183      |
| Provision for loan losses                        | (623 )         | (9 )     | -         | -                  | (632 )      |
| Income (loss) before income tax                  | 7,459          | 247      | (408 )    | (24 )              | 7,274       |
| Net income (loss)                                | 5,048          | 163      | (266 )    | (16 )              | 4,929       |
| For the nine months ended September 30,<br>2015  |                |          |           |                    |             |
| Interest income                                  | \$55,895       | \$4,081  | \$60      | \$(60 )            | \$59,976    |
| Net interest income                              | 52,864         | 3,468    | (699 )    | -                  | 55,633      |
| Provision for loan losses                        | (1,032 )       | (5 )     | -         | -                  | (1,037 )    |
| Income (loss) before income tax                  | 23,063         | (766 )   | (1,097 )  | (71 )              | 21,129      |
| Net income (loss)                                | 15,623         | (437 )   | (693 )    | (46 )              | 14,447      |
| 2014   |                |          |           |                    |             |
| Interest income                                  | \$55,153       | \$5,555  | \$41      | \$(41 )            | \$60,708    |
| Net interest income                              | 51,721         | 4,500    | (1,022 )  | -                  | 55,199      |
| Provision for loan losses                        | (2,018 )       | (31 )    | -         | -                  | (2,049 )    |
| Income (loss) before income tax                  | 20,151         | 908      | (1,210 )  | (71 )              | 19,778      |
| Net income (loss)                                | 14,345         | 607      | (665 )    | (168 )             | 14,119      |

(1)Includes amounts relating to our parent company and certain insignificant operations.

(2)Includes parent company's investment in subsidiaries and cash balances maintained at subsidiary.

6. Shareholders' Equity and Earnings Per Common Share

On January 21, 2015, our Board of Directors authorized a share repurchase plan (the "Repurchase Plan") to buy back up to 5% of our outstanding common stock through December 31, 2015. We expect to accomplish the repurchases



through open market transactions, though we could effect repurchases through other means, such as privately negotiated transactions. The timing and amount of any share repurchases will depend on a variety of factors, including, among others, securities law restrictions, the trading price of our common stock, regulatory requirements, potential alternative uses for capital, and our financial performance. The Repurchase Plan does not obligate us to acquire any particular amount of common stock, and it may be modified or suspended at any time at our discretion. We expect to fund any repurchases from cash on hand. During the nine months ended September 30, 2015, we repurchased 659,162 shares of common stock for an aggregate purchase price of \$9.0 million.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

On November 15, 2011, we entered into a Tax Benefits Preservation Plan (the "Preservation Plan") with our stock transfer agent, American Stock Transfer & Trust Company. Our Board of Directors adopted the Preservation Plan in an effort to protect the value to our shareholders of our ability to use deferred tax assets such as net operating loss carry forwards to reduce potential future federal income tax obligations. Under federal tax rules, this value could be lost in the event we experienced an "ownership change," as defined in Section 382 of the Internal Revenue Code. The Preservation Plan attempts to protect this value by reducing the likelihood that we will experience such an ownership change by discouraging any person who is not already a 5% shareholder from becoming a 5% shareholder (with certain limited exceptions).

On November 15, 2011, our Board of Directors declared a dividend of one preferred share purchase right (a "Right") for each outstanding share of our common stock under the terms of the Preservation Plan. The dividend is payable to the holders of common stock outstanding as of the close of business on November 15, 2011, or outstanding at any time thereafter but before the earlier of a "Distribution Date" and the date the Preservation Plan terminates. Each Right entitles the registered holder to purchase from us 1/1000 of a share of our Series C Junior Participating Preferred Stock, no par value per share ("Series C Preferred Stock"). Each 1/1000 of a share of Series C Preferred Stock has economic and voting terms similar to those of one whole share of common stock. The Rights are not exercisable and generally do not become exercisable until a person or group has acquired, subject to certain exceptions and conditions, beneficial ownership of 4.99% or more of the outstanding shares of common stock. At that time, each Right will generally entitle its holder to purchase securities of the Company at a discount of 50% to the current market price of the common stock. However, the Rights owned by the person acquiring beneficial ownership of 4.99% or more of the outstanding shares of common stock would automatically be void. The significant dilution that would result is expected to deter any person from acquiring beneficial ownership of 4.99% or more and thereby triggering the Rights.

To date, none of the Rights have been exercised or have become exercisable because no unpermitted 4.99% or more change in the beneficial ownership of the outstanding common stock has occurred. The Rights will generally expire on the earlier to occur of the close of business on November 15, 2016, and certain other events described in the Preservation Plan, including such date as our Board of Directors determines that the Preservation Plan is no longer necessary for its intended purposes.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A reconciliation of basic and diluted net income per common share follows:

|   | Three Months<br>Ended<br>September 30,<br>2015 |         | Nine Months<br>Ended<br>September 30,<br>2015 |          |
|---|--|---------|---|----------|
|   | 2014   | 2014    | 2014  | 2014     |
|   | (In thousands, except per share amounts)       |         |   |          |
| Net income  | \$5,047  | \$4,929 | \$14,447                                      | \$14,119 |
| Weighted average shares outstanding (1)   | 22,673   | 22,940  | 22,852  | 22,919   |
| Restricted stock units  | 230  | 306     | 283   | 305      |
| Effect of stock options   | 118  | 123     | 120   | 126      |
| Stock units for deferred compensation plan for non-employee directors             | 112  | 109     | 111   | 114      |
| Weighted average shares outstanding for calculation of diluted earnings per share | 23,133   | 23,478  | 23,366  | 23,464   |
| Net income per common share   |  |         |   |          |
| Basic (1)   | \$0.22   | \$0.21  | \$0.63  | \$0.62   |
| Diluted   | \$0.22   | \$0.21  | \$0.62  | \$0.60   |

(1) Basic net income per common share includes weighted average common shares outstanding during the period and participating share awards.

Weighted average stock options outstanding that were not considered in computing diluted net income per share because they were anti-dilutive totaled 0.03 million for both three-month periods ending September 30, 2015 and 2014, respectively and totaled 0.03 million for both nine-month periods ending September 30, 2015 and 2014, respectively.

7. Derivative Financial Instruments

We are required to record derivatives on our Condensed Consolidated Statements of Financial Condition as assets and liabilities measured at their fair value. The accounting for increases and decreases in the value of derivatives depends upon the use of derivatives and whether the derivatives qualify for hedge accounting.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our derivative financial instruments according to the type of hedge in which they are designated follows:

|  | September 30, 2015     |                                |               |
|--|------------------------|--------------------------------|---------------|
|  | Notional<br>Amount     | Average<br>Maturity<br>(years) | Fair<br>Value |
|  | (Dollars in thousands) |                                |               |
| No hedge designation                         |                        |                                |               |
| Rate-lock mortgage loan commitments          | \$24,746               | 0.1                            | \$823         |
| Mandatory commitments to sell mortgage loans | 49,791                 | 0.1                            | (409)         |
| Pay-fixed interest rate swap agreements      | 19,616                 | 7.3                            | (674)         |
| Pay-variable interest rate swap agreements   | 19,616                 | 7.3                            | 674           |
| Purchased options                            | 1,681                  | 5.9                            | 126           |
| Written options                              | 1,681                  | 5.9                            | (126)         |
| Total  | \$117,131              | 2.7                            | \$414         |

|  | December 31, 2014      |                                |               |
|--|------------------------|--------------------------------|---------------|
|  | Notional<br>Amount     | Average<br>Maturity<br>(years) | Fair<br>Value |
|  | (Dollars in thousands) |                                |               |
| No hedge designation                         |                        |                                |               |
| Rate-lock mortgage loan commitments          | \$16,759               | 0.1                            | \$437         |
| Mandatory commitments to sell mortgage loans | 38,600                 | 0.1                            | (184)         |
| Pay-fixed interest rate swap agreements      | 3,300                  | 9.4                            | (182)         |
| Pay-variable interest rate swap agreements   | 3,300                  | 9.4                            | 182           |
| Total  | \$61,959               | 1.1                            | \$253         |

Certain financial derivative instruments have not been designated as hedges. The fair value of these derivative financial instruments has been recorded on our Condensed Consolidated Statements of Financial Condition and is adjusted on an ongoing basis to reflect their then current fair value. The changes in fair value of derivative financial instruments not designated as hedges are recognized in earnings.

In the ordinary course of business, we enter into rate-lock mortgage loan commitments with customers (“Rate-Lock Commitments”). These commitments expose us to interest rate risk. We also enter into mandatory commitments to sell mortgage loans (“Mandatory Commitments”) to reduce the impact of price fluctuations of mortgage loans held for sale and Rate-Lock Commitments. Mandatory Commitments help protect our loan sale profit margin from fluctuations in interest rates. The changes in the fair value of Rate-Lock Commitments and Mandatory Commitments are recognized currently as part of net gains on mortgage loans. We obtain market prices on Mandatory Commitments and Rate-Lock Commitments. Net gains on mortgage loans, as well as net income may be more volatile as a result of these derivative instruments, which are not designated as hedges.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During 2014, we began a program that allows commercial loan customers to lock in a fixed rate for a longer period of time than we would normally offer for interest rate risk reasons. We will enter into a variable rate commercial loan and an interest rate swap agreement with a customer and then enter into an offsetting interest rate swap agreement with an unrelated party. The interest rate swap agreement fair values will generally move in opposite directions resulting in little or no net impact on our Condensed Consolidated Statements of Operations. All of the interest rate swap agreements in the table above relate to this program.

During the third quarter of 2015, we began offering to our deposit customers an equity linked time deposit product ("Altitude CD"). The Altitude CD is a time deposit that provides the customer a guaranteed return of principle at maturity plus a potential equity return (a written option), while we receive a like stream of funds based on the equity return (a purchased option). The written and purchased options will generally move in opposite directions resulting in little or no net impact on our Condensed Consolidated Statements of Operations. All of the written and purchased options in the table above relate to this Altitude CD product.

The following tables illustrate the impact that the derivative financial instruments discussed above have on individual line items in the Condensed Consolidated Statements of Financial Condition for the periods presented:

## Fair Values of Derivative Instruments

|  | Asset Derivatives            |               |                              |               | Liability Derivatives        |               |                              |               |
|--|------------------------------|---------------|------------------------------|---------------|------------------------------|---------------|------------------------------|---------------|
|  | September 30,<br>2015        |               | December 31,<br>2014         |               | September 30,<br>2015        |               | December 31,<br>2014         |               |
|  | Balance<br>Sheet<br>Location | Fair<br>Value | Balance<br>Sheet<br>Location | Fair<br>Value | Balance<br>Sheet<br>Location | Fair<br>Value | Balance<br>Sheet<br>Location | Fair<br>Value |
| (In thousands)                                       |                              |               |                              |               |                              |               |                              |               |
| Derivatives not designated<br>as hedging instruments |                              |               |                              |               |                              |               |                              |               |
| Rate-lock mortgage loan<br>commitments               | Other<br>assets              | \$823         | Other assets                 | \$437         | Other liabilities            | \$-           | Other<br>liabilities         | \$-           |
| Mandatory commitments<br>to sell mortgage loans      | Other<br>assets              | -             | Other assets                 | -             | Other liabilities            | 409           | Other<br>liabilities         | 184           |
| Pay-fixed interest rate<br>swap agreements           | Other<br>assets              | -             | Other assets                 | -             | Other liabilities            | 674           | Other<br>liabilities         | 182           |
| Pay-variable interest rate<br>swap agreements        | Other<br>assets              | 674           | Other assets                 | 182           | Other liabilities            | -             | Other<br>liabilities         | -             |
| Purchased options                                    | Other<br>assets              | 126           | Other assets                 | -             | Other liabilities            | -             | Other<br>liabilities         | -             |
| Written options                                      | Other<br>assets              | -             | Other assets                 | -             | Other liabilities            | 126           | Other<br>liabilities         | -             |
| Total derivatives                                    |                              | \$1,623       |                              | \$619         |                              | \$1,209       |                              | \$366         |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The effect of derivative financial instruments on the Condensed Consolidated Statements of Operations follows:

Three Month Periods Ended September 30,

|  | Gain (Loss) Recognized in Other Comprehensive Income (Effective Portion) 2015 | Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) 2014 | Gain (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) 2015 | Gain (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) 2014 | Location of Gain (Loss) Recognized in Income (1) | Gain (Loss) Recognized in Income 2015 | Gain (Loss) Recognized in Income 2014 |
|--|---|---|---|---|--|---------------------------------------|---------------------------------------|
| (In thousands)                               |   |   |   |   |  |                                       |                                       |
| Cash Flow Hedges                             |   |   |   |   |  |                                       |                                       |
| Pay-fixed interest rate swap agreements (2)  | \$ -  | Interest expense  | \$ -  | \$ (95 )  |  | \$ -                                  | \$ -                                  |
| Total  | \$ -  |   | \$ -  | \$ (95 )  |  | \$ -                                  | \$ -                                  |
| No hedge designation                         |   |   |   |   |  |                                       |                                       |
| Rate-lock mortgage loan commitments          |   |   |   |   | Net mortgage loan gains                          | \$281                                 | \$(77 )                               |
| Mandatory commitments to sell mortgage loans |   |   |   |   | Net mortgage loan gains                          | (745)                                 | 220                                   |
| Pay-fixed interest rate swap agreements      |   |   |   |   | Interest income                                  | (452)                                 | 7                                     |
| Pay-variable interest rate swap agreements   |   |   |   |   | Interest income                                  | 452                                   | (7 )                                  |
| Purchased options                            |   |   |   |   | Interest expense                                 | 126                                   | -                                     |
| Written options                              |   |   |   |   | Interest expense                                 | (126)                                 | -                                     |
| U.S. Treasury short position                 |   |   |   |   | Gain on securities                               | -                                     | 127                                   |
| Total  |   |   |   |   |  | \$(464)                               | \$270                                 |

(1) For cash flow hedges, this location and amount refers to the ineffective portion.

(2) Relates to a terminated pay-fixed interest rate swap whose termination fee was included in accumulated other comprehensive loss and was being amortized into earnings through December 31, 2014.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|  | Nine Month Periods Ended September 30, |  |  |  | Gain (Loss)                                      |                                  |
|--|--|--|--|--|--|----------------------------------|
|  | Gain (Loss)                            | Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) | Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) | Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) | Location of Gain (Loss) Recognized in Income (1) | Gain (Loss) Recognized in Income |
|  | 2015                                   | 2014   | 2015   | 2014   |  | 2015 2014                        |
|  | (In thousands)                         |  |  |  |  |                                  |
| <b>Cash Flow Hedges</b>                      |  |  |  |  |  |                                  |
| Pay-fixed interest rate swap agreements (2)  | \$-                                    | \$ -   | Interest expense   | \$ -   | \$ (285 )  | \$- \$-                          |
| Total  | \$-                                    | \$ -   |  | \$ -   | \$ (285 )  | \$- \$-                          |
| <b>No hedge designation</b>                  |  |  |  |  |  |                                  |
| Rate-lock mortgage loan commitments          |  |  |  |  | Net mortgage loan gains                          | \$386 \$147                      |
| Mandatory commitments to sell mortgage loans |  |  |  |  | Net mortgage loan gains                          | (225) (134)                      |
| Pay-fixed interest rate swap agreements      |  |  |  |  | Interest income                                  | (492) (92 )                      |
| Pay-variable interest rate swap agreements   |  |  |  |  | Interest income                                  | 492 92                           |
| Purchased options                            |  |  |  |  | Interest expense                                 | 126 -                            |
| Written options                              |  |  |  |  | Interest expense                                 | (126) -                          |
| U.S. Treasury short position                 |  |  |  |  | Gain on securities                               | - 179                            |
| Total  |  |  |  |  |  | \$161 \$192                      |

(1) For cash flow hedges, this location and amount refers to the ineffective portion.

(2) Relates to a terminated pay-fixed interest rate swap whose termination fee was included in accumulated other comprehensive loss and was being amortized into earnings through December 31, 2014.

8. Intangible Assets

The following table summarizes intangible assets, net of amortization:

|   | September 30, 2015 |              | December 31, 2014 |              |
|---|--------------------|--------------|-------------------|--------------|
|   | Gross              | Accumulated  | Gross             | Accumulated  |
|   | Amount             | Amortization | Amount            | Amortization |
|   | (In thousands)     |              |                   |              |
| Amortized intangible assets - core deposits | \$6,118            | \$ 3,752     | \$6,118           | \$ 3,491     |





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization of other intangibles has been estimated through 2020 and thereafter in the following table.

|                                       | (In<br>thousands) |
|---------------------------------------|-------------------|
| Three months ending December 31, 2015 | \$ 86             |
| 2016                                  | 347               |
| 2017                                  | 346               |
| 2018                                  | 346               |
| 2019                                  | 346               |
| 2020 and thereafter                   | 895               |
| Total                                 | \$ 2,366          |

9. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.3 million shares of common stock as of September 30, 2015. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of September 30, 2015. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

During each first quarter period of 2015 and 2014, pursuant to our long-term incentive plan, we granted 0.07 million shares of restricted stock and 0.03 million performance stock units (“PSU”) to certain officers. The shares of restricted stock issued during 2015 cliff vest after a period of three years, the shares of restricted stock issued during 2014 vest ratably over three years and the PSUs issued in both periods cliff vest after a period of three years. The performance feature of the PSUs is based on a comparison of our total shareholder return over the three year period starting on the grant date to the total shareholder return over that period for an index of our peers in the banking industry. No long term incentive grants were made during the second or third quarters of 2015 or 2014.

Our directors may elect to receive a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis pursuant to the non-employee director stock purchase plan referenced above). Shares equal in value to that portion of each director’s fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.004 million shares and 0.011 million shares to directors during the first nine months of 2015 and 2014, respectively and expensed their value during those same periods.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$0.4 million and \$1.1 million during the three and nine month periods ended September 30, 2015, respectively, and was \$0.3 million and \$0.8 million during the same periods in 2014, respectively. The corresponding tax benefit relating to this expense was \$0.1 million and \$0.4 million for the three and nine month periods ended September 30, 2015, respectively and \$0.1 million and \$0.3 million for the same periods in 2014. Total expense recognized for non-employee director share based payments was \$0.02 million and \$0.05 million during the three and nine month periods ended September 30, 2015, respectively, and was \$0.05 million and \$0.14 million during the same periods in 2014, respectively. The corresponding tax benefit relating to this expense was \$0.01 million and \$0.02 million for the three and nine month periods ended September 30, 2015, respectively and \$0.02 million and \$0.05 million during the same periods in 2014.

At September 30, 2015, the total expected compensation cost related to non-vested stock options, restricted stock, PSUs and restricted stock unit awards not yet recognized was \$1.8 million. The weighted-average period over which this amount will be recognized is 1.8 years.

A summary of outstanding stock option grants and related transactions follows:

|                                   | Number<br>of<br>Shares | Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(Years) | Aggregated<br>Intrinsic<br>Value<br>(In<br>thousands) |
|-----------------------------------|------------------------|------------------------------|---|---|
| Outstanding at January 1, 2015    | 281,820                | \$ 4.69                      |   |   |
| Granted                           | -                      |                              |   |   |
| Exercised                         | (31,450 )              | 3.35                         |   |   |
| Forfeited                         | (2,096 )               | 4.77                         |   |   |
| Expired                           | (1,924 )               | 6.79                         |   |   |
| Outstanding at September 30, 2015 | 246,350                | \$ 4.85                      | 6.35  | \$ 2,472  |
| Vested and expected to vest at    |                        |                              |   |   |
| September 30, 2015                | 245,298                | \$ 4.84                      | 6.35  | \$ 2,463  |
| Exercisable at September 30, 2015 | 222,742                | \$ 4.70                      | 6.22  | \$ 2,271  |

A summary of outstanding non-vested restricted stock, restricted stock units and PSUs and related transactions follows:

|                                | Number<br>of Shares | Weighted-<br>Average<br>Grant<br>Date<br>Fair Value |
|--------------------------------|---------------------|---|
| Outstanding at January 1, 2015 | 407,130             | \$ 6.31   |
| Granted                        | 108,422             | 13.06   |
| Vested                         | (249,526)           | 3.92  |
| Forfeited                      | (4,384 )            | 12.88   |

Outstanding at September 30, 2015 261,642 \$ 11.28

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During the third quarter of 2015, 0.23 million restricted stock units relating to a grant in 2012 vested. In addition, as permitted by our long-term incentive plan, 0.07 million shares were withheld from the shares that would otherwise have been issued to executive officers for these vesting restricted stock units in order to satisfy tax withholding obligations.

Certain information regarding options exercised during the periods follows:

|                        | Three<br>Months<br>Ended<br>September<br>30,<br>2015 |       | Nine<br>Months<br>Ended<br>September<br>30,<br>2014 |       |
|------------------------|--|-------|---|-------|
|                        | 2015   | 2014  | 2015  | 2014  |
|                        | (In thousands)                                       |       |   |       |
| Intrinsic value        | \$71   | \$123 | \$314   | \$231 |
| Cash proceeds received | \$23   | \$30  | \$105   | \$66  |
| Tax benefit realized   | \$25   | \$44  | \$110   | \$81  |

10. Income Tax

Income tax expense was \$2.3 million during each three month period ended September 30, 2015 and 2014 and \$6.7 million and \$5.7 million during the nine months ended September 30, 2015 and 2014, respectively.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at both September 30, 2015 and 2014, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

We did maintain a valuation allowance against our deferred tax assets of approximately \$1.0 million at both September 30, 2015 and December 31, 2014. This valuation allowance on our deferred tax assets primarily relates to state income taxes at our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business.

At September 30, 2015 and December 31, 2014, we had approximately \$1.0 million and \$1.1 million, respectively of gross unrecognized tax benefits. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease during the balance of 2015.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

11. Regulatory Matters

Capital guidelines adopted by Federal and State regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank's current year's net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of September 30, 2015, the Bank had negative undivided profits of \$15.9 million. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2014, we requested regulatory approval for a \$15.0 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on March 28, 2014 and the Bank returned \$15.0 million of capital to the parent company on April 9, 2014. During January of 2015, we requested regulatory approval for an additional \$18.5 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on February 13, 2015, and the Bank returned \$18.5 million of capital to the parent company on February 17, 2015. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total, Tier 1, and common equity Tier 1 (as of January 1, 2015) capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can result in certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of September 30, 2015 and December 31, 2014, categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation ("FDIC") categorization.

On July 2, 2013, the Federal Reserve approved a final rule that establishes an integrated regulatory capital framework (the "New Capital Rules"). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity Tier 1 capital, the most loss-absorbing form of capital, and implement strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. The New Capital Rules became effective for us on January 1, 2015.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual capital amounts and ratios follow:

|  | Actual                 |         | Minimum for Adequately Capitalized Institutions |        | Minimum for Well-Capitalized Institutions |         |
|--|------------------------|---------|---|--------|---|---------|
|  | Amount                 | Ratio   | Amount  | Ratio  | Amount                                    | Ratio   |
|  | (Dollars in thousands) |         |   |        |   |         |
| September 30, 2015                                   |                        |         |   |        |   |         |
| Total capital to risk-weighted assets                |                        |         |   |        |   |         |
| Consolidated   | \$276,230              | 16.98 % | \$130,163                                       | 8.00 % | NA  | NA      |
| Independent Bank                                     | 253,647                | 15.61   | 130,004   | 8.00   | \$162,506                                 | 10.00 % |
| Tier 1 capital to risk-weighted assets               |                        |         |   |        |   |         |
| Consolidated   | \$255,613              | 15.71 % | \$97,622  | 6.00 % | NA  | NA      |
| Independent Bank                                     | 233,123                | 14.35   | 97,503  | 6.00   | \$130,005                                 | 8.00 %  |
| Common equity tier 1 capital to risk-weighted assets |                        |         |   |        |   |         |
| Consolidated   | \$238,884              | 14.68 % | \$73,216  | 4.50 % | NA  | NA      |
| Independent Bank                                     | 233,123                | 14.35   | 73,128  | 4.50   | \$105,629                                 | 6.50 %  |
| Tier 1 capital to average assets                     |                        |         |   |        |   |         |
| Consolidated   | \$255,613              | 11.16 % | \$91,582  | 4.00 % | NA  | NA      |
| Independent Bank                                     | 233,123                | 10.19   | 91,509  | 4.00   | \$114,387                                 | 5.00 %  |
| December 31, 2014                                    |                        |         |   |        |   |         |
| Total capital to risk-weighted assets                |                        |         |   |        |   |         |
| Consolidated   | \$265,163              | 18.06 % | \$117,427                                       | 8.00 % | NA  | NA      |
| Independent Bank                                     | 247,883                | 16.90   | 117,374   | 8.00   | \$146,718                                 | 10.00 % |
| Tier 1 capital to risk-weighted assets               |                        |         |   |        |   |         |
| Consolidated   | \$246,628              | 16.80 % | \$58,714  | 4.00 % | NA  | NA      |
| Independent Bank                                     | 229,361                | 15.63   | 58,687  | 4.00   | \$88,031                                  | 6.00 %  |
| Tier 1 capital to average assets                     |                        |         |   |        |   |         |
| Consolidated   | \$246,628              | 11.18 % | \$88,206  | 4.00 % | NA  | NA      |
| Independent Bank                                     | 229,361                | 10.46   | 87,687  | 4.00   | \$109,609                                 | 5.00 %  |

NA - Not applicable

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The components of our regulatory capital are as follows:

|   | Consolidated       |                   | Independent Bank   |                   |
|---|--------------------|-------------------|--------------------|-------------------|
|   | September 30, 2015 | December 31, 2014 | September 30, 2015 | December 31, 2014 |
|   | (In thousands)     |                   |                    |                   |
| Total shareholders' equity  | \$252,980          | \$250,371         | \$255,659          | \$257,832         |
| Add (deduct)  |                    |                   |                    |                   |
| Accumulated other comprehensive (gain) loss for regulatory purposes   | (1,302 )           | 5,636             | (1,302 )           | 5,636             |
| Intangible assets   | (946 )             | (2,627 )          | (946 )             | (2,627 )          |
| Disallowed deferred tax assets  | (11,848 )          | (40,500 )         | (20,288 )          | (30,728 )         |
| Disallowed capitalized mortgage loan servicing rights   | -                  | (752 )            | -                  | (752 )            |
| Common equity tier 1 capital  | 238,884            | 212,128           | 233,123            | 229,361           |
| Qualifying trust preferred securities   | 34,500             | 34,500            | -                  | -                 |
| Disallowed deferred tax assets  | (17,771 )          | -                 | -                  | -                 |
| Tier 1 capital  | 255,613            | 246,628           | 233,123            | 229,361           |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 20,617             | 18,535            | 20,524             | 18,522            |
| Total risk-based capital  | \$276,230          | \$265,163         | \$253,647          | \$247,883         |

12. Fair Value Disclosures

FASB ASC topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC topic 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets. Level 1 instruments include securities traded on active exchange markets, such as the New York Stock Exchange, as well as U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. Level 2 instruments include securities traded in less active dealer or broker markets.

Level 3: Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

We used the following methods and significant assumptions to estimate fair value:

Securities: Where quoted market prices are available in an active market, securities (trading or available for sale) are classified as Level 1 of the valuation hierarchy. Level 1 securities include certain preferred stocks included in our trading portfolio for which there are quoted prices in active markets. If quoted market prices are not available for the specific security, then fair values are estimated by (1) using quoted market prices of securities with similar characteristics, (2) matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted prices, or (3) a discounted cash flow analysis whose significant fair value inputs can generally be verified and do not typically involve judgment by management. These securities are classified as Level 2 of the valuation hierarchy and include agency securities, private label residential mortgage-backed securities, other asset backed securities, municipal securities, trust preferred securities and corporate securities.

Loans held for sale: The fair value of mortgage loans held for sale is based on mortgage backed security pricing for comparable assets (recurring Level 2).

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. 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. At September 30, 2015 and December 31, 2014, all of our total impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

Other real estate: At the time of acquisition, other real estate is recorded at fair value, less estimated costs to sell, which becomes the property's new basis. Subsequent write-downs to reflect declines in value since the time of acquisition may occur from time to time and are recorded in net (gains) losses on other real estate and repossessed assets in the Condensed Consolidated Statements of Operations. The fair value of the property used at and subsequent to the time of acquisition is typically determined by a third party appraisal of the property. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value.



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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by us. Once received, an independent third party (for commercial properties over \$0.25 million) or a member of our Collateral Evaluation Department (for commercial properties under \$0.25 million) or a member of our Special Assets Group (for retail properties) reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. We compare the actual selling price of collateral that has been sold to the most recent appraised value of our properties to determine what additional adjustment, if any, should be made to the appraisal value to arrive at fair value. For commercial and retail properties we typically discount an appraisal to account for various factors that the appraisal excludes in its assumptions. These additional discounts generally do not result in material adjustments to the appraised value.

Capitalized mortgage loan servicing rights: The fair value of capitalized mortgage loan servicing rights is based on a valuation model used by an independent third party that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Certain model assumptions are generally unobservable and are based upon the best information available including data relating to our own servicing portfolio, reviews of mortgage servicing assumption and valuation surveys and input from various mortgage servicers and, therefore, are recorded as nonrecurring Level 3. Management evaluates the third party valuation for reasonableness each quarter as part of our financial reporting control processes.

Derivatives: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets (recurring Level 2). The fair value of interest rate swap agreements is based on a discounted cash flow analysis whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management (recurring Level 2). The fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management (recurring Level 2).



|   |     |   |   |     |
|---|-----|---|---|-----|
| Land, land development & construction-real estate | 639 | - | - | 639 |
| Commercial and industrial                         | 165 | - | - | 165 |
| Mortgage  |     |   |   |     |
| 1-4 Family  | 51  | - | - | 51  |
| Resort Lending                                    | 107 | - | - | 107 |
| Installment                                       |     |   |   |     |
| Home equity - 1st lien                            | 36  | - | - | 36  |

(1)Included in accrued income and other assets

(2)Included in accrued expenses and other liabilities

(3)Only includes servicing rights that are carried at fair value due to recognition of a valuation allowance.

(4) Only includes impaired loans with specific loss allocations based on collateral value.

(5)Only includes other real estate with subsequent write downs to fair value.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|   | Fair Value Measurements<br>Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
|---|--|---|---|
|   | Fair<br>Value<br>Measure-<br>ments<br>(In thousands)   |   |   |
| December 31, 2014:                                |  |   |   |
| Measured at Fair Value on a Recurring Basis:      |  |   |   |
| Assets  |  |   |   |
| Trading securities                                | \$203  | \$203   | \$ -  |
| Securities available for sale                     |  |   |   |
| U.S. agency                                       | 35,006   | -   | 35,006  |
| U.S. agency residential mortgage-backed           | 257,558  | -   | 257,558   |
| U.S. agency commercial mortgage-backed            | 33,728   | -   | 33,728  |
| Private label residential mortgage-backed         | 6,013  | -   | 6,013   |
| Other asset backed                                | 32,353   | -   | 32,353  |
| Obligations of states and political subdivisions  | 143,415  | -   | 143,415   |
| Corporate   | 22,664   | -   | 22,664  |
| Trust preferred                                   | 2,441  | -   | 2,441   |
| Loans held for sale                               | 23,662   | -   | 23,662  |
| Derivatives (1)                                   | 619  | -   | 619   |
| Liabilities                                       |  |   |   |
| Derivatives (2)                                   | 366  | -   | 366   |
| Measured at Fair Value on a Non-recurring basis:  |  |   |   |
| Assets  |  |   |   |
| Capitalized mortgage loan servicing rights (3)    | 9,197  | -   | 9,197   |
| Impaired loans (4)                                |  |   |   |
| Commercial  |  |   |   |
| Income producing - real estate                    | 869  | -   | 869   |
| Land, land development & construction-real estate | 354  | -   | 354   |
| Commercial and industrial                         | 2,601  | -   | 2,601   |
| Mortgage  |  |   |   |
| 1-4 Family  | 1,306  | -   | 1,306   |
| Other real estate (5)                             |  |   |   |
| Commercial  |  |   |   |
| Income producing - real estate                    | 479  | -   | 479   |
| Land, land development & construction-real estate | 737  | -   | 737   |
| Mortgage  |  |   |   |
| 1-4 Family  | 102  | -   | 102   |

|                        |     |   |   |     |
|------------------------|-----|---|---|-----|
| Resort Lending         | 575 | - | - | 575 |
| Installment            |     |   |   |     |
| Home equity - 1st lien | 13  | - | - | 13  |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

(3) Only includes servicing rights that are carried at fair value due to recognition of a valuation allowance.

(4) Only includes impaired loans with specific loss allocations based on collateral value.

(5) Only includes other real estate with subsequent write downs to fair value.

There were no transfers between Level 1 and Level 2 during the nine months ended September 30, 2015 and 2014.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Changes in fair values for financial assets which we have elected the fair value option for the periods presented were as follows:

| Changes in Fair Values for the Nine-Month<br>Periods Ended September 30 for Items<br>Measured at<br>Fair Value Pursuant to Election of the Fair<br>Value Option |      |   |       |   |     |       |
|---|------|---|-------|---|-----|-------|
|   | 2015 |   | 2014  |   |     |       |
|   |      | Total<br>Change<br>in Fair<br>Values<br>Included<br>in<br>Current<br>Period<br>Earnings |       | Total<br>Change<br>in Fair<br>Values<br>Included<br>in<br>Current<br>Period<br>Earnings |     |       |
| Trading securities  | \$22 | \$-   | \$ 22 | \$32  | \$- | \$ 32 |
| Loans held for sale   | -    | 311   | 311   | -   | 127 | 127   |

(In thousands)

For those items measured at fair value pursuant to our election of the fair value option, interest income is recorded within the Condensed Consolidated Statements of Operations based on the contractual amount of interest income earned on these financial assets and dividend income is recorded based on cash dividends.

The following represent impairment charges recognized during the three and nine month periods ended September 30, 2015 and 2014 relating to assets measured at fair value on a non-recurring basis:

Capitalized mortgage loan servicing rights, whose individual strata are measured at fair value, had a carrying amount of \$7.9 million which is net of a valuation allowance of \$4.1 million at September 30, 2015, and had a carrying amount of \$9.2 million which is net of a valuation allowance of \$3.8 million at December 31, 2014. A recovery (charge) of \$(0.9) million and \$(0.3) million was included in our results of operations for the three and nine month periods ending September 30, 2015, respectively and \$0.5 million and \$0.04 million during the same periods in 2014. Loans which are measured for impairment using the fair value of collateral for collateral dependent loans had a carrying amount of \$10.3 million, with a valuation allowance of \$3.8 million at September 30, 2015, and had a carrying amount of \$8.2 million, with a valuation allowance of \$3.1 million at December 31, 2014. The provision for loan losses included in our results of operations relating to impaired loans was an expense of \$1.0 million and \$0.5 million for the three month periods ending September 30, 2015 and 2014, respectively, and an expense of \$1.9 million and \$1.4 million for the nine month periods ending September 30, 2015 and 2014, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$1.0 million which is net of a valuation allowance of \$1.7 million at September 30, 2015, and a carrying amount of \$1.9 million which is net of a valuation allowance of \$2.5 million at December 31, 2014. An additional charge relating to other real estate measured at fair value of \$0.03 million and \$0.30 million was included in our results of operations during the three and nine month periods ended September 30, 2015, respectively and \$0.3 million and \$0.4 million during the same periods in 2014.

We had no assets or liabilities measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) during the nine months ended September 30, 2015 and 2014.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Quantitative information about Level 3 fair value measurements measured on a non-recurring basis follows:

|  | Asset<br>(Liability)<br>Fair<br>Value<br>(In<br>thousands) | Valuation<br>Technique                 | Unobservable<br>Inputs                              | Weighted<br>Average |
|--|--|--|---|---------------------|
| September 30, 2015                         |  |  |   |                     |
| Capitalized mortgage loan servicing rights | \$ 7,931   | Present value of net servicing revenue | Discount rate                                       | 10.03 %             |
|  |  |  | Cost to service                                     | \$ 80               |
|  |  |  | Ancillary income                                    | 24                  |
|  |  |  | Float rate  | 1.38 %              |
| Impaired loans                             |  |  |   |                     |
| Commercial (1)                             | 5,309  | Sales comparison approach              | Adjustment for differences between comparable sales | (7.2 )%             |
|  |  | Income approach                        | Capitalization rate                                 | 9.3                 |
| Mortgage                                   | 715  | Sales comparison approach              | Adjustment for differences between comparable sales | 4.1                 |
| Other real estate                          |  |  |   |                     |
| Commercial                                 | 804  | Sales comparison approach              | Adjustment for differences between comparable sales | (3.9 )              |
| Mortgage and installment                   | 194  | Sales comparison approach              | Adjustment for differences between comparable sales | 75.6                |
| December 31, 2014                          |  |  |   |                     |
| Capitalized mortgage loan servicing rights | \$ 9,197   | Present value of net servicing revenue | Discount rate                                       | 10.07 %             |
|  |  |  | Cost to service                                     | \$ 82               |
|  |  |  | Ancillary income                                    | 25                  |
|  |  |  | Float rate  | 1.77 %              |
| Impaired loans                             |  |  |   |                     |
| Commercial (1)                             | 2,751  | Sales comparison approach              | Adjustment for differences between comparable sales | (3.8 )%             |
|  |  | Income approach                        | Capitalization rate                                 | 9.3                 |
| Mortgage                                   | 1,306  | Sales comparison approach              | Adjustment for differences between comparable sales | 8.6                 |
| Other real estate                          |  |  |   |                     |
| Commercial                                 | 1,216  | Sales comparison approach              | Adjustment for differences between comparable sales | (9.0 )              |
| Mortgage and installment                   | 690  | Sales comparison approach              | Adjustment for differences between comparable sales | 34.3                |

(1) In addition to the valuation techniques and unobservable inputs discussed above, at September 30, 2015 and December 31, 2014, we had an impaired collateral dependent commercial relationship that totaled \$0.4 million and



\$1.1 million, respectively that was primarily secured by collateral other than real estate. Collateral securing this relationship primarily included machinery and equipment and inventory at September 30, 2015 and also included accounts receivable at December 31, 2014. Valuation techniques at September 30, 2015, included discounting restructuring firm valuations based on estimates of value recovery of each particular asset type. Discount rates used ranged from 0% to 100% of stated values. Valuation techniques at December 31, 2014, included discounting cost and financial statement value approaches based on estimates of value recovery of each particular asset type. Discount rates used ranged from 35% to 100% of stated values.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table reflects the difference between the aggregate fair value and the aggregate remaining contractual principal balance outstanding for loans held for sale for which the fair value option has been elected for the periods presented.

|                     | Aggregate<br>Fair<br>Value<br>(In thousands) | Difference | Contractual<br>Principal |
|---------------------|--|------------|--------------------------|
| Loans held for sale |  |            |                          |
| September 30, 2015  | \$25,462                                     | \$ 935     | \$ 24,527                |
| December 31, 2014   | 23,662                                       | 624        | 23,038                   |

13. Fair Values of Financial Instruments

Most of our assets and liabilities are considered financial instruments. Many of these financial instruments lack an available trading market and it is our general practice and intent to hold the majority of our financial instruments to maturity. Significant estimates and assumptions were used to determine the fair value of financial instruments. These estimates are subjective in nature, involving uncertainties and matters of judgment, and therefore, fair values cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Estimated fair values have been determined using available data and methodologies that are considered suitable for each category of financial instrument. For instruments with adjustable interest rates which reprice frequently and without significant credit risk, it is presumed that estimated fair values approximate the recorded book balances.

Cash and due from banks and interest bearing deposits: The recorded book balance of cash and due from banks and interest bearing deposits approximate fair value and are classified as Level 1.

Interest bearing deposits - time: Interest bearing deposits - time have been valued based on a model using a benchmark yield curve plus a base spread and are classified as Level 2.

Securities: Financial instrument assets actively traded in a secondary market have been valued using quoted market prices. Trading securities are classified as Level 1 while securities available for sale are classified as Level 2 as described in Note #12.

Federal Home Loan Bank and Federal Reserve Bank Stock: It is not practicable to determine the fair value of FHLB and FRB Stock due to restrictions placed on transferability.

Net loans and loans held for sale: The fair value of loans is calculated by discounting estimated future cash flows using estimated market discount rates that reflect credit and interest-rate risk inherent in the loans resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described in Note #12. Loans held for sale are classified as Level 2 as described in Note #12.

Accrued interest receivable and payable: The recorded book balance of accrued interest receivable and payable approximate fair value and are classified at the same Level as the asset and liability they are associated with.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Derivative financial instruments: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets, the fair value of interest rate swap agreements is based on a discounted cash flow analysis whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management and the fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management. Each of these instruments has been classified as Level 2 as described in note #12.

Deposits: Deposits without a stated maturity, including demand deposits, savings, NOW and money market accounts, have a fair value equal to the amount payable on demand. Each of these instruments is classified as Level 1. Deposits with a stated maturity, such as certificates of deposit have generally been valued based on the discounted value of contractual cash flows using a discount rate approximating current market rates for liabilities with a similar maturity resulting in a Level 2 classification.

Other borrowings: Other borrowings have been valued based on the discounted value of contractual cash flows using a discount rate approximating current market rates for liabilities with a similar maturity resulting in a Level 2 classification.

Subordinated debentures: Subordinated debentures have generally been valued based on a quoted market price of similar instruments resulting in a Level 2 classification.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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The estimated recorded book balances and fair values follow:

|   | Recorded<br>Book<br>Balance<br>(In thousands) | Fair Value  | Fair Value Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
|---|---|-------------|---|---|---|
| September 30, 2015                                    |   |             |   |   |   |
| Assets  |   |             |   |   |   |
| Cash and due from banks                               | \$52,146                                      | \$52,146    | \$52,146  | \$ -  | \$ -  |
| Interest bearing deposits                             | 53,051  | 53,051      | 53,051  | -   | -   |
| Interest bearing deposits - time                      | 13,029  | 13,053      | -   | 13,053  | -   |
| Trading securities                                    | 225   | 225         | 225   | -   | -   |
| Securities available for sale                         | 604,662                                       | 604,662     | -   | 604,662   | -   |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 15,286  | NA          | NA  | NA  | NA  |
| Net loans and loans held for sale                     | 1,468,857                                     | 1,435,597   | -   | 25,462  | 1,410,135   |
| Accrued interest receivable                           | 6,473   | 6,473       | 8   | 2,068   | 4,397   |
| Derivative financial instruments                      | 1,623   | 1,623       | -   | 1,623   | -   |
| Liabilities   |   |             |   |   |   |
| Deposits with no stated maturity (1)                  | \$1,639,402                                   | \$1,639,402 | \$1,639,402   | \$ -  | \$ -  |
| Deposits with stated maturity (1)                     | 421,560                                       | 419,803     | -   | 419,803   | -   |
| Other borrowings                                      | 12,070  | 13,474      | -   | 13,474  | -   |
| Subordinated debentures                               | 35,569  | 22,885      | -   | 22,885  | -   |
| Accrued interest payable                              | 420   | 420         | 20  | 400   | -   |
| Derivative financial instruments                      | 1,209   | 1,209       | -   | 1,209   | -   |
| December 31, 2014                                     |   |             |   |   |   |
| Assets  |   |             |   |   |   |
| Cash and due from banks                               | \$48,326                                      | \$48,326    | \$48,326  | \$ -  | \$ -  |
| Interest bearing deposits                             | 25,690  | 25,690      | 25,690  | -   | -   |
| Interest bearing deposits - time                      | 13,561  | 13,585      | -   | 13,585  | -   |
| Trading securities                                    | 203   | 203         | 203   | -   | -   |
| Securities available for sale                         | 533,178                                       | 533,178     | -   | 533,178   | -   |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 19,919  | NA          | NA  | NA  | NA  |
| Net loans and loans held for sale                     | 1,407,634                                     | 1,394,424   | -   | 23,662  | 1,370,762   |
| Accrued interest receivable                           | 5,995   | 5,995       | 2   | 1,599   | 4,394   |
| Derivative financial instruments                      | 619   | 619         | -   | 619   | -   |
| Liabilities   |   |             |   |   |   |

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|                                      |             |             |             |         |     |
|--------------------------------------|-------------|-------------|-------------|---------|-----|
| Deposits with no stated maturity (1) | \$1,534,175 | \$1,534,175 | \$1,534,175 | \$-     | \$- |
| Deposits with stated maturity (1)    | 390,127     | 389,139     | -           | 389,139 | -   |
| Other borrowings                     | 12,470      | 14,560      | -           | 14,560  | -   |
| Subordinated debentures              | 35,569      | 23,328      | -           | 23,328  | -   |
| Accrued interest payable             | 380         | 380         | 21          | 359     | -   |
| Derivative financial instruments     | 366         | 366         | -           | 366     | -   |

Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$12.0 million and \$13.6 million at September 30, 2015 and December 31, 2014, respectively. Deposits with a stated maturity include (1) reciprocal deposits with a recorded book balance of \$35.9 million and \$40.1 million at September 30, 2015 and December 31, 2014, respectively.

The fair values for commitments to extend credit and standby letters of credit are estimated to approximate their aggregate book balance, which is nominal and therefore are not disclosed.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale the entire holdings of a particular financial instrument.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business, the value of future earnings attributable to off-balance sheet activities and the value of assets and liabilities that are not considered financial instruments.

Fair value estimates for deposit accounts do not include the value of the core deposit intangible asset resulting from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

14. Contingent Liabilities

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$0.5 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.

The litigation matters described in the preceding paragraph primarily include claims that have been brought against us for damages, but do not include litigation matters where we seek to collect amounts owed to us by third parties (such as litigation initiated to collect delinquent loans or vehicle service contract counterparty receivables). These excluded, collection-related matters may involve claims or counterclaims by the opposing party or parties, but we have excluded such matters from the disclosure contained in the preceding paragraph in all cases where we believe the possibility of us paying damages to any opposing party is remote. Risks associated with the likelihood that we will not collect the full amount owed to us, net of reserves, are disclosed elsewhere in this report.

Our Mepco segment conducts its payment plan business activities across the United States. Mepco acquires the payment plans from companies (which we refer to as Mepco's "counterparties") at a discount from the face amount of the payment plan. Each payment plan (which are classified as payment plan receivables in our Condensed Consolidated Statements of Financial Condition) permits a consumer to purchase a vehicle service contract by making installment payments, generally for a term of 12 to 24 months, to the sellers of those contracts (one of the "counterparties"). Mepco thereafter collects the payments from consumers. In acquiring the payment plan, Mepco generally funds a portion of the cost to the seller of the service contract and a portion of the cost to the administrator of the service contract. The administrator, in turn, pays the necessary contractual liability insurance policy ("CLIP") premium to the insurer or risk retention group.

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Consumers are allowed to voluntarily cancel the service contract at any time and are generally entitled to receive a refund from the administrator of the unearned portion of the service contract at the time of cancellation. As a result, while Mepco does not owe any refund to the consumer, it also does not have any recourse against the consumer for nonpayment of a payment plan and therefore does not evaluate the creditworthiness of the individual consumer. If a consumer stops making payments on a payment plan or exercises the right to voluntarily cancel the service contract, the service contract seller and administrator are each obligated to refund to Mepco the amount necessary to make Mepco whole as a result of its funding of the service contract. In addition, the insurer or risk retention group that issued the CLIP for the service contract often guarantees all or a portion of the refund to Mepco. See note #4 above for a breakdown of Mepco's payment plan receivables by the level of recourse Mepco has against various counterparties.

Upon the cancellation of a service contract and the completion of the billing process to the counterparties for amounts due to Mepco, there is a decrease in the amount of "payment plan receivables" and an increase in the amount of "vehicle service contract counterparty receivables" until such time as the amount due from the counterparty is collected. These amounts represent funds actually due to Mepco from its counterparties for cancelled service contracts. At September 30, 2015 and December 31, 2014, the aggregate amount of such obligations owing to Mepco by counterparties, net of write-downs and reserves made through the recognition of vehicle service contract counterparty contingencies expense, totaled \$7.3 million and \$7.2 million, respectively. Mepco is currently in the process of working to recover these receivables, primarily through litigation against counterparties.

In some cases, Mepco requires collateral or guaranties by the principals of the counterparties to secure these refund obligations; however, this is generally only the case when no rated insurance company is involved to guarantee the repayment obligation of the seller and administrator counterparties. In most cases, there is no collateral to secure the counterparties' refund obligations to Mepco, but Mepco has the contractual right to offset unpaid refund obligations against amounts Mepco would otherwise be obligated to fund to the counterparties. In addition, even when collateral is involved, the refund obligations of these counterparties are not fully secured. Mepco incurs losses when it is unable to fully recover funds owing to it by counterparties upon cancellation of the underlying service contracts. The sudden failure of one of Mepco's major counterparties (an insurance company, administrator, or seller/dealer) could expose us to significant losses.

When counterparties do not honor their contractual obligations to Mepco to repay funds, we recognize estimated losses. Mepco pursues collection (including commencing legal action if necessary) of funds due to it under its various contracts with counterparties. Mepco has had to initiate litigation against certain counterparties, including third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. Charges related to estimated losses for vehicle service contract counterparty contingencies included in non-interest expense totaled \$0.03 million for both three month periods ended September 30, 2015 and 2014, respectively and totaled \$0.09 million and \$0.17 million for the nine month periods ended September 30, 2015 and 2014, respectively. These charges are being classified in non-interest expense because they are associated with a default or potential default of a contractual obligation under our counterparty contracts as opposed to loss on the administration of the payment plan itself.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our estimate of probable incurred losses from vehicle service contract counterparty contingencies requires a significant amount of judgment because a number of factors can influence the amount of loss that we may ultimately incur. These factors include our estimate of future cancellations of vehicle service contracts, our evaluation of collateral that may be available to recover funds due from our counterparties, and our assessment of the amount that may ultimately be collected from counterparties in connection with their contractual obligations. We apply a rigorous process, based upon historical payment plan activity and past experience, to estimate probable incurred losses and quantify the necessary reserves for our vehicle service contract counterparty contingencies, but there can be no assurance that our modeling process will successfully identify all such losses.

We believe our assumptions regarding the collection of vehicle service contract counterparty receivables are reasonable, and we based them on our good faith judgments using data currently available. We also believe the current amount of reserves we have established and the vehicle service contract counterparty contingencies expense that we have recorded are appropriate given our estimate of probable incurred losses at the applicable Condensed Consolidated Statement of Financial Condition date. However, because of the uncertainty surrounding the numerous and complex assumptions made, actual losses could exceed the charges we have taken to date.

The provision for loss reimbursement on sold loans represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac and Ginnie Mae). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The provision for loss reimbursement on sold loans was a credit of \$0.04 million and zero for the three months ended September 30, 2015 and 2014, respectively and a credit of \$0.06 million and \$0.5 million for the nine months ended September 30, 2015 and 2014, respectively. The credit provision in the first nine months of 2015 is due primarily to the settlement of certain loss reimbursement claims at slightly lower amounts than what had been specifically reserved for previously. The credit provision in the first nine months of 2014 is due primarily to the rescission of certain loss reimbursement requests by Freddie Mac that had been pending and accrued for at the end of 2013. The reserve for loss reimbursements on sold mortgage loans totaled \$0.5 million at both September 30, 2015 and December 31, 2014. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at September 30, 2015 and December 31, 2014 also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

15. Accumulated Other Comprehensive Loss (“AOCL”)

A summary of changes in AOCL follows:

|   | Unrealized<br>Gains<br>(Losses)<br>on<br>Available<br>for Sale<br>Securities | Dispropor-<br>tionate<br>Tax<br>Effects<br>from<br>Securities<br>Available<br>for Sale | Unrealized<br>Losses on<br>Settled<br>Derivatives | Total     |
|---|--|--|---|-----------|
| For the three months ended September 30,<br>2015    |  |  |   |           |
| Balances at beginning of period                     | \$ 408   | \$ (5,798 )  | \$ -  | \$(5,390) |
| Other comprehensive loss before reclassifications   | 894  | -  | -   | 894       |
| Amounts reclassified from AOCL                      | -  | -  | -   | -         |
| Net current period other comprehensive income       | 894  | -  | -   | 894       |
| Balances at end of period                           | \$ 1,302   | \$ (5,798 )  | \$ -  | \$(4,496) |
| 2014  |  |  |   |           |
| Balances at beginning of period                     | \$ (376 )  | \$ (5,798 )  | \$ (124 )   | \$(6,298) |
| Other comprehensive income before reclassifications | 226  | -  | -   | 226       |
| Amounts reclassified from AOCL                      | (73 )  | -  | 62  | (11 )     |
| Net current period other comprehensive income       | 153  | -  | 62  | 215       |
| Balances at end of period                           | \$ (223 )  | \$ (5,798 )  | \$ (62 )  | \$(6,083) |
| For the nine months ended September 30,<br>2015     |  |  |   |           |
| Balances at beginning of period                     | \$ 162   | \$ (5,798 )  | \$ -  | \$(5,636) |
| Other comprehensive income before reclassifications | 1,189  | -  | -   | 1,189     |
| Amounts reclassified from AOCL                      | (49 )  | -  | -   | (49 )     |
| Net current period other comprehensive income       | 1,140  | -  | -   | 1,140     |
| Balances at end of period                           | \$ 1,302   | \$ (5,798 )  | \$ -  | \$(4,496) |
| 2014  |  |  |   |           |
| Balances at beginning of period                     | \$ (3,200 )  | \$ (5,798 )  | \$ (247 )   | \$(9,245) |
| Other comprehensive income before reclassifications | 3,051  | -  | -   | 3,051     |
| Amounts reclassified from AOCL                      | (74 )  | -  | 185   | 111       |
| Net current period other comprehensive income       | 2,977  | -  | 185   | 3,162     |
| Balances at end of period                           | \$ (223 )  | \$ (5,798 )  | \$ (62 )  | \$(6,083) |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The disproportionate tax effects from securities available for sale arose due to tax effects of other comprehensive income (“OCI”) in the presence of a valuation allowance against our deferred tax assets and a pretax loss from operations. Generally, the amount of income tax expense or benefit allocated to operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided when, in the presence of a valuation allowance against deferred tax assets, there is a pretax loss from operations and pretax income from other categories in the current period. In such instances, income from other categories must offset the current loss from operations, the tax benefit of such offset being reflected in operations.

A summary of reclassifications out of each component of AOCL for the three months ended September 30 follows:

| AOCL Component                                    | Amount<br>Reclassified<br>From<br>AOCL<br>(In<br>thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|---|---|--|
| 2015  |   |  |
| Unrealized gains on available for sale securities | \$ -  | Net gains on securities  |
|   | -   | Net impairment loss recognized in earnings                               |
|   | -   | Total reclassifications before tax                                       |
|   | -   | Tax expense  |
|   | \$ -  | Reclassifications, net of tax  |
| 2014  |   |  |
| Unrealized gains on available for sale securities | \$ 121  | Net gains on securities  |
|   | (9  | ) Net impairment loss recognized in earnings                             |
|   | 112   | Total reclassifications before tax                                       |
|   | 39  | Tax expense  |
|   | \$ 73   | Reclassifications, net of tax  |
| Unrealized gains on settled derivatives           | \$ (95  | ) Interest expense   |
|   | (33   | ) Tax benefit  |
|   | \$ (62  | ) Reclassification, net of tax   |
|   | \$ 11   | Total reclassifications for the period, net of tax                       |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A summary of reclassifications out of each component of AOCL for the nine months ended September 30 follows:

| AOCL Component                                    | Amount<br>Reclassified<br>From<br>AOCL<br>(In<br>thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|---|---|--|
| 2015  |   |  |
| Unrealized gains on available for sale securities | \$ 75   | Net gains on securities  |
|   | -   | Net impairment loss recognized in earnings                               |
|   | 75  | Total reclassifications before tax                                       |
|   | 26  | Tax expense  |
|   | \$ 49   | Reclassifications, net of tax  |
| 2014  |   |  |
| Unrealized gains on available for sale securities | \$ 123  | Net gains on securities  |
|   | (9)   | )Net impairment loss recognized in earnings                              |
|   | 114   | Total reclassifications before tax                                       |
|   | 40  | Tax expense  |
|   | \$ 74   | Reclassifications, net of tax  |
| Unrealized gains on settled derivatives           | \$ (285)  | )Interest expense  |
|   | (100)   | )Tax benefit   |
|   | \$ (185)  | )Reclassification, net of tax  |
|   | \$ (111)  | )Total reclassifications for the period, net of tax                      |

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ITEM 2.

Management's Discussion and Analysis  
of Financial Condition and Results of Operations

**Introduction.** The following section presents additional information to assess the financial condition and results of operations of Independent Bank Corporation, its wholly-owned bank, Independent Bank (the "Bank"), and their subsidiaries. This section should be read in conjunction with the Condensed Consolidated Financial Statements. We also encourage you to read our 2014 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC"). That report includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

**Overview.** We provide banking services to customers located primarily in Michigan's Lower Peninsula. As a result, our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula. At times, we have experienced a difficult economy in Michigan which in turn had an adverse effect on our performance. As a result of the recession, we incurred net losses from 2008 through 2011 and found it necessary to take certain steps to preserve capital and maintain our regulatory capital ratios.

Economic conditions in Michigan began to show signs of improvement during 2010. Generally, these improvements have continued into 2015, albeit at an uneven pace. There has been an overall decline in the unemployment rate as well as generally improving housing prices and other related statistics (such as home sales and new building permits). In addition, since early- to mid-2009, we have seen an improvement in our asset quality metrics. In particular, since early 2012, we have generally experienced a decline in non-performing assets, reduced levels of new loan defaults, and reduced levels of loan net charge-offs. As a result of the foregoing factors and others, we returned to profitability in 2012 and have now been profitable for 15 consecutive quarters. In addition, we completed various transactions to improve our capital structure.

**Recent Developments.** On April 29, 2015 the Bank entered into a Purchase and Assumption Agreement ("PAA") with Isabella Bank (based in Mt. Pleasant, Michigan). Pursuant to the PAA, on August 28, 2015, we sold the fixed assets (including an automated teller machine), real property and certain other assets of our bank branch located at 210 South Saginaw Road, Midland, Michigan (the "Midland Branch") to Isabella Bank. The deposit liabilities of the Midland Branch were assumed by Isabella Bank. Under the terms of the PAA, Isabella Bank paid a premium of \$0.6 million (which was equal to 6.0% of the average deposit liabilities of \$9.7 million based on the 20-day average ending two business days prior to the closing date of August 28, 2015) and \$0.85 million for the real property and fixed assets (including the ATM). The real property and the fixed assets (including the ATM) had a net book value of approximately \$0.2 million as of August 28, 2015. We recorded a net gain of \$1.2 million in the third quarter of 2015 on the sale of the Midland Branch.

In January 2015, we adopted a plan to consolidate certain branch offices (the "Branch Consolidation"). This Branch Consolidation reflects our ongoing cost reduction initiatives and undertakings to further improve the overall efficiency of our operations. The Branch Consolidation resulted in the closing of six of our branch offices on April 30, 2015. It is expected that the aggregate, annual reduction in non-interest expenses resulting from the Branch Consolidation will amount to approximately \$1.6 million. We also estimate a potential annual loss of revenue of approximately \$0.3 million to \$0.4 million due to possible customer attrition. We also undertook certain additional staffing reductions related to our retail banking operations. In connection with the Branch Consolidation and these staffing reductions, we recorded \$0.2 million of severance expenses in the first quarter of 2015. We recorded a net gain of approximately \$0.2 million in the second quarter of 2015 (included in Other Non-Interest Income) that was comprised of a \$0.3 million gain on the sale of the real property of two of the branches that was partially offset by \$0.1 million of write downs of the fixed assets (including real property) of the other four branches. We are in the process of disposing of the real property associated with these other four branches (two of which we expect to donate to local community

groups).

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Regulation. On July 2, 2013, the Federal Reserve Board (the "FRB") approved a final rule that establishes an integrated regulatory capital framework (the "New Capital Rules"). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The 2.5% capital conservation buffer is being phased in over a four-year period beginning in 2016. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. Under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital. We were subject to the New Capital Rules beginning on January 1, 2015, and as of September 30, 2015 we exceeded all of the capital ratio requirements of the New Capital Rules.

It is against this backdrop that we discuss our results of operations for the third quarter and first nine months of 2015 as compared to 2014 and our financial condition as of September 30, 2015.

Results of Operations

Summary. We recorded net income of \$5.0 million and \$4.9 million, respectively, during the three months ended September 30, 2015 and 2014. The increase in net income on a comparative quarterly basis is due primarily to an increase in net interest income and a decrease in non-interest expense that were partially offset by an increase in the provision for loan losses (a lower credit) and a decrease in non-interest income.

We recorded net income of \$14.4 million and \$14.1 million, respectively, during the nine months ended September 30, 2015 and 2014. The increase in net income on a comparative year-to-date basis is due primarily to increases in net interest income and non-interest income and a decrease in non-interest expense that were partially offset by increases in the provision for loan losses (a lower credit) and income tax expense.

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## Key performance ratios

|                                     | Three months ended |        | Nine months ended |        |
|-------------------------------------|--------------------|--------|-------------------|--------|
|                                     | September 30,      |        | September 30      |        |
|                                     | 2015               | 2014   | 2015              | 2014   |
| Net income (annualized) to          |                    |        |                   |        |
| Average assets                      | 0.86%              | 0.87%  | 0.84%             | 0.84%  |
| Average common shareholders' equity | 7.84               | 7.95   | 7.59              | 7.86   |
| Net income per common share         |                    |        |                   |        |
| Basic                               | \$0.22             | \$0.21 | \$0.63            | \$0.62 |
| Diluted                             | 0.22               | 0.21   | 0.62              | 0.60   |

Net interest income. Net interest income is the most important source of our earnings and thus is critical in evaluating our results of operations. Changes in our net interest income are primarily influenced by our level of interest-earning assets and the income or yield that we earn on those assets and the manner and cost of funding our interest-earning assets. Certain macro-economic factors can also influence our net interest income such as the level and direction of interest rates, the difference between short-term and long-term interest rates (the steepness of the yield curve) and the general strength of the economies in which we are doing business. Finally, risk management plays an important role in our level of net interest income. The ineffective management of credit risk and interest-rate risk in particular can adversely impact our net interest income.

Our net interest income totaled \$18.8 million during the third quarter of 2015, an increase of \$0.7 million, or 3.6% from the year-ago period. The quarterly increase in net interest income in 2015 compared to 2014 primarily reflects a \$91.5 million increase in average interest-earning assets that was partially offset by a three basis point decrease in our tax equivalent net interest income as a percent of average interest-earning assets (the "net interest margin").

For the first nine months of 2015, net interest income totaled \$55.6 million, an increase of \$0.4 million, or 0.8% from 2014. The year-to-date increase in net interest income in 2015 compared to 2014 primarily reflects a \$79.0 million increase in average interest-earning assets that was partially offset by a 12 basis point decrease in our net interest margin.

The decline in our net interest margin is primarily due to the prolonged low interest rate environment that has pushed our average yield on loans lower.

Interest rates have generally been at extremely low levels since 2008 due primarily to the FRB's monetary policies and its efforts to stimulate the U.S. economy. This very low interest rate environment has generally had an adverse impact on our interest income and net interest income. Based on recent announcements by the FRB, short-term interest rates are expected to remain extremely low until at least late-2015 or early-2016. Given the repricing characteristics of our interest-earning assets and interest-bearing liabilities (and our level of non-interest bearing demand deposits), we would expect that our net interest margin will generally benefit on a long-term basis from rising interest rates.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the third quarter and first nine months of 2015 non-accrual loans averaged \$12.9 million and \$13.7 million, respectively compared to \$17.1 million and \$18.4 million, respectively for the same periods in 2014. In addition, in the third quarter and first nine months of 2015 we had net recoveries of \$0.16 million and \$0.34 million, respectively, of accrued and unpaid interest on loans placed on or taken off non-accrual during each period compared to net recoveries of \$0.06 million and \$0.21 million, respectively, during the same periods in 2014.





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## Average Balances and Tax Equivalent Rates

|  | Three Months Ended<br>September 30, |                  |                          | 2014               |          |                          |
|--|-------------------------------------|------------------|--------------------------|--------------------|----------|--------------------------|
|  | Average<br>Balance                  | 2015<br>Interest | Rate<br>( <sup>3</sup> ) | Average<br>Balance | Interest | Rate<br>( <sup>3</sup> ) |
| (Dollars in thousands)   |                                     |                  |                          |                    |          |                          |
| <b>Assets</b> <sup>(1)</sup>   |                                     |                  |                          |                    |          |                          |
| Taxable loans  | \$1,470,529                         | \$17,834         | 4.83 %                   | \$1,390,811        | \$17,768 | 5.08 %                   |
| Tax-exempt loans <sup>(2)</sup>  | 3,740                               | 54               | 5.73                     | 4,803              | 77       | 6.36                     |
| Taxable securities   | 520,805                             | 1,901            | 1.46                     | 484,687            | 1,644    | 1.35                     |
| Tax-exempt securities <sup>(2)</sup>                                   | 33,104                              | 347              | 4.19                     | 40,613             | 430      | 4.20                     |
| Interest bearing cash and repurchase agreement                         | 68,972                              | 70               | 0.40                     | 76,529             | 61       | 0.32                     |
| Other investments  | 15,231                              | 225              | 5.86                     | 23,415             | 264      | 4.47                     |
| Interest Earning Assets  | 2,112,381                           | 20,431           | 3.85                     | 2,020,858          | 20,244   | 3.98                     |
| Cash and due from banks  | 45,477                              |                  |                          | 46,643             |          |                          |
| Other assets, net  | 164,253                             |                  |                          | 179,861            |          |                          |
| Total Assets   | \$2,322,111                         |                  |                          | \$2,247,362        |          |                          |
| <b>Liabilities</b>   |                                     |                  |                          |                    |          |                          |
| Savings and interest-bearing checking                                  | \$990,229                           | 266              | 0.11                     | \$949,039          | 270      | 0.11                     |
| Time deposits  | 371,501                             | 721              | 0.77                     | 402,951            | 966      | 0.95                     |
| Other borrowings   | 47,769                              | 465              | 3.86                     | 67,114             | 649      | 3.84                     |
| Interest Bearing Liabilities   | 1,409,499                           | 1,452            | 0.41                     | 1,419,104          | 1,885    | 0.53                     |
| Non-interest bearing deposits  | 633,305                             |                  |                          | 551,617            |          |                          |
| Other liabilities  | 23,844                              |                  |                          | 30,734             |          |                          |
| Shareholders' equity   | 255,463                             |                  |                          | 245,907            |          |                          |
| Total liabilities and shareholders' equity                             | \$2,322,111                         |                  |                          | \$2,247,362        |          |                          |
| Net Interest Income  |                                     | \$18,979         |                          |                    | \$18,359 |                          |
| Net Interest Income as a Percent of Average Interest<br>Earning Assets |                                     |                  | 3.58 %                   |                    |          | 3.61 %                   |

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(1) All domestic.

(2) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 35%

(3) Annualized

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## Average Balances and Tax Equivalent Rates

|  | Nine Months Ended<br>September 30, |          |                          | 2014               |          |                          |
|--|------------------------------------|----------|--------------------------|--------------------|----------|--------------------------|
|  | 2015                               |          |                          | 2014               |          |                          |
|  | Average<br>Balance                 | Interest | Rate<br>( <sup>3</sup> ) | Average<br>Balance | Interest | Rate<br>( <sup>3</sup> ) |
|  | (Dollars in thousands)             |          |                          |                    |          |                          |
| <b>Assets</b> <sup>(1)</sup>   |                                    |          |                          |                    |          |                          |
| Taxable loans  | \$1,446,857                        | \$52,736 | 4.87%                    | \$1,377,884        | \$54,024 | 5.24%                    |
| Tax-exempt loans <sup>(2)</sup>  | 4,097                              | 189      | 6.17                     | 5,028              | 239      | 6.36                     |
| Taxable securities   | 518,906                            | 5,528    | 1.42                     | 470,995            | 4,623    | 1.31                     |
| Tax-exempt securities <sup>(2)</sup>                                   | 32,790                             | 1,021    | 4.15                     | 41,493             | 1,268    | 4.09                     |
| Interest bearing cash and repurchase agreement                         | 64,913                             | 194      | 0.40                     | 87,511             | 219      | 0.33                     |
| Other investments  | 17,772                             | 728      | 5.48                     | 23,416             | 857      | 4.89                     |
| Interest Earning Assets  | 2,085,335                          | 60,396   | 3.87                     | 2,006,327          | 61,230   | 4.08                     |
| Cash and due from banks  | 44,829                             |          |                          | 45,137             |          |                          |
| Other assets, net  | 167,849                            |          |                          | 184,709            |          |                          |
| Total Assets   | \$2,298,013                        |          |                          | \$2,236,173        |          |                          |
| <b>Liabilities</b>   |                                    |          |                          |                    |          |                          |
| Savings and interest- bearing checking                                 | \$988,594                          | 792      | 0.11                     | \$953,008          | 799      | 0.11                     |
| Time deposits  | 373,235                            | 2,169    | 0.78                     | 421,775            | 2,990    | 0.95                     |
| Other borrowings   | 47,930                             | 1,382    | 3.86                     | 59,362             | 1,720    | 3.87                     |
| Interest Bearing Liabilities   | 1,409,759                          | 4,343    | 0.41                     | 1,434,145          | 5,509    | 0.51                     |
| Non-interest bearing deposits  | 609,192                            |          |                          | 529,654            |          |                          |
| Other liabilities  | 24,581                             |          |                          | 32,226             |          |                          |
| Shareholders' equity   | 254,481                            |          |                          | 240,148            |          |                          |
| Total liabilities and shareholders' equity                             | \$2,298,013                        |          |                          | \$2,236,173        |          |                          |
| Net Interest Income  |                                    | \$56,053 |                          |                    | \$55,721 |                          |
| Net Interest Income as a Percent of Average Interest<br>Earning Assets |                                    |          | 3.59%                    |                    |          | 3.71%                    |

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(1) All domestic.

(2) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 35%

(3) Annualized

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Provision for loan losses. The provision for loan losses was a credit of \$0.2 million and \$0.6 million during the three months ended September 30, 2015 and 2014, respectively. During the nine-month periods ended September 30, 2015 and 2014, the provision was a credit of \$1.0 million and \$2.0 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See “Portfolio Loans and asset quality” for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the third quarter and first nine months of 2015.

Non-interest income. Non-interest income is a significant element in assessing our results of operations. We regard net gains on mortgage loans as a core recurring source of revenue but they are quite cyclical and thus can be volatile. We regard net gains (losses) on securities as a “non-operating” component of non-interest income.

Non-interest income totaled \$10.1 million during the three months ended September 30, 2015, a decrease of \$0.4 million from the comparable period in 2014. For the first nine months of 2015 non-interest income totaled \$30.1 million, a \$0.5 million increase from the comparable period in 2014. The components of non-interest income are as follows:

## Non-Interest Income

|   | Three months<br>ended<br>September 30,<br>2015 |          | Nine months<br>ended<br>September 30,<br>2014 |          |
|---|--|----------|---|----------|
|   | 2015   | 2014     | 2015  | 2014     |
|   | (In thousands)                                 |          |   |          |
| Service charges on deposit accounts                         | \$3,294  | \$3,579  | \$9,261                                       | \$10,166 |
| Interchange income  | 2,169  | 1,984    | 6,551   | 5,992    |
| Net gains (losses) on assets:                               |  |          |   |          |
| Mortgage loans  | 1,812  | 1,490    | 5,735   | 4,139    |
| Securities  | 45   | 168      | 97  | 334      |
| Other than temporary loss on securities available for sale: |  |          |   |          |
| Total impairment loss                                       | -  | (9)      | -   | (9)      |
| Recognized in other comprehensive loss                      | -  | -        | -   | -        |
| Net impairment loss in earnings                             | -  | (9)      | -   | (9)      |
| Mortgage loan servicing                                     | (556)  | 932      | 476   | 1,389    |
| Investment and insurance commissions                        | 447  | 404      | 1,380   | 1,305    |
| Bank owned life insurance                                   | 304  | 361      | 979   | 1,021    |
| Title insurance fees  | 281  | 243      | 874   | 734      |
| Gain on branch sale   | 1,193  | -        | 1,193   | -        |
| Other   | 1,130  | 1,391    | 3,522   | 4,503    |
| Total non-interest income                                   | \$10,119                                       | \$10,543 | \$30,068                                      | \$29,574 |

Service charges on deposit accounts declined on both a comparative quarterly and year-to-date basis in 2015 as compared to 2014. The decrease in such service charges in 2015 principally results from a decline in non-sufficient funds (“NSF”) occurrences and related NSF fees. We believe the decline in NSF occurrences is principally due to our customers managing their finances more closely in order to reduce NSF activity and avoid the associated fees.

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Interchange income increased on both a comparative quarterly and year-to-date basis in 2015 as compared to 2014. The increase in interchange income primarily results from a new Debit Brand Agreement with MasterCard (which replaces our former agreement with VISA) that we executed in January 2014. We began converting our debit card base to MasterCard in June 2014 and completed the conversion in September 2014.

The Dodd-Frank Act includes a provision under which interchange fees for debit cards are set by the FRB under a restrictive “reasonable and proportional cost” per transaction standard. On June 29, 2011, the FRB issued final rules (that were effective October 1, 2011) on interchange fees for debit cards. Overall, these final rules established price caps for debit card interchange fees that were significantly lower than previous averages. However, debit card issuers with less than \$10 billion in assets (like us) are exempt from this rule. On a long-term basis, it is not clear how competitive market factors may impact debit card issuers who are exempt from the rule. However, we have been experiencing some reduction in per transaction interchange revenue due to certain transaction routing changes, particularly at large merchants.

Net gains on mortgage loans increased on both a quarterly and a year to date basis. Mortgage loan activity is summarized as follows:

## Mortgage Loan Activity

|   | Three months ended     |          | Nine months ended |           |
|---|------------------------|----------|-------------------|-----------|
|   | September 30,          |          | September 30,     |           |
|   | 2015                   | 2014     | 2015              | 2014      |
|   | (Dollars in thousands) |          |                   |           |
| Mortgage loans originated   | \$79,648               | \$77,501 | \$260,744         | \$187,172 |
| Mortgage loans sold   | 71,063                 | 62,007   | 221,957           | 156,090   |
| Mortgage loans sold with servicing rights released                  | 872                    | 11,229   | 4,314             | 27,447    |
| Net gains on the sale of mortgage loans                             | 1,812                  | 1,490    | 5,735             | 4,139     |
| Net gains as a percent of mortgage loans sold (“Loan Sales Margin”) | 2.55 %                 | 2.40 %   | 2.58 %            | 2.65 %    |
| Fair value adjustments included in the Loan Sales Margin            | (0.05 )                | (0.13 )  | 0.21              | 0.09      |

The increases in mortgage loan originations, sales and net gains in 2015 as compared to 2014 is due primarily to a decrease in mortgage loan interest rates during parts of 2015 that resulted in an increase in mortgage loan refinance volumes as well as an improving housing market which has resulted in an increase in purchase money mortgage origination volume.

The volume of loans sold is dependent upon our ability to originate mortgage loans as well as the demand for fixed-rate obligations and other loans that we choose to not put into portfolio because of our established interest-rate risk parameters. (See “Portfolio Loans and asset quality.”) Net gains on mortgage loans are also dependent upon economic and competitive factors as well as our ability to effectively manage exposure to changes in interest rates and thus can often be a volatile part of our overall revenues.

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Net gains as a percentage of mortgage loans sold (our “Loan Sales Margin”) are impacted by several factors including competition and the manner in which the loan is sold (with servicing rights retained or released). Our decision to sell or retain mortgage loan servicing rights is primarily influenced by an evaluation of the price being paid for mortgage loan servicing by outside third parties compared to our calculation of the economic value of retaining such servicing. Net gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding the aforementioned fair value accounting adjustments, the Loan Sales Margin would have been 2.60% and 2.53% in the third quarters of 2015 and 2014, respectively and 2.37% and 2.56% for the comparative 2015 and 2014 year-to-date periods, respectively. The decrease in the year-to-date Loan Sales Margin (excluding fair value adjustments) in 2015 was generally due to a narrowing of primary-to-secondary market pricing spreads reflecting increased price competition. The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale.

Net securities gains totaled \$0.045 million and \$0.097 million during the three and nine months ended September 30, 2015, respectively, and \$0.168 million and \$0.334 million for the respective comparable periods in 2014. The third quarter 2015 net securities gain was due to an increase in the fair value of trading securities. The year-to-date 2015 net securities gain was due primarily to the sale of U.S. agency residential mortgage-backed securities. The 2014 net securities gains were due primarily to the sale of a municipal security as well as fair value adjustments on trading securities and a U.S. treasury short sale position.

We recorded no net impairment losses in 2015 for other than temporary impairment of securities available for sale. We recorded net other than temporary impairment charges on securities available for sale of \$0.009 million during both the three and nine months ended September 30, 2014. These 2014 impairment charges all related to private label residential mortgage-backed investment securities. (See “Securities.”)

Mortgage loan servicing generated a loss of \$0.6 million and income of \$0.5 million in the third quarter and first nine months of 2015, respectively, compared to income of \$0.9 million and \$1.4 million in the third quarter and first nine months of 2014, respectively. These variances are primarily due to changes in the valuation allowance on and the amortization of capitalized mortgage loan servicing rights. The period end valuation allowance is based on the valuation of the mortgage loan servicing portfolio. Activity related to capitalized mortgage loan servicing rights is as follows:

## Capitalized Mortgage Loan Servicing Rights

|   | Three months<br>ended<br>September 30,<br>2015 |          | Nine months<br>ended<br>September 30,<br>2014 |          |
|---|--|----------|---|----------|
|   | 2015   | 2014     | 2015  | 2014     |
|   | (In thousands)                                 |          |   |          |
| Balance at beginning of period          | \$12,535                                       | \$12,796 | \$12,106                                      | \$13,710 |
| Originated servicing rights capitalized | 678  | 489      | 2,128   | 1,253    |
| Amortization                            | (700 )   | (628 )   | (2,259 )                                      | (1,827 ) |
| Change in valuation allowance           | (883 )   | 523      | (345 )  | 44       |
| Balance at end of period                | \$11,630                                       | \$13,180 | \$11,630                                      | \$13,180 |
| Valuation allowance at end of period    | \$4,118  | \$2,811  | \$4,118                                       | \$2,811  |

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At September 30, 2015 we were servicing approximately \$1.65 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.34% and a weighted average service fee of approximately 25.3 basis points. Remaining capitalized mortgage loan servicing rights at September 30, 2015 totaled \$11.6 million, representing approximately 71 basis points on the related amount of mortgage loans serviced for others. The capitalized mortgage loan servicing had an estimated fair market value of \$11.9 million at September 30, 2015.

Investment and insurance commissions increased slightly on both a comparative quarterly and year-to-date basis in 2015 compared to 2014. These changes primarily reflect the sales volumes of such products.

Income from bank owned life insurance declined on both a comparative quarterly and year-to-date basis in 2015 compared to 2014 reflecting a lower average crediting rate on our cash surrender value. Our separate account is primarily invested in agency mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our bank owned life insurance was \$54.1 million and \$53.6 million at September 30, 2015 and December 31, 2014, respectively.

Title insurance fees were higher on both a comparative quarterly and year-to-date basis in 2015 as compared to 2014. The amount of title insurance fees is primarily a function of the level of mortgage loans that we originated. During 2015, an increase in title insurance revenues related to mortgage loans was partially offset by a decline in title insurance revenues related to commercial loans and a lower retention bonus as compared to 2014.

Other non-interest income decreased on both a comparative quarterly and year-to-date basis in 2015 compared to 2014. This decrease is primarily due to declines in rental income on other real estate ("ORE") and income from merchant card processing. The decline in rental income on ORE is due to the sales of income-producing properties. The decline in income from merchant card processing is due primarily to a change in our third-party processing provider and the timeframe required to transition customers from the prior provider.

Non-interest expense. Non-interest expense is an important component of our results of operations. We strive to efficiently manage our cost structure and management is focused on a number of initiatives to reduce and contain non-interest expenses.

Non-interest expense decreased by \$0.2 million to \$21.9 million and by \$1.4 million to \$65.6 million during the three- and nine-month periods ended September 30, 2015, respectively, compared to the same periods in 2014. The components of non-interest expense are as follows:

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## Non-Interest Expense

|   | Three months<br>ended<br>September 30, |          | Nine months<br>ended<br>September 30, |          |
|---|--|----------|---------------------------------------|----------|
|   | 2015                                   | 2014     | 2015                                  | 2014     |
|   | (in thousands)                         |          |                                       |          |
| Compensation  | \$8,419                                | \$8,574  | \$24,880                              | \$25,321 |
| Performance-based compensation                      | 1,572                                  | 1,203    | 4,604                                 | 3,348    |
| Payroll taxes and employee benefits                 | 2,038                                  | 1,941    | 6,121                                 | 6,105    |
| Compensation and employee benefits                  | 12,029                                 | 11,718   | 35,605                                | 34,774   |
| Occupancy, net                                      | 1,940                                  | 2,079    | 6,399                                 | 6,715    |
| Data processing                                     | 2,001                                  | 1,790    | 5,958                                 | 5,653    |
| Loan and collection                                 | 816                                    | 1,391    | 2,938                                 | 4,283    |
| Furniture, fixtures and equipment                   | 998                                    | 1,005    | 2,915                                 | 3,127    |
| Communications                                      | 754                                    | 712      | 2,184                                 | 2,212    |
| Legal and professional fees                         | 519                                    | 559      | 1,352                                 | 1,380    |
| Advertising   | 406                                    | 427      | 1,338                                 | 1,547    |
| FDIC deposit insurance                              | 350                                    | 396      | 1,044                                 | 1,235    |
| Interchange expense                                 | 279                                    | 368      | 859                                   | 1,112    |
| Supplies  | 190                                    | 249      | 619                                   | 746      |
| Credit card and bank service fees                   | 197                                    | 226      | 602                                   | 734      |
| Amortization of intangible assets                   | 86                                     | 134      | 260                                   | 402      |
| Vehicle service contract counterparty contingencies | 30                                     | 28       | 89                                    | 169      |
| Costs related to unfunded lending commitments       | 26                                     | 12       | 46                                    | 27       |
| Provision for loss reimbursement on sold loans      | (35 )                                  | -        | (59 )                                 | (466 )   |
| Net (gains) losses on ORE and repossessed assets    | 5                                      | (285 )   | (173 )                                | (410 )   |
| Other   | 1,288                                  | 1,275    | 3,633                                 | 3,804    |
| Total non-interest expense                          | \$21,879                               | \$22,084 | \$65,609                              | \$67,044 |

Compensation and employee benefits expenses, in total, increased \$0.3 million, or 2.7%, on a quarterly comparative basis and increased \$0.8 million, or 2.4%, for the first nine months of 2015 compared to the same periods in 2014.

Compensation expense decreased by \$0.2 million, or 1.8%, and by \$0.4 million, or 1.7%, in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014. Average full-time equivalent employees (“FTEs”) were reduced by approximately 5.5% and 4.4% during the third quarter and first nine months of 2015, respectively, compared to the year ago periods. However, the impact of the FTE reductions was partially offset by merit raises granted in 2015.

Performance-based compensation increased by \$0.4 million and by \$1.3 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014, due primarily to a higher accrual for anticipated incentive compensation based on our estimated 2015 performance as compared to goals.

Payroll taxes and employee benefits increased by \$0.097 million and \$0.016 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014, due primarily to an increase in recruiting costs principally for our mortgage banking operations.

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Occupancy, net, decreased by \$0.1 million and \$0.3 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014. These declines are primarily due to decreases in utility costs, real estate property taxes and property insurance which reflect fewer properties owned due to sales or other dispositions.

Data processing expenses increased by \$0.2 million and by \$0.3 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014, due primarily to costs associated with a new sales and marketing system and a new mortgage loan origination system and the outsourcing of certain network and desktop delivery functions as well as an increase in mobile banking expenses.

Loan and collection expenses primarily reflect costs related to the management and collection of non-performing loans and other problem credits. These expenses have further declined in 2015, which primarily reflects the overall year-over-year decrease in non-performing assets. (See "Portfolio Loans and asset quality.")

Furniture, fixtures and equipment, communications, and supplies expenses, collectively, were lower on both a comparative quarterly and year-to-date basis, which primarily reflects our cost reduction efforts.

Legal and professional fees were slightly lower on both a comparative quarterly and year-to-date basis. The decreases are due primarily to a decline in legal fees and consulting fees at the Bank.

Advertising expenses were lower on both a comparative quarterly and year-to-date basis due primarily to a reduction in outdoor (billboard) advertising and 2014 including expenses related to a website redesign.

FDIC deposit insurance expense decreased by \$0.046 million and by \$0.191 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014. The decline in 2015 principally reflects a reduction in the Bank's risk based premium rate due to our continued improving financial metrics.

Interchange expense primarily represents our third-party cost to process debit card transactions. This cost has declined on both a comparative quarterly and year-to-date basis due primarily to the impact of a new seven-year core data processing contract that we executed in March 2014.

Credit card and bank service fees decreased on both a comparative quarterly and year-to-date basis primarily due to a decline in the number of payment plans being serviced by Mepco in 2015 compared to 2014.

The amortization of intangible assets primarily relates to branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$2.4 million and \$2.6 million at September 30, 2015 and December 31, 2014, respectively. See Note #8 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets.



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We record estimated incurred losses associated with Mepco's vehicle service contract payment plan receivables in our provision for loan losses and establish a related allowance for loan losses. (See "Portfolio Loans and asset quality.") We record estimated incurred losses associated with defaults by Mepco's counterparties as "vehicle service contract counterparty contingencies expense," which is included in non-interest expenses in our Condensed Consolidated Statements of Operations. Such expenses totaled \$0.03 million and \$0.09 million for vehicle service contract payment plan counterparty contingencies in the third quarter and first nine months of 2015, respectively, compared to \$0.03 million and \$0.17 million, respectively, for the same periods in 2014.

Our estimate of probable incurred losses from vehicle service contract counterparty contingencies requires a significant amount of judgment because a number of factors can influence the amount of loss that we may ultimately incur. These factors include our estimate of future cancellations of vehicle service contracts, our evaluation of collateral that may be available to recover funds due from our counterparties, and our assessment of the amount that may ultimately be collected from counterparties in connection with their contractual obligations. We apply a rigorous process, based upon historical payment plan activity and past experience, to estimate probable incurred losses and quantify the necessary reserves for our vehicle service contract counterparty contingencies, but there can be no assurance that our modeling process will successfully identify all such losses.

In particular, as noted in our Risk Factors included in Part I - Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014, Mepco has had to initiate litigation against certain counterparties, including third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. In addition, see Note #14 to the Condensed Consolidated Financial Statements included within this report for more information about Mepco's business, certain risks and difficulties we currently face with respect to that business, and reserves we have established (through vehicle service contract counterparty contingencies expense) for losses related to the business.

The changes in cost related to unfunded lending commitments are primarily impacted by changes in the amounts of such commitments to originate portfolio loans as well as (for commercial loan commitments) the grade (pursuant to our loan rating system) of such commitments.

The provision for loss reimbursement on sold loans was a credit of \$0.035 million and a credit of \$0.059 million in the third quarter and first nine months of 2015, respectively, compared to an expense of zero and a credit of \$0.47 million in the third quarter and first nine months of 2014, respectively. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac and Ginnie Mae). The third quarter and year-to-date credit provisions in 2015 are due primarily to the settlement of certain loss reimbursement claims at slightly lower amounts than what had been specifically reserved for previously. The credit provision in the first nine months of 2014 is due primarily to the rescission of certain loss reimbursement requests by Freddie Mac that had been pending and accrued for at the end of 2013. Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The reserve for loss reimbursements on sold mortgage loans totaled \$0.54 million and \$0.69 million at September 30, 2015 and December 31, 2014, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at September 30, 2015, and December 31, 2014, also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.



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Net (gains) losses on ORE and repossessed assets primarily represent the gain or loss on the sale or additional write downs on these assets subsequent to the transfer of the asset from our loan portfolio. This transfer occurs at the time we acquire the collateral that secured the loan. At the time of acquisition, the other real estate or repossessed asset is valued at fair value, less estimated costs to sell, which becomes the new basis for the asset. Any write-downs at the time of acquisition are charged to the allowance for loan losses. We recorded a net loss of \$0.005 million and a net gain of \$0.173 million in the third quarter and first nine months of 2015, respectively (as compared to net gains of \$0.285 million and \$0.410 million, respectively, recorded in the same periods in 2014). The gains primarily reflect greater stability in real estate prices during the last two years, with some markets even experiencing price increases.

Other non-interest expenses were relatively unchanged and decreased by \$0.2 million in the third quarter and first nine months of 2015, respectively, compared to the same periods in 2014. The year-to-date comparative decline is due primarily to decreases in insurance costs and fraud related expenses.

Income tax expense. We recorded an income tax expense of \$2.3 million and \$6.7 million in the third quarter and the first nine months of 2015, respectively. This compares to an income tax expense of \$2.3 million and \$5.7 million in the third quarter and the first nine months of 2014, respectively.

Our actual federal income tax expense is different than the amount computed by applying our statutory federal income tax rate to our pre-tax income primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance. In addition, the second quarter and year-to-date 2014 income tax expense was reduced by a credit of approximately \$0.7 million due to a true-up of the amount of unrecognized tax benefits relative to certain net operating loss carryforwards and the reversal of a valuation allowance on a capital loss carryforward that was believed to not be more likely than not to be realized prior to a strategy executed during the second quarter of 2014 that generated capital gains.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at both September 30, 2015 and 2014, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

We did maintain a valuation allowance against our deferred tax assets of approximately \$1.0 million at both September 30, 2015 and December 31, 2014. This valuation allowance on our deferred tax assets primarily relates to state income taxes at our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business.

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Because of our net operating loss and tax credit carryforwards, we are still subject to the rules of Section 382 of the Internal Revenue Code of 1986, as amended. An ownership change, as defined by these rules, would negatively affect our ability to utilize our net operating loss carryforwards and other deferred tax assets in the future. If such an ownership change were to occur, we may suffer higher-than-anticipated tax expense, and consequently lower net income and cash flow, in those future years. Although we cannot control market purchases or sales of our common stock, we have in place a Tax Benefits Preservation Plan to dissuade any movement in our stock that would trigger an ownership change to avoid triggering any Section 382 limitations.

**Business Segments.** Our reportable segments are based upon legal entities. We currently have two reportable segments: Independent Bank and Mepco. These business segments are also differentiated based on the products and services provided. We evaluate performance based principally on net income (loss) of the respective reportable segments.

The following table presents net income (loss) by business segment.

**Business Segments**

|                      | Three months<br>ended<br>September 30,<br>2015 |         | Nine months<br>ended<br>September 30,<br>2015 |          |
|----------------------|--|---------|---|----------|
|                      | 2014   |         | 2014  |          |
|                      | (in thousands)                                 |         |   |          |
| Independent Bank     | \$5,455  | \$5,048 | \$15,623                                      | \$14,345 |
| Mepco                | (168 )   | 163     | (437 )  | 607      |
| Other <sup>(1)</sup> | (224 )   | (266 )  | (693 )  | (665 )   |
| Elimination          | (16 )  | (16 )   | (46 )   | (168 )   |
| Net income (loss)    | \$5,047  | \$4,929 | \$14,447                                      | \$14,119 |

<sup>(1)</sup>Includes amounts relating to our parent company and certain insignificant operations.

The increase in net income on a comparative quarterly basis at Independent Bank is due primarily to an increase in net interest income and a decrease in non-interest expense that were partially offset by an increase in the provision for loan losses (a lower credit) and a decrease in non-interest income. The increase in year-to-date net income at Independent Bank in 2015 compared to 2014 is primarily due to increases in net interest income and non-interest income and a decrease in non-interest expense that were partially offset by increases in the provision for loan losses (a smaller credit) and in income tax expense. (See “Net interest income,” “Provision for loan losses,” “Non-interest income,” “Non-interest expense,” “Income tax expense,” and “Portfolio Loans and asset quality.”)

The change in Mepco’s results (net losses in 2015 compared to net income in 2014) is due to a decrease in net interest income as a result of a decline in year-over-year average payment plan receivables and a decrease in non-interest income due to a decline in rental income on ORE that were partially offset by a decrease in non-interest expense. All of Mepco’s funding is provided by Independent Bank through an intercompany loan (that is eliminated in consolidation). The rate on this intercompany loan is based on the Prime Rate (currently 3.25%). Mepco might not be able to obtain such favorable funding costs on its own in the open market.

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## Financial Condition

Summary. Our total assets increased by \$146.1 million, or 6.5%, during the first nine months of 2015 due primarily to increases in cash and cash equivalents, securities available for sale and loans. Loans, excluding loans held for sale ("Portfolio Loans"), totaled \$1.47 billion at September 30, 2015, an increase of \$58.0 million, or 4.1%, from December 31, 2014. (See "Portfolio Loans and asset quality.")

Deposits totaled \$2.06 billion at September 30, 2015, compared to \$1.92 billion at December 31, 2014. The \$136.7 million increase in total deposits during the period is primarily due to growth in checking, savings and time account balances.

Securities. We maintain diversified securities portfolios, which include obligations of U.S. government-sponsored agencies, securities issued by states and political subdivisions, residential and commercial mortgage-backed securities, asset-backed securities, corporate securities and trust preferred securities. We regularly evaluate asset/liability management needs and attempt to maintain a portfolio structure that provides sufficient liquidity and cash flow. Except as discussed below, we believe that the unrealized losses on securities available for sale are temporary in nature and are expected to be recovered within a reasonable time period. We believe that we have the ability to hold securities with unrealized losses to maturity or until such time as the unrealized losses reverse. (See "Asset/liability management.")

## Securities

|                               | Unrealized                          |         |         | Fair<br>Value |
|-------------------------------|-------------------------------------|---------|---------|---------------|
|                               | Amortized<br>Cost<br>(In thousands) | Gains   | Losses  |               |
| Securities available for sale |                                     |         |         |               |
| September 30, 2015            | \$602,659                           | \$4,205 | \$2,202 | \$604,662     |
| December 31, 2014             | 532,930                             | 3,317   | 3,069   | 533,178       |

Securities available for sale increased during 2015 due primarily to the purchase of U.S. agency, corporate, and asset-backed securities. The securities were purchased to utilize funds generated from the increase in total deposits. (See "Deposits" and "Liquidity and capital resources.")

Our portfolio of available-for-sale securities is reviewed quarterly for impairment in value. In performing this review, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet these recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income or loss. We recorded no net other than temporary impairment charges on securities in earnings in 2015. We recorded \$0.009 million of net other than temporary impairment charges on securities in earnings in 2014.

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Sales of securities were as follows (See “Non-interest income.”):

|                        | Nine months<br>ended<br>September 30,<br>2015      2014<br>(In thousands) |          |
|------------------------|---|----------|
| Proceeds               | \$ 11,786   | \$ 7,630 |
| Gross gains            | \$ 75   | \$ 123   |
| Gross losses           | -   | -        |
| Net impairment charges | -   | (9 )     |
| Fair value adjustments | 22  | 211      |
| Net gains              | \$ 97   | \$ 325   |

Portfolio Loans and asset quality. In addition to the communities served by our Bank branch network, our principal lending markets also include nearby communities and metropolitan areas. Subject to established underwriting criteria, we also may participate in commercial lending transactions with certain non-affiliated banks.

The senior management and board of directors of our Bank retain authority and responsibility for credit decisions and we have adopted uniform underwriting standards. Our loan committee structure and the loan review process attempt to provide requisite controls and promote compliance with such established underwriting standards. However, there can be no assurance that our lending procedures and the use of uniform underwriting standards will prevent us from incurring significant credit losses in our lending activities.

We generally retain loans that may be profitably funded within established risk parameters. (See “Asset/liability management.”) As a result, we may hold adjustable-rate mortgage loans as Portfolio Loans, while 15- and 30-year, fixed-rate obligations are generally sold to mitigate exposure to changes in interest rates. (See “Non-interest income.”)

IndexNon-performing assets <sup>(1)</sup>

|  | September<br>30,<br>2015  | December<br>31,<br>2014 |
|--|---------------------------|-------------------------|
|  | (Dollars in<br>thousands) |                         |
| Non-accrual loans  | \$15,834                  | \$ 15,231               |
| Loans 90 days or more past due and still accruing interest | -                         | 7                       |
| Total non-performing loans                                 | 15,834                    | 15,238                  |
| Other real estate and repossessed assets                   | 3,851                     | 6,454                   |
| Total non-performing assets                                | \$19,685                  | \$ 21,692               |

## As a percent of Portfolio Loans

|  |        |   |        |   |
|--|--------|---|--------|---|
| Non-performing loans   | 1.08   | % | 1.08   | % |
| Allowance for loan losses                                      | 1.68   |   | 1.84   |   |
| Non-performing assets to total assets                          | 0.82   |   | 0.96   |   |
| Allowance for loan losses as a percent of non-performing loans | 155.39 |   | 170.56 |   |

<sup>(1)</sup> Excludes loans classified as "trouble debt restructured" that are not past due and vehicle service contract counterparty receivables, net.

## Troubled debt restructurings ("TDR")

|                                    | September 30, 2015 |                      |          |
|------------------------------------|--------------------|----------------------|----------|
|                                    | Commercial         | Retail               | Total    |
|                                    | (In thousands)     |                      |          |
| Performing TDRs                    | \$22,257           | \$69,726             | \$91,983 |
| Non-performing TDRs <sup>(1)</sup> | 1,501              | 3,887 <sup>(2)</sup> | 5,388    |
| Total                              | \$23,758           | \$73,613             | \$97,371 |

|                                    | December 31, 2014 |                      |           |
|------------------------------------|-------------------|----------------------|-----------|
|                                    | Commercial        | Retail               | Total     |
|                                    | (In thousands)    |                      |           |
| Performing TDRs                    | \$29,475          | \$73,496             | \$102,971 |
| Non-performing TDRs <sup>(1)</sup> | 1,978             | 5,225 <sup>(2)</sup> | 7,203     |
| Total                              | \$31,453          | \$78,721             | \$110,174 |

(1) Included in non-performing assets table above.

(2) Also includes loans on non-accrual at the time of modification until six payments are received on a timely basis.

Non-performing loans increased by \$0.6 million, or 3.9%, during the first nine months of 2015 due principally to a \$3.4 million increase in non-performing commercial loans that was largely offset by decreases in non-performing mortgage and consumer/installment loans. The increase in non-performing commercial loans was primarily due to the movement of a \$4.2 million commercial relationship into non-accrual during the third quarter of 2015. This relationship is primarily secured by income producing properties and had been previously classified as an accruing "watch" credit. The declines in non-performing mortgage and consumer/installment loans primarily reflect reduced levels of new loan defaults as well as loan charge-offs, pay-offs, negotiated transactions, and the migration of loans into ORE. In general, improving economic conditions in our market areas, as well as our collection and resolution efforts, have resulted in a longer-term downward trend in non-performing loans. However, we are still experiencing

some loan defaults, particularly related to commercial loans secured by income-producing property and mortgage loans secured by resort/vacation property.

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Non-performing loans exclude performing loans that are classified as troubled debt restructurings (“TDRs”). Performing TDRs totaled \$92.0 million, or 6.3% of total Portfolio Loans, and \$103.0 million, or 7.3% of total Portfolio Loans, at September 30, 2015 and December 31, 2014, respectively. The decrease in the amount of performing TDRs in the first nine months of 2015 reflects declines in both commercial loan and retail loan TDRs.

ORE and repossessed assets totaled \$3.9 million at September 30, 2015, compared to \$6.5 million at December 31, 2014. This decrease is primarily the result of sales of ORE being in excess of the migration of non-performing loans secured by real estate into ORE as the foreclosure process is completed.

We will place a loan that is 90 days or more past due on non-accrual, unless we believe the loan is both well secured and in the process of collection. Accordingly, we have determined that the collection of the accrued and unpaid interest on any loans that are 90 days or more past due and still accruing interest is probable.

The ratio of loan net charge-offs to average Portfolio Loans was 0.03% on an annualized basis in the first nine months of 2015 compared to 0.27% in the first nine months of 2014. The \$2.4 million decline in loan net charge-offs is primarily due to a \$1.7 million decrease in commercial loan net charge-offs as well as decreases in mortgage loan (\$0.6 million) and consumer/installment loan (\$0.1 million) net charge-offs. The overall decrease in loan net charge-offs primarily reflects a year-over-year reduction in loan defaults and improvement in collateral liquidation values.

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## Allowance for loan losses

|  | Nine months ended      |                         |          |                         |
|--|------------------------|-------------------------|----------|-------------------------|
|  | September 30,<br>2015  |                         | 2014     |                         |
|  | Loans                  | Unfunded<br>Commitments | Loans    | Unfunded<br>Commitments |
|  | (Dollars in thousands) |                         |          |                         |
| Balance at beginning of period   | \$25,990               | \$ 539                  | \$32,325 | \$ 508                  |
| Additions (deductions)   |                        |                         |          |                         |
| Provision for loan losses  | (1,037 )               | -                       | (2,049 ) | -                       |
| Recoveries credited to allowance   | 3,418                  | -                       | 5,438    | -                       |
| Loans charged against the allowance  | (3,767 )               | -                       | (8,206 ) | -                       |
| Additions (deductions) included in non-interest expense                            | -                      | 46                      | -        | 27                      |
| Balance at end of period   | \$24,604               | \$ 585                  | \$27,508 | \$ 535                  |
| Net loans charged against the allowance to average Portfolio<br>Loans (annualized) | 0.03                   | %                       | 0.27     | %                       |

## Allocation of the Allowance for Loan Losses

|  | September<br>30,<br>2015 | December<br>31,<br>2014 |
|--|--------------------------|-------------------------|
|  | (In thousands)           |                         |
| Specific allocations                               | \$12,776                 | \$13,233                |
| Other adversely rated commercial loans             | 1,259                    | 761                     |
| Historical loss allocations                        | 5,798                    | 6,773                   |
| Additional allocations based on subjective factors | 4,771                    | 5,223                   |
| Total  | \$24,604                 | \$25,990                |

Some loans will not be repaid in full. Therefore, an allowance for loan losses (“AFLL”) is maintained at a level which represents our best estimate of losses incurred. In determining the AFLL and the related provision for loan losses, we consider four principal elements: (i) specific allocations based upon probable losses identified during the review of the loan portfolio, (ii) allocations established for other adversely rated commercial loans, (iii) allocations based principally on historical loan loss experience, and (iv) additional allowances based on subjective factors, including local and general economic business factors and trends, portfolio concentrations and changes in the size and/or the general terms of the loan portfolios.

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The first AFLL element (specific allocations) reflects our estimate of probable incurred losses based upon our systematic review of specific loans. These estimates are based upon a number of factors, such as payment history, financial condition of the borrower, discounted collateral exposure and discounted cash flow analysis. Impaired commercial, mortgage and installment loans are allocated allowance amounts using this first element. The second AFLL element (other adversely rated commercial loans) reflects the application of our commercial loan rating system. This rating system is similar to those employed by state and federal banking regulators. Commercial loans that are rated below a certain predetermined classification are assigned a loss allocation factor for each loan classification category that is based upon a historical analysis of both the probability of default and the expected loss rate (“loss given default”). The lower the rating assigned to a loan or category, the greater the allocation percentage that is applied. The third AFLL element (historical loss allocations) is determined by assigning allocations to higher rated (“non-watch credit”) commercial loans using a probability of default and loss given default similar to the second AFLL element and to homogenous mortgage and installment loan groups based upon borrower credit score and portfolio segment. For homogenous mortgage and installment loans a probability of default for each homogenous pool is calculated by way of credit score migration. Historical loss data for each homogenous pool coupled with the associated probability of default is utilized to calculate an expected loss allocation rate. The fourth AFLL element (additional allocations based on subjective factors) is based on factors that cannot be associated with a specific credit or loan category and reflects our attempt to ensure that the overall allowance for loan losses appropriately reflects a margin for the imprecision necessarily inherent in the estimates of expected credit losses. We consider a number of subjective factors when determining this fourth element, including local and general economic business factors and trends, portfolio concentrations and changes in the size, mix and the general terms of the overall loan portfolio.

Increases in the AFLL are recorded by a provision for loan losses charged to expense. Although we periodically allocate portions of the AFLL to specific loans and loan portfolios, the entire AFLL is available for incurred losses. We generally charge-off commercial, homogenous residential mortgage, and installment loans and payment plan receivables when they are deemed uncollectible or reach a predetermined number of days past due based on product, industry practice and other factors. Collection efforts may continue and recoveries may occur after a loan is charged against the allowance.

While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors.

Mepco’s allowance for losses is determined in a similar manner as discussed above, and primarily takes into account historical loss experience and other subjective factors deemed relevant to Mepco’s payment plan business. Estimated incurred losses associated with Mepco’s outstanding vehicle service contract payment plans are included in the provision for loan losses. Mepco recorded credits of \$0.005 million and \$0.031 million in the first nine months of 2015 and 2014, respectively, for its provision for loan losses. Mepco’s allowance for loan losses totaled \$0.07 million at both September 30, 2015 and December 31, 2014. Mepco has established procedures for vehicle service contract payment plan servicing, administration and collections, including the timely cancellation of the vehicle service contract, in order to protect our position in the event of payment default or voluntary cancellation by the customer. Mepco has also established procedures to attempt to prevent and detect fraud since the payment plan origination activities and initial customer contacts are done entirely through unrelated third parties (vehicle service contract administrators and sellers or automobile dealerships). However, there can be no assurance that the aforementioned risk management policies and procedures will prevent us from the possibility of incurring significant credit or fraud related losses in this business segment. The estimated incurred losses described in this paragraph should be distinguished from the possible losses we may incur from counterparties failing to pay their obligations to Mepco. See Note #14 to the Condensed Consolidated Financial Statements included within this report.

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The allowance for loan losses decreased \$1.4 million to \$24.6 million at September 30, 2015, from \$26.0 million at December 31, 2014, and was equal to 1.68% of total Portfolio Loans at September 30, 2015, compared to 1.84% at December 31, 2014. Three of the four components of the allowance for loan losses outlined above declined in the first nine months of 2015. The allowance for loan losses related to specific loans decreased \$0.5 million in 2015 due primarily to a decline in the balance of individually impaired loans as well as charge-offs. The allowance for loan losses related to other adversely rated commercial loans increased \$0.5 million in 2015 primarily due to an increase in the balance of such loans included in this component to \$34.1 million at September 30, 2015 from \$30.6 million at December 31, 2014. The allowance for loan losses related to historical losses decreased \$1.0 million during 2015 due principally to the use of a lower estimated probability of default for homogenous mortgage and installment loans (resulting from lower loan net charge-offs and reduced levels of new defaults on loans). The allowance for loan losses related to subjective factors decreased \$0.5 million during 2015 primarily due to the improvement of various economic indicators used in computing this portion of the allowance.

Deposits and borrowings. Historically, the loyalty of our customer base has allowed us to price deposits competitively, contributing to a net interest margin that compares favorably to our peers. However, we still face a significant amount of competition for deposits within many of the markets served by our branch network, which limits our ability to materially increase deposits without adversely impacting the weighted-average cost of core deposits.

To attract new core deposits, we have implemented various account acquisition strategies as well as branch staff sales training. Account acquisition initiatives have historically generated increases in customer relationships. Over the past several years, we have also expanded our treasury management products and services for commercial businesses and municipalities or other governmental units and have also increased our sales calling efforts in order to attract additional deposit relationships from these sectors. We view long-term core deposit growth as an important objective. Core deposits generally provide a more stable and lower cost source of funds than alternative sources such as short-term borrowings. (See “Liquidity and capital resources.”)

Deposits totaled \$2.06 billion and \$1.92 billion at September 30, 2015, and December 31, 2014, respectively. The \$136.7 million increase in deposits in the first nine months of 2015 is due to growth in checking, savings and time deposit account balances. Reciprocal deposits totaled \$47.9 million and \$53.7 million at September 30, 2015, and December 31, 2014, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network’s Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At September 30, 2015, we had approximately \$522.8 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

We have also implemented strategies that incorporate using federal funds purchased, other borrowings and Brokered CDs to fund a portion of our interest-earning assets. The use of such alternate sources of funds supplements our core deposits and is also an integral part of our asset/liability management efforts.

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Other borrowings, comprised almost entirely of advances from the Federal Home Loan Bank (the "FHLB"), totaled \$12.1 million and \$12.5 million at September 30, 2015, and December 31, 2014, respectively.

As described above, we utilize wholesale funding, including FHLB borrowings and Brokered CDs to augment our core deposits and fund a portion of our assets. At September 30, 2015, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$60.0 million, or 2.9% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all. Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. We discontinued the active use of derivative financial instruments during 2008. We began to again utilize interest-rate swaps in 2014, relating to our commercial lending activities. During the first nine months of 2015 and 2014, we entered into \$16.6 million and \$2.4 million (aggregate notional amounts), respectively, of interest rate swaps with commercial loan customers, which were offset with interest rate swaps that the Bank entered into with a broker-dealer. We recorded \$0.30 million and \$0.05 million of fee income related to these transactions during the first nine months of 2015 and 2014, respectively.

Liquidity and capital resources. Liquidity risk is the risk of being unable to timely meet obligations as they come due at a reasonable funding cost or without incurring unacceptable losses. Our liquidity management involves the measurement and monitoring of a variety of sources and uses of funds. Our Condensed Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus our liquidity management on maintaining adequate levels of liquid assets (primarily funds on deposit with the FRB and certain investment securities) as well as developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for purchasing investment securities or originating Portfolio Loans as well as to be able to respond to unforeseen liquidity needs.

Our primary sources of funds include our deposit base, secured advances from the FHLB, a federal funds purchased borrowing facility with another commercial bank, and access to the capital markets (for Brokered CDs).

At September 30, 2015, we had \$296.9 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$1.64 billion of our deposits at September 30, 2015, were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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We have developed contingency funding plans that stress test our liquidity needs that may arise from certain events such as an adverse change in our financial metrics (for example, credit quality or regulatory capital ratios). Our liquidity management also includes periodic monitoring that measures quick assets (defined generally as short-term assets with maturities less than 30 days and loans held for sale) to total assets, short-term liability dependence and basic surplus (defined as quick assets compared to short-term liabilities). Policy limits have been established for our various liquidity measurements and are monitored on a monthly basis. In addition, we also prepare cash flow forecasts that include a variety of different scenarios.

We believe that we currently have adequate liquidity at our Bank because of our cash and cash equivalents, our portfolio of securities available for sale, our access to secured advances from the FHLB, our ability to issue Brokered CDs and our improved financial metrics.

We also believe that the available cash on hand at the parent company (including time deposits) of approximately \$22.0 million as of September 30, 2015, provides sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures and to pay a cash dividend on our common stock for the foreseeable future.

Effective management of capital resources is critical to our mission to create value for our shareholders. In addition to common stock, our capital structure also currently includes cumulative trust preferred securities.

## Capitalization

|   | September<br>30,<br>2015 | December<br>31,<br>2014 |
|---|--------------------------|-------------------------|
|   | (In thousands)           |                         |
| Subordinated debentures                     | \$35,569                 | \$35,569                |
| Amount not qualifying as regulatory capital | (1,069 )                 | (1,069 )                |
| Amount qualifying as regulatory capital     | 34,500                   | 34,500                  |
| Shareholders' equity                        |                          |                         |
| Common stock                                | 343,601                  | 352,462                 |
| Accumulated deficit                         | (86,125 )                | (96,455 )               |
| Accumulated other comprehensive loss        | (4,496 )                 | (5,636 )                |
| Total shareholders' equity                  | 252,980                  | 250,371                 |
| Total capitalization                        | \$287,480                | \$284,871               |

We currently have three special purpose entities that originally issued \$39.5 million of cumulative trust preferred securities. These special purpose entities issued common securities and provided cash to our parent company that in turn issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Condensed Consolidated Statements of Financial Condition.

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On December 1, 2014, we purchased 5,000 shares of trust preferred securities (liquidation amount of \$1,000 per security, representing a total of \$5.0 million) that were issued by IBC Capital Finance IV. The trust preferred securities have been retired along with certain related common stock issued by IBC Capital Finance IV and subordinated debentures issued by us.

The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at September 30, 2015, and December 31, 2014. Although the Dodd-Frank Act further limited Tier 1 treatment for trust preferred securities, those new limits did not apply to our outstanding trust preferred securities. Further, the New Capital Rules grandfathered the treatment of our trust preferred securities as qualifying regulatory capital.

Common shareholders' equity increased to \$253.0 million at September 30, 2015 from \$250.4 million at December 31, 2014, due primarily to our net income in the first nine months of 2015 as well as a decline in our accumulated other comprehensive loss that were partially offset by dividends and share repurchases. Our tangible common equity ("TCE") totaled \$250.6 million and \$247.7 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 10.48% and 11.03% at September 30, 2015 and December 31, 2014, respectively.

Because the Bank currently has negative "undivided profits" (i.e. a retained deficit) of \$15.9 million at September 30, 2015, under Michigan banking regulations, the Bank is not currently permitted to pay a dividend. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2015, we requested regulatory approval for an \$18.5 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on February 13, 2015, and the Bank returned \$18.5 million of capital to the parent company on February 17, 2015. Also see note #11 to the Condensed Consolidated Financial Statements included within this report.

On January 21, 2015, our Board of Directors authorized a share repurchase plan. Under the terms of the share repurchase plan, we are authorized to buy back up to 5% of our outstanding common stock. The repurchase plan is authorized to last through December 31, 2015. We intend and expect to accomplish the repurchases through open market transactions, though we could affect repurchases through other means, such as privately negotiated transactions. The timing and amount of any share repurchases will depend on a variety of factors, including, among others, securities law restrictions, the trading price of our common stock, other regulatory requirements, potential alternative uses for capital, and our financial performance. The repurchase program does not obligate us to acquire any particular amount of common stock, and it may be modified or suspended at any time at our discretion. During the first nine months of 2015 we repurchased 659,162 shares of our common stock pursuant to this plan at an average price of \$13.69 per share.

We resumed a quarterly cash dividend on our common stock of six cents per share in May 2014 and have continued to pay regular quarterly dividends at that amount through August 2015. In October 2015, our Board of Directors increased the quarterly cash dividend on our common stock to eight cents per share.

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As of September 30, 2015 and December 31, 2014, our Bank (and holding company) continued to meet the requirements to be considered “well-capitalized” under federal regulatory standards (also see note #11 to the Condensed Consolidated Financial Statements included within this report).

Asset/liability management. Interest-rate risk is created by differences in the cash flow characteristics of our assets and liabilities. Options embedded in certain financial instruments, including caps on adjustable-rate loans as well as borrowers’ rights to prepay fixed-rate loans, also create interest-rate risk.

Our asset/liability management efforts identify and evaluate opportunities to structure our statement of financial condition in a manner that is consistent with our mission to maintain profitable financial leverage within established risk parameters. We evaluate various opportunities and alternate asset/liability management strategies carefully and consider the likely impact on our risk profile as well as the anticipated contribution to earnings. The marginal cost of funds is a principal consideration in the implementation of our asset/liability management strategies, but such evaluations further consider interest-rate and liquidity risk as well as other pertinent factors. We have established parameters for interest-rate risk. We regularly monitor our interest-rate risk and report at least quarterly to our board of directors.

We employ simulation analyses to monitor our interest-rate risk profile and evaluate potential changes in our net interest income and market value of portfolio equity that result from changes in interest rates. The purpose of these simulations is to identify sources of interest-rate risk. The simulations do not anticipate any actions that we might initiate in response to changes in interest rates and, accordingly, the simulations do not provide a reliable forecast of anticipated results. The simulations are predicated on immediate, permanent and parallel shifts in interest rates and generally assume that current loan and deposit pricing relationships remain constant. The simulations further incorporate assumptions relating to changes in customer behavior, including changes in prepayment rates on certain assets and liabilities.



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## Changes in Market Value of Portfolio Equity and Net Interest Income

| Change in Interest Rates | Market Value Of Portfolio Equity(1) |                | Net Interest Income(2) |                |  |  |
|--------------------------|-------------------------------------|----------------|------------------------|----------------|--|--|
|                          | Percent Change                      | Percent Change | Percent Change         | Percent Change |  |  |
| (Dollars in thousands)   |                                     |                |                        |                |  |  |
| September 30, 2015       |                                     |                |                        |                |  |  |
| 200 basis point rise     | \$420,900                           | 8.93 %         | \$ 78,400              | 6.52 %         |  |  |
| 100 basis point rise     | 407,500                             | 5.46           | 76,300                 | 3.67           |  |  |
| Base-rate scenario       | 386,400                             | -              | 73,600                 | -              |  |  |
| 100 basis point decline  | 357,600                             | (7.45 )        | 70,900                 | (3.67 )        |  |  |
| December 31, 2014        |                                     |                |                        |                |  |  |
| 200 basis point rise     | \$421,700                           | 9.56 %         | \$ 75,600              | 6.03 %         |  |  |
| 100 basis point rise     | 406,800                             | 5.69           | 73,600                 | 3.23           |  |  |
| Base-rate scenario       | 384,900                             | -              | 71,300                 | -              |  |  |
| 100 basis point decline  | 355,000                             | (7.77 )        | 69,200                 | (2.95 )        |  |  |

(1) Simulation analyses calculate the change in the net present value of our assets and liabilities, including debt and related financial derivative instruments, under parallel shifts in interest rates by discounting the estimated future cash flows using a market-based discount rate. Cash flow estimates incorporate anticipated changes in prepayment speeds and other embedded options.

(2) Simulation analyses calculate the change in net interest income under immediate parallel shifts in interest rates over the next twelve months, based upon a static statement of financial condition, which includes debt and related financial derivative instruments, and do not consider loan fees.

Accounting standards update. See Note #2 to the Condensed Consolidated Financial Statements included elsewhere in this report for details on recently issued accounting pronouncements and their impact on our financial statements.

Fair valuation of financial instruments. Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) topic 820 - “Fair Value Measurements and Disclosures” (“FASB ASC topic 820”) defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

We utilize fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. FASB ASC topic 820 differentiates between those assets and liabilities required to be carried at fair value at every reporting period (“recurring”) and those assets and liabilities that are only required to be adjusted to fair value under certain circumstances (“nonrecurring”). Trading securities, securities available-for-sale, loans held for sale, and derivatives are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a nonrecurring basis, such as loans held for investment, capitalized mortgage loan servicing rights and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. See Note #12 to the Condensed Consolidated Financial Statements included within this report for a complete discussion on our use of fair valuation of financial instruments and the related measurement techniques.



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Litigation Matters

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$0.5 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.

The litigation matters described in the preceding paragraph primarily include claims that have been brought against us for damages, but do not include litigation matters where we seek to collect amounts owed to us by third parties (such as litigation initiated to collect delinquent loans or vehicle service contract counterparty receivables). These excluded, collection-related matters may involve claims or counterclaims by the opposing party or parties, but we have excluded such matters from the disclosure contained in the preceding paragraph in all cases where we believe the possibility of us paying damages to any opposing party is remote. Risks associated with the likelihood that we will not collect the full amount owed to us, net of reserves, are disclosed elsewhere in this report.

Critical Accounting Policies

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for other than temporary impairment of investment securities, the allowance for loan losses, originated mortgage loan servicing rights, vehicle service contract payment plan counterparty contingencies, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014.

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Item 3.

Quantitative and Qualitative Disclosures about Market Risk

See applicable disclaimers set forth in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2 under the caption “Asset/liability management.”

Item 4.

Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

With the participation of management, our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) for the period ended September 30, 2015, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended September 30, 2015, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## Part II

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2014.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Company maintains a Deferred Compensation and Stock Purchase Plan for Non-Employee Directors (the "Plan") pursuant to which non-employee directors can elect to receive shares of the Company's common stock in lieu of fees otherwise payable to the director for his or her service as a director. A director can elect to receive shares on a current basis or to defer receipt of the shares, in which case the shares are issued to a trust to be held for the account of the director and then generally distributed to the director after his or her retirement from the Board. Pursuant to this Plan, during the third quarter of 2015, the Company issued 698 shares of common stock to non-employee directors on a current basis and 472 shares of common stock to the trust for distribution to directors on a deferred basis. The shares were issued on July 1, 2015, at a price of \$13.56 per share, representing aggregate fees of \$0.02 million. The price per share was the consolidated closing bid price per share of the Company's common stock as of the date of issuance, as determined in accordance with NASDAQ Marketplace Rules. The Company issued the shares pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933 due to the fact that the issuance of the shares was made on a private basis pursuant to the Plan.

The following table shows certain information relating to purchases of common stock for the three-months ended September 30, 2015:

| Period         | Total<br>Number of<br>Shares<br>Purchased(1) | Average<br>Price<br>Paid Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of a<br>Publicly<br>Announced<br>Plan | Remaining<br>Number of<br>Shares<br>Authorized<br>for<br>Purchase<br>Under the<br>Plan |
|----------------|--|---------------------------------------|--|--|
| July 2015      | -  | \$ -                                  | -  | 870,515  |
| August 2015    | 299,923                                      | 14.08                                 | 227,500  | 643,015  |
| September 2015 | 154,247                                      | 14.00                                 | 154,247  | 488,768  |
| Total          | 454,170                                      | \$ 14.05                              | 381,747  | 488,768  |

Represents (i) 72,423 shares withheld from the shares that would otherwise have been issued to certain officers in (1) order to satisfy tax withholding obligations resulting from vesting of restricted stock units and (ii) 381,747 shares purchased in the open market pursuant to a publicly announced plan.

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Item 6. Exhibits

(a) The following exhibits (listed by number corresponding to the Exhibit Table as Item 601 in Regulation S-K) are filed with this report:

11. Computation of Earnings Per Share.

31.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

31.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

32.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

32.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

101.INS Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date November 4, 2015 By/s/ Robert N. Shuster  
Robert N. Shuster, Principal Financial Officer

Date November 4, 2015 By/s/ James J. Twarozynski  
James J. Twarozynski, Principal Accounting Officer