

Edgar Filing: ISABELLA BANK Corp - Form 10-Q

ISABELLA BANK Corp  
Form 10-Q  
August 07, 2018  
UNITED STATES  
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 June 30, 2018

or

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 0-18415

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

Michigan 38-2830092  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

401 N. Main St, Mt. Pleasant, MI 48858  
(Address of principal executive offices) (Zip code)  
(989) 772-9471

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer ☐ Accelerated filer ✓

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

Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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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The number of common shares outstanding of the registrant's Common Stock (no par value) was 7,845,606 as of August 1, 2018.

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ISABELLA BANK CORPORATION  
QUARTERLY REPORT ON FORM 10-Q

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Forward Looking Statements

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended and Rule 3b-6 promulgated thereunder. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project,” or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, federal or state tax laws, monetary and fiscal policy, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, cyber-security risk, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

Glossary of Acronyms and Abbreviations

The acronyms and abbreviations identified below may be used throughout this Quarterly Report on Form 10-Q or in our other SEC filings. You may find it helpful to refer back to this page while reading this report.

AFS: Available-for-sale	GAAP: U.S. generally accepted accounting principles
ALLL: Allowance for loan and lease losses	GLB Act: Gramm-Leach-Bliley Act of 1999
AOCI: Accumulated other comprehensive income	IFRS: International Financial Reporting Standards
ASC: FASB Accounting Standards Codification	IRR: Interest rate risk
ASU: FASB Accounting Standards Update	ISDA: International Swaps and Derivatives Association
ATM: Automated Teller Machine	JOBS Act: Jumpstart our Business Startups Act
BHC Act: Bank Holding Company Act of 1956	LIBOR: London Interbank Offered Rate
CECL: Current Expected Credit Losses	N/A: Not applicable
CFPB: Consumer Financial Protection Bureau	N/M: Not meaningful
CIK: Central Index Key	NASDAQ: NASDAQ Stock Market Index
CRA: Community Reinvestment Act	NASDAQ Banks: NASDAQ Bank Stock Index
DIF: Deposit Insurance Fund	NAV: Net asset value
DIFS: Department of Insurance and Financial Services	NOW: Negotiable order of withdrawal
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NSF: Non-sufficient funds
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	OCI: Other comprehensive income (loss)
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OMSR: Originated mortgage servicing rights
ESOP: Employee Stock Ownership Plan	OREO: Other real estate owned
Exchange Act: Securities Exchange Act of 1934	OTTI: Other-than-temporary impairment
FASB: Financial Accounting Standards Board	PBO: Projected benefit obligation
FDI Act: Federal Deposit Insurance Act	

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FDIC: Federal Deposit Insurance Corporation

FFIEC: Federal Financial Institutions Examinations Council

FRB: Federal Reserve Bank

FHLB: Federal Home Loan Bank

Freddie Mac: Federal Home Loan Mortgage Corporation

FTE: Fully taxable equivalent

PCAOB: Public Company Accounting  
Oversight Board

Rabbi Trust: A trust established to fund  
the Directors Plan

SEC: U.S. Securities and Exchange  
Commission

SOX: Sarbanes-Oxley Act of 2002

Tax Act: Tax Cuts and Jobs Act, enacted  
December 22, 2017

TDR: Troubled debt restructuring

XBRL: eXtensible Business Reporting  
Language

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

## INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

	June 30 2018	December 31 2017
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$22,055	\$ 25,267
Interest bearing balances due from banks	158	5,581
Total cash and cash equivalents	22,213	30,848
AFS securities, at fair value	524,108	548,730
Equity securities, at fair value	—	3,577
Mortgage loans AFS	1,420	1,560
Loans		
Commercial	691,623	634,759
Agricultural	125,249	128,269
Residential real estate	273,607	272,368
Consumer	61,277	56,123
Gross loans	1,151,756	1,091,519
Less allowance for loan and lease losses	8,200	7,700
Net loans	1,143,556	1,083,819
Premises and equipment	28,267	28,450
Corporate owned life insurance policies	27,377	27,026
Accrued interest receivable	5,684	7,063
Equity securities without readily determinable fair values	23,743	23,454
Goodwill and other intangible assets	48,497	48,547
Other assets	12,090	10,056
<b>TOTAL ASSETS</b>	<b>\$1,836,955</b>	<b>\$ 1,813,130</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$234,377	\$ 237,511
NOW accounts	222,678	231,666
Certificates of deposit under \$250 and other savings	745,065	728,090
Certificates of deposit over \$250	72,642	67,991
Total deposits	1,274,762	1,265,258
Borrowed funds	362,496	344,878
Accrued interest payable and other liabilities	7,748	8,089
Total liabilities	1,645,006	1,618,225
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,933,250 shares (including 21,652 shares held in the Rabbi Trust) in 2018 and 7,857,293 shares (including 31,769 shares held in the Rabbi Trust) in 2017	142,489	140,277
Shares to be issued for deferred compensation obligations	5,423	5,502
Retained earnings	54,204	51,728
Accumulated other comprehensive income (loss)	(10,167	) (2,602 )
Total shareholders' equity	191,949	194,905
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,836,955</b>	<b>\$ 1,813,130</b>

See notes to interim condensed consolidated financial statements (unaudited).

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands except per share amounts)

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2018	2017	2018	2017
Interest income				
Loans, including fees	\$12,076	\$10,685	\$23,372	\$20,805
AFS securities				
Taxable	2,110	2,188	4,232	4,301
Nontaxable	1,331	1,413	2,713	2,828
Federal funds sold and other	196	212	517	425
Total interest income	15,713	14,498	30,834	28,359
Interest expense				
Deposits	2,230	1,615	4,276	3,155
Borrowings	1,511	1,413	2,866	2,704
Total interest expense	3,741	3,028	7,142	5,859
Net interest income	11,972	11,470	23,692	22,500
Provision for loan losses	328	9	712	36
Net interest income after provision for loan losses	11,644	11,461	22,980	22,464
Noninterest income				
Service charges and fees	1,488	1,405	2,976	2,935
Net gain on sale of mortgage loans	87	199	168	354
Earnings on corporate owned life insurance policies	181	183	351	363
Net gains on sale of AFS securities	—	142	—	142
Other	980	859	1,728	1,610
Total noninterest income	2,736	2,788	5,223	5,404
Noninterest expenses				
Compensation and benefits	5,679	4,817	11,173	10,374
Furniture and equipment	1,571	1,352	3,050	2,696
Occupancy	807	815	1,631	1,652
Other	2,727	2,523	5,026	4,736
Total noninterest expenses	10,784	9,507	20,880	19,458
Income before federal income tax expense	3,596	4,742	7,323	8,410
Federal income tax expense	263	898	528	1,430
NET INCOME	\$3,333	\$3,844	\$6,795	\$6,980
Earnings per common share				
Basic	\$0.42	\$0.49	\$0.86	\$0.89
Diluted	\$0.41	\$0.48	\$0.84	\$0.87
Cash dividends per common share	\$0.26	\$0.25	\$0.52	\$0.50

See notes to interim condensed consolidated financial statements (unaudited).





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(Dollars in thousands)

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2018	2017	2018	2017
Net income	\$3,333	\$3,844	\$6,795	\$6,980
Unrealized gains (losses) on AFS securities				
Unrealized gains (losses) on AFS securities arising during the period	(1,978 )	2,570	(10,035)	4,247
Reclassification adjustment for net (gains) losses included in net income	—	(142 )	—	(142 )
Tax effect (1)	442	(762 )	2,126	(1,212 )
Unrealized gains (losses) on AFS securities, net of tax	(1,536 )	1,666	(7,909 )	2,893
Unrealized gains (losses) on derivative instruments arising during the period	31	(61 )	153	(44 )
Tax effect (1)	(6 )	21	(32 )	15
Unrealized gains (losses) on derivative instruments, net of tax	25	(40 )	121	(29 )
Other comprehensive income (loss), net of tax	(1,511 )	1,626	(7,788 )	2,864
Comprehensive income	\$1,822	\$5,470	\$(993 )	\$9,844

(1) See "Note 11 – Accumulated Other Comprehensive Income" for tax effect reconciliation.

See notes to interim condensed consolidated financial statements (unaudited).

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(UNAUDITED)

(Dollars in thousands except per share amounts)

	Common Stock		Common Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
	Common Shares Outstanding	Amount				
Balance, January 1, 2017	7,821,069	\$ 139,525	\$ 5,038	\$ 46,114	\$ (2,778 )	\$ 187,899
Comprehensive income (loss)	—	—	—	6,980	2,864	9,844
Issuance of common stock	135,516	3,764	—	—	—	3,764
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	176	(176 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	302	—	—	302
Common stock purchased for deferred compensation obligations	—	(197 )	—	—	—	(197 )
Common stock repurchased pursuant to publicly announced repurchase plan	(94,032 )	(2,622 )	—	—	—	(2,622 )
Cash dividends paid (\$0.50 per common share)	—	—	—	(3,920 )	—	(3,920 )
Balance, June 30, 2017	7,862,553	\$ 140,646	\$ 5,164	\$ 49,174	\$ 86	\$ 195,070
Balance, January 1, 2018	7,857,293	\$ 140,277	\$ 5,502	\$ 51,728	\$ (2,602 )	\$ 194,905
Comprehensive income (loss)	—	—	—	6,795	(7,788 )	(993 )
Adoption of ASU 2016-01	—	—	—	(223 )	223	—
Issuance of common stock	121,437	3,272	—	—	—	3,272
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	383	(383 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	304	—	—	304
Common stock purchased for deferred compensation obligations	—	(205 )	—	—	—	(205 )
Common stock repurchased pursuant to publicly announced repurchase plan	(45,480 )	(1,238 )	—	—	—	(1,238 )
Cash dividends paid (\$0.52 per common share)	—	—	—	(4,096 )	—	(4,096 )
Balance, June 30, 2018	7,933,250	\$ 142,489	\$ 5,423	\$ 54,204	\$ (10,167 )	\$ 191,949

See notes to interim condensed consolidated financial statements (unaudited).

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)

	Six Months Ended June 30	
	2018	2017
<b>OPERATING ACTIVITIES</b>		
Net income	\$6,795	\$6,980
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	712	36
Impairment of foreclosed assets	—	28
Depreciation	1,448	1,440
Amortization of OMSR	153	170
Amortization of acquisition intangibles	50	62
Net amortization of AFS securities	969	1,062
Net unrealized (gains) losses on equity securities, at fair value	41	—
Net (gains) losses on sale of AFS securities	—	(142 )
Net (gains) losses on sale of equity securities, at fair value	(1 )	—
Net gain on sale of mortgage loans	(168 )	(354 )
Increase in cash value of corporate owned life insurance policies	(351 )	(363 )
Share-based payment awards under equity compensation plan	304	302
Origination of loans held-for-sale	(10,178)	(19,081)
Proceeds from loan sales	10,486	19,769
Net changes in operating assets and liabilities which provided (used) cash:		
Accrued interest receivable	1,379	894
Other assets	(353 )	(1,734 )
Accrued interest payable and other liabilities	(341 )	(382 )
Net cash provided by (used in) operating activities	10,945	8,687
<b>INVESTING ACTIVITIES</b>		
Activity in AFS securities		
Sales	—	12,827
Maturities, calls, and principal payments	39,609	45,021
Purchases	(25,991)	(64,429)
Sale of equity securities, at fair value	3,537	—
Net loan principal (originations) collections	(60,517)	(37,842)
Proceeds from sales of foreclosed assets	192	98
Purchases of premises and equipment	(1,265 )	(805 )
Net cash provided by (used in) investing activities	(44,435)	(45,130)

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

	Six Months Ended	
	June 30	
	2018	2017
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	\$9,504	\$15,112
Net increase (decrease) in borrowed funds	17,618	23,246
Cash dividends paid on common stock	(4,096 )	(3,920 )
Proceeds from issuance of common stock	3,272	3,764
Common stock repurchased	(1,238 )	(2,622 )
Common stock purchased for deferred compensation obligations	(205 )	(197 )
Net cash provided by (used in) financing activities	24,855	35,383
Increase (decrease) in cash and cash equivalents	(8,635 )	(1,060 )
Cash and cash equivalents at beginning of period	30,848	22,894
Cash and cash equivalents at end of period	\$22,213	\$21,834
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$7,120	\$5,872
Income taxes paid	\$—	\$1,630
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$68	\$124

See notes to interim condensed consolidated financial statements (unaudited).

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands except per share amounts)

Note 1 – Basis of Presentation

As used in these notes, as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to "Isabella," the "Corporation," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank or the "Bank" refers to Isabella Bank Corporation's subsidiary, Isabella Bank. The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2017.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2017.

Reclassifications: Certain amounts reported in the interim 2017 consolidated financial statements have been reclassified to conform with the 2018 presentation.

Note 2 – Accounting Standards Updates

Recently Adopted Accounting Standards Updates

ASU No. 2014-09: "Revenue from Contracts with Customers"

In May 2014, ASU No. 2014-09 was issued and created new Topic 606 to provide a common revenue standard to achieve consistency and clarification to the revenue recognition principles. The guidance outlines steps to achieve the core principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. These steps consist of: (1) identify the contract(s) with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when (or as) the entity satisfies a performance obligation. The new authoritative guidance, as amended, was effective on January 1, 2018. We reviewed our contracts related to trust and investment services and those related to other noninterest income to determine if changes in income recognition were required as a result of this guidance. Implementation of this guidance did not have a significant impact on our operating results for the three and six month periods ended June 30, 2018.

ASU No. 2016-01: "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities" and ASU No. 2018-03: "Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities"

In January 2016, ASU No. 2016-01 was issued and set forth the following: 1) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment and requiring measurement of the investment at fair value when an impairment exists; 3) for public entities, eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; 4) for public entities, requires the use of exit price notion when measuring the fair value of financial instruments for disclosure purposes; 5) requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; 6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and 7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.





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The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2017. As a result of this guidance, the change in the fair value of equity investments has been recorded in net income beginning on January 1, 2018. Equity securities are now recorded separately from AFS securities and are recorded at a fair value which approximates an exit price notion. Adoption of this guidance had an insignificant impact on our operations and its future impact will depend on the fair value of these investments at the future measurement dates. The disclosures related to equity investment securities reflect a fully retrospective presentation for comparative purposes.

For discussion of the fair value measurement of financial instruments, refer to “Note 12 – Fair Value”.

In February 2018, ASU No. 2018-03 was issued and sets forth correction or improvement amendments for specific issues that may arise within the scope of ASU 2016-01. These amendments have been adopted and did not have a significant impact on our operating results or financial statement disclosures.

ASU No. 2017-09: “Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting”

In May 2017, ASU No. 2017-09 was issued and provided guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting under Topic 718. The current disclosure requirements in Topic 718 apply regardless of whether an entity is required to apply modification accounting under the amendments in this update. An entity should account for the effects of a modification unless all of the following are met:

1. The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification.
2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified.
3. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2017 and did not have a significant impact on our operating results or financial statement disclosures.

Pending Accounting Standards Updates

ASU No. 2016-02: “Leases (Topic 842)”

In February 2016, ASU No. 2016-02 was issued to create Topic 842 - Leases which will require recognition of lease assets and lease liabilities on the balance sheet for leases previously classified as operating leases. Accounting guidance is set forth for both lessee and lessor accounting. Under lessee accounting, a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term.

For finance leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income; and 3) classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows. For operating leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis; and 3) classify all cash payments within operating activities in the statement of cash flows.

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018. We have and will continue to review our lease agreements to determine the appropriate treatment under this guidance. We do not expect these changes to have a significant impact on our operating results or financial statement disclosures.



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ASU No. 2016-13: “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments”

In June 2016, ASU No. 2016-13 was issued and updated the measurement for credit losses for AFS debt securities and assets measured at amortized cost which include loans, trade receivables, and any other financial assets with the contractual right to receive cash. Current GAAP requires an “incurred loss” methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. Under the incurred loss approach, entities are limited to a probable initial recognition threshold when credit losses are measured under GAAP; an entity generally only considers past events and current conditions in measuring the incurred loss.

Under the new guidance, the incurred loss impairment methodology in current GAAP is replaced with a methodology that reflects current expected credit losses (CECL). This methodology requires consideration of a broader range of reasonable and supportable information to calculate credit loss estimates. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances which applies to assets measured either collectively or individually.

The update allows an entity to revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts. In addition, the disclosures of credit quality indicators in relation to the amortized cost of financing receivables, a current disclosure requirement, are further disaggregated by year of origination (or vintage). The vintage information will be useful for financial statement users to better assess changes in underwriting standards and credit quality trends in asset portfolios over time and the effect of those changes on credit losses.

Overall, the update will allow entities the ability to measure expected credit losses without the restriction of incurred or probable losses that exist under current GAAP. For users of the financial statements, the update provides decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019 and may have a significant impact on our operations and financial statement disclosures as well as that of the banking industry as a whole.

We have invested a considerable amount of effort toward this guidance and will continue to invest considerable effort until its effective date. A committee was formed and has developed a road map to implementation. This committee will monitor progress to ensure timely and accurate adoption of the guidance. We have identified and collected required borrower and loan level data, as we recognize that quality data is key to properly identify loan segments and then apply the most appropriate methodology to each segment. We’ve identified a software solution that will support us in estimating the ALLL under CECL guidance and are currently in contract negotiations with the vendor that will enable us to run parallel models during 2019. This will allow us to solidify our methodology for implementation in 2020.

#### Note 3 – AFS Securities

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

	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$ 194	\$ —	\$ 4	\$ 190
States and political subdivisions	200,976	1,857	560	202,273
Auction rate money market preferred	3,200	—	65	3,135
Mortgage-backed securities	204,411	41	6,815	197,637
Collateralized mortgage obligations	124,544	50	3,721	120,873
Total	\$533,325	\$ 1,948	\$ 11,165	\$524,108



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	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$217	\$ —	\$ 1	\$216
States and political subdivisions	204,131	4,486	143	208,474
Auction rate money market preferred	3,200	—	151	3,049
Mortgage-backed securities	210,757	390	2,350	208,797
Collateralized mortgage obligations	129,607	160	1,573	128,194
Total	\$547,912	\$ 5,036	\$ 4,218	\$548,730

The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2018 are as follows:

	Maturing					Total
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	
Government sponsored enterprises	\$—	\$ 194	\$—	\$—	\$ —	\$194
States and political subdivisions	27,593	81,665	62,446	29,272	—	200,976
Auction rate money market preferred	—	—	—	—	3,200	3,200
Mortgage-backed securities	—	—	—	—	204,411	204,411
Collateralized mortgage obligations	—	—	—	—	124,544	124,544
Total amortized cost	\$27,593	\$ 81,859	\$62,446	\$ 29,272	\$ 332,155	\$533,325
Fair value	\$27,640	\$ 82,336	\$63,199	\$ 29,288	\$ 321,645	\$524,108

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

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

A summary of the sales activity of AFS securities was as follows for the:

	Three Months Ended June 30 2017	Six Months Ended June 30 2017
Proceeds from sales of AFS securities	\$—	\$—
Gross realized gains (losses)	\$—	\$—
Applicable income tax expense (benefit)	\$—	\$—

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The following information pertains to AFS securities with gross unrealized losses at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position.

	June 30, 2018		December 31, 2017		Total Unrealized Losses
	Less Than Twelve Months	Twelve Months or More	Less Than Twelve Months	Twelve Months or More	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$4	\$190	\$ —	\$ —	\$ 4
States and political subdivisions	378	32,949	182	9,012	560
Auction rate money market preferred	—	—	65	3,135	65
Mortgage-backed securities	3,265	125,130	3,550	69,214	6,815
Collateralized mortgage obligations	2,490	94,355	1,231	22,523	3,721
Total	\$6,137	\$252,624	\$ 5,028	\$ 103,884	\$ 11,165
Number of securities in an unrealized loss position:		159		91	250

Unrealized losses on our AFS securities portfolio are the result of recent increases in intermediate-term and long-term benchmark interest rates and not credit issues.

As of June 30, 2018 and December 31, 2017, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

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

During the fourth quarter of 2016, we identified one municipal bond as other-than-temporarily impaired. While management estimated the OTTI to be realized, we also engaged the services of an independent investment valuation firm to estimate the amount of impairment as of December 31, 2016. The valuation calculated the estimated market value utilizing two different approaches:

- 1) Market - Appraisal and Comparable Investments
- 2) Income - Discounted Cash Flow Method

The two methods were then weighted, with a higher weighting applied to the Market approach, to determine the estimated impairment. As a result of this analysis, we reduced the carrying value to \$230 which required us to recognize an OTTI of \$770 in earnings for the year ended December 31, 2016. Based on internal analysis of this bond as of June 30, 2018, there was no additional OTTI recognized as of June 30, 2018 and the carrying value of this bond remained at \$230.

Based on our analysis which included the criteria outlined above, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell any AFS securities in

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an unrealized loss position before recovery of their cost basis, we do not believe that the values of any other AFS securities are other-than-temporarily impaired as of June 30, 2018 or December 31, 2017, with the exception of the one municipal bond discussed above.

Note 4 – Loans and ALLL

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

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method. The accrual of interest on commercial, agricultural, and residential real estate loans is discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Upon transferring the loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful. For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance and achievement of current payment status.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, advances to mortgage brokers, farmland and agricultural production, and loans to states and political subdivisions. Repayment of these loans is dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to \$15,000. Borrowers with direct credit needs of more than \$15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports.

We entered into a mortgage purchase program in 2016 with a financial institution where we participate in advances to mortgage brokers ("advances"). The mortgage brokers originate residential mortgage loans with the intent to sell them on the secondary market. We participate in the advance to the mortgage broker, which is secured by the underlying mortgage loan, until it is ultimately sold on the secondary market. As such, the average life of each participated advance is approximately 20-30 days. Funds from the sale of the loan are used to pay off our participation in the advance to the mortgage broker. We classify these advances as commercial loans and include the outstanding balance in commercial loans on our consolidated balance sheet. Under the participation agreement, we committed to a maximum outstanding aggregate amount of \$30,000. The difference between our outstanding balances and the maximum outstanding aggregate amount is classified as "Unfunded commitments under lines of credit" in the "Contractual Obligations and Loan Commitments" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations of this report.

We offer adjustable rate mortgages, construction loans, and fixed rate residential real estate loans which have amortization periods up to a maximum of 30 years. We consider the anticipated direction of interest rates, balance sheet duration, the sensitivity of our balance sheet to changes in interest rates, our liquidity needs, and overall loan demand to determine whether or not to sell fixed rate loans to Freddie Mac.



Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 100% of the lower of the appraised value of the property or the purchase price. Private mortgage insurance is typically required on loans with loan-to-value ratios in excess of 80% unless the loan qualifies for government guarantees.

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Underwriting criteria for originated residential real estate loans generally include:

- Evaluation of the borrower’s ability to make monthly payments.
- Evaluation of the value of the property securing the loan.
- Ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower’s gross income.
- Ensuring all debt servicing does not exceed 40% of income.
- Verification of acceptable credit reports.
- Verification of employment, income, and financial information.

Appraisals are performed by independent appraisers and reviewed for appropriateness. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market underwriting system; loans in excess of \$500 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors’ Loan Committee, or the Board of Directors.

Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 15 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower’s perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

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

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

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan’s outstanding balance and the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair value of the collateral, less cost to sell. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio, with the exception of advances to mortgage brokers, over the preceding five years. With no historical losses on advances to mortgage brokers, there is no allocation in the commercial segment displayed in the following tables based on historical loss factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

	Allowance for Loan Losses					
	Three Months Ended June 30, 2018					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2018	\$1,840	\$ 1,224	\$ 2,482	\$ 795	\$ 1,859	\$8,200
Charge-offs	(489 )	—	(29 )	(48 )	—	(566 )
Recoveries	101	—	69	68	—	238
Provision for loan losses	745	(242 )	(355 )	67	113	328
June 30, 2018	\$2,197	\$ 982	\$ 2,167	\$ 882	\$ 1,972	\$8,200

	Allowance for Loan Losses					
	Six Months Ended June 30, 2018					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2018	\$1,706	\$ 611	\$ 2,563	\$ 900	\$ 1,920	\$7,700
Charge-offs	(494 )	—	(39 )	(136 )	—	(669 )

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Recoveries	204	—	125	128	—	457
Provision for loan losses	781	371	(482	) (10	) 52	712
June 30, 2018	\$2,197	\$ 982	\$ 2,167	\$ 882	\$ 1,972	\$8,200

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Allowance for Loan Losses and Recorded Investment in Loans  
June 30, 2018

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$ 506	\$ 102	\$ 1,451	\$ —	\$ —	\$ 2,059
Collectively evaluated for impairment	1,691	880	716	882	1,972	6,141
Total	\$ 2,197	\$ 982	\$ 2,167	\$ 882	\$ 1,972	\$ 8,200
Loans						
Individually evaluated for impairment	\$ 10,030	\$ 12,894	\$ 7,748	\$ 11		\$ 30,683
Collectively evaluated for impairment	681,593	112,355	265,859	61,266		1,121,073
Total	\$ 691,623	\$ 125,249	\$ 273,607	\$ 61,277		\$ 1,151,756

Allowance for Loan Losses  
Three Months Ended June 30, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2017	\$ 1,771	\$ 527	\$ 3,098	\$ 671	\$ 1,433	\$ 7,500
Charge-offs	(25 )	—	—	(44 )	—	(69 )
Recoveries	55	—	63	42	—	160
Provision for loan losses	177	(52 )	(563 )	(86 )	533	9
June 30, 2017	\$ 1,978	\$ 475	\$ 2,598	\$ 583	\$ 1,966	\$ 7,600

Allowance for Loan Losses  
Six Months Ended June 30, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2017	\$ 1,814	\$ 884	\$ 2,664	\$ 624	\$ 1,414	\$ 7,400
Charge-offs	(52 )	—	(43 )	(118 )	—	(213 )
Recoveries	188	—	99	90	—	377
Provision for loan losses	28	(409 )	(122 )	(13 )	552	36
June 30, 2017	\$ 1,978	\$ 475	\$ 2,598	\$ 583	\$ 1,966	\$ 7,600

Allowance for Loan Losses and Recorded Investment in Loans  
December 31, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$ 650	\$ —	\$ 1,480	\$ —	\$ —	\$ 2,130
Collectively evaluated for impairment	1,056	611	1,083	900	1,920	5,570
Total	\$ 1,706	\$ 611	\$ 2,563	\$ 900	\$ 1,920	\$ 7,700
Loans						
Individually evaluated for impairment	\$ 8,099	\$ 10,598	\$ 7,939	\$ 17		\$ 26,653
Collectively evaluated for impairment	626,660	117,671	264,429	56,106		1,064,866
Total	\$ 634,759	\$ 128,269	\$ 272,368	\$ 56,123		\$ 1,091,519

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

Rating	June 30, 2018				Agricultural			
	Commercial		Advances to Mortgage Brokers	Total	Agricultural		Total	Total
	Real Estate	Other			Real Estate	Other		
1 - Excellent	\$23	\$30	\$ —	\$53	\$—	\$34	\$34	\$87
2 - High quality	6,144	19,832	—	25,976	3,026	521	3,547	29,523
3 - High satisfactory	117,355	55,626	23,864	196,845	19,751	7,037	26,788	223,633
4 - Low satisfactory	353,308	91,678	—	444,986	45,287	17,964	63,251	508,237
5 - Special mention	12,205	2,171	—	14,376	9,970	5,245	15,215	29,591
6 - Substandard	5,368	2,073	—	7,441	6,623	6,034	12,657	20,098
7 - Vulnerable	1,646	300	—	1,946	2,152	1,605	3,757	5,703
8 - Doubtful	—	—	—	—	—	—	—	—
<b>Total</b>	<b>\$496,049</b>	<b>\$171,710</b>	<b>\$23,864</b>	<b>\$691,623</b>	<b>\$86,809</b>	<b>\$38,440</b>	<b>\$125,249</b>	<b>\$816,872</b>

  

Rating	December 31, 2017				Agricultural			
	Commercial		Advances to Mortgage Brokers	Total	Agricultural		Total	Total
	Real Estate	Other			Real Estate	Other		
1 - Excellent	\$24	\$316	\$ —	\$340	\$—	\$34	\$34	\$374
2 - High quality	8,402	12,262	—	20,664	2,909	1,024	3,933	24,597
3 - High satisfactory	131,826	46,668	12,081	190,575	21,072	8,867	29,939	220,514
4 - Low satisfactory	326,166	75,591	—	401,757	47,835	18,467	66,302	468,059
5 - Special mention	8,986	3,889	—	12,875	10,493	8,546	19,039	31,914
6 - Substandard	5,521	2,298	—	7,819	4,325	2,747	7,072	14,891
7 - Vulnerable	729	—	—	729	1,531	419	1,950	2,679
8 - Doubtful	—	—	—	—	—	—	—	—
<b>Total</b>	<b>\$481,654</b>	<b>\$141,024</b>	<b>\$12,081</b>	<b>\$634,759</b>	<b>\$88,165</b>	<b>\$40,104</b>	<b>\$128,269</b>	<b>\$763,028</b>

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

1. EXCELLENT – Substantially Risk Free

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

- High liquidity, strong cash flow, low leverage.
- Unquestioned ability to meet all obligations when due.

Experienced management, with management succession in place.

Secured by cash.

2. HIGH QUALITY – Limited Risk

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

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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

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♣ Access to alternative financing.

♣ Well defined primary and secondary source of repayment.

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

3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

♣ Working capital adequate to support operations.

♣ Cash flow sufficient to pay debts as scheduled.

♣ Management experience and depth appear favorable.

♣ Loan performing according to terms.

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

4. LOW SATISFACTORY – Acceptable Risk

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

♣ Would include most start-up businesses.

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

♣ Management's abilities are apparent, yet unproven.

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

- Loan structure generally in accordance with policy.

♣ If secured, loan collateral coverage is marginal.

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

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

5. SPECIAL MENTION – Criticized

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

♣ Downward trend in sales, profit levels, and margins.

♣ Impaired working capital position.

♣ Cash flow is strained in order to meet debt repayment.

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

- Shrinking equity cushion.

♣ Diminishing primary source of repayment and questionable secondary source.

♣ Management abilities are questionable.

♣ Weak industry conditions.

♣ Litigation pending against the borrower.

♣ Collateral or guaranty offers limited protection.

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

6. SUBSTANDARD – Classified

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

♣ Sustained losses have severely eroded the equity and cash flow.

♣ Deteriorating liquidity.

♣ Serious management problems or internal fraud.

♣ Original repayment terms liberalized.

♣ Likelihood of bankruptcy.

♣ Inability to access other funding sources.

♣ Reliance on secondary source of repayment.

- Ⓛitigation filed against borrower.
- Ⓞollateral provides little or no value.
- Ⓡequires excessive attention of the loan officer.
- Ⓡborrower is uncooperative with loan officer.



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## 7. VULNERABLE – Classified

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

- Insufficient cash flow to service debt.
- Minimal or no payments being received.
- Limited options available to avoid the collection process.
- Transition status, expect action will take place to collect loan without immediate progress being made.

## 8. DOUBTFUL – Workout

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

- Normal operations are severely diminished or have ceased.
- Seriously impaired cash flow.
- Original repayment terms materially altered.
- Secondary source of repayment is inadequate.
- Survivability as a “going concern” is impossible.
- Collection process has begun.
- Bankruptcy petition has been filed.
- Judgments have been filed.
- Portion of the loan balance has been charged-off.

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

	June 30, 2018				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:		90 Days or More	Nonaccrual			
	30-59 Days	60-89 Days					
Commercial							
Commercial real estate	\$1,531	\$60	\$ —	\$ 1,646	\$ 3,237	\$492,812	\$496,049
Commercial other	565	827	—	300	1,692	170,018	171,710
Advances to mortgage brokers	—	—	—	—	—	23,864	23,864
Total commercial	2,096	887	—	1,946	4,929	686,694	691,623
Agricultural							
Agricultural real estate	576	149	125	2,152	3,002	83,807	86,809
Agricultural other	34	410	—	1,605	2,049	36,391	38,440
Total agricultural	610	559	125	3,757	5,051	120,198	125,249
Residential real estate							
Senior liens	1,028	350	29	779	2,186	230,258	232,444
Junior liens	33	—	—	10	43	6,261	6,304
Home equity lines of credit	38	185	—	—	223	34,636	34,859
Total residential real estate	1,099	535	29	789	2,452	271,155	273,607
Consumer							
Secured	18	8	—	—	26	57,393	57,419
Unsecured	17	—	—	—	17	3,841	3,858
Total consumer	35	8	—	—	43	61,234	61,277
Total	\$3,840	\$1,989	\$ 154	\$ 6,492	\$ 12,475	\$1,139,281	\$1,151,756

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	December 31, 2017				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
<b>Commercial</b>							
Commercial real estate	\$295	\$325	\$54	\$729	\$1,403	\$480,251	\$481,654
Commercial other	1,069	28	18	—	1,115	139,909	141,024
Advances to mortgage brokers	—	—	—	—	—	12,081	12,081
<b>Total commercial</b>	<b>1,364</b>	<b>353</b>	<b>72</b>	<b>729</b>	<b>2,518</b>	<b>632,241</b>	<b>634,759</b>
<b>Agricultural</b>							
Agricultural real estate	84	190	—	1,531	1,805	86,360	88,165
Agricultural other	39	—	104	419	562	39,542	40,104
<b>Total agricultural</b>	<b>123</b>	<b>190</b>	<b>104</b>	<b>1,950</b>	<b>2,367</b>	<b>125,902</b>	<b>128,269</b>
<b>Residential real estate</b>							
Senior liens	3,718	234	132	325	4,409	225,007	229,416
Junior liens	69	10	—	23	102	6,812	6,914
Home equity lines of credit	293	—	77	—	370	35,668	36,038
<b>Total residential real estate</b>	<b>4,080</b>	<b>244</b>	<b>209</b>	<b>348</b>	<b>4,881</b>	<b>267,487</b>	<b>272,368</b>
<b>Consumer</b>							
Secured	37	10	10	—	57	52,005	52,062
Unsecured	13	—	—	—	13	4,048	4,061
<b>Total consumer</b>	<b>50</b>	<b>10</b>	<b>10</b>	<b>—</b>	<b>70</b>	<b>56,053</b>	<b>56,123</b>
<b>Total</b>	<b>\$5,617</b>	<b>\$797</b>	<b>\$395</b>	<b>\$3,027</b>	<b>\$9,836</b>	<b>\$1,081,683</b>	<b>\$1,091,519</b>

**Impaired Loans**

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

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

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

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

	June 30, 2018			December 31, 2017		
	Recorded Balance	Unpaid Principal Balance	Valuation Allowance	Recorded Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$4,065	\$4,354	\$ 492	\$4,089	\$4,378	\$ 626
Commercial other	827	827	14	995	995	24
Agricultural real estate	396	396	102	—	—	—
Residential real estate senior liens	7,662	8,232	1,447	7,816	8,459	1,473
Residential real estate junior liens	23	23	4	44	44	7
Total impaired loans with a valuation allowance	12,973	13,832	2,059	12,944	13,876	2,130
Impaired loans without a valuation allowance						
Commercial real estate	3,701	3,816		1,791	1,865	
Commercial other	1,437	1,481		1,224	1,224	
Agricultural real estate	7,137	7,137		7,913	7,913	
Agricultural other	5,361	5,361		2,685	2,685	
Home equity lines of credit	63	363		79	379	
Consumer secured	11	11		17	17	
Total impaired loans without a valuation allowance	17,710	18,169		13,709	14,083	
Impaired loans						
Commercial	10,030	10,478	506	8,099	8,462	650
Agricultural	12,894	12,894	102	10,598	10,598	—
Residential real estate	7,748	8,618	1,451	7,939	8,882	1,480
Consumer	11	11	—	17	17	—
Total impaired loans	\$30,683	\$32,001	\$ 2,059	\$26,653	\$27,959	\$ 2,130

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

	Three Months Ended June 30			
	2018		2017	
	Average Interest Recorded Income Balance Recognized		Average Interest Recorded Income Balance Recognized	
Impaired loans with a valuation allowance				
Commercial real estate	\$5,006	\$ 13	\$4,641	\$ 84
Commercial other	1,463	15	1,146	23
Agricultural real estate	639	2	—	—
Residential real estate senior liens	7,747	16	8,385	83
Residential real estate junior liens	30	—	77	1
Home equity lines of credit	—	—	35	—
Total impaired loans with a valuation allowance	14,885	46	14,284	191
Impaired loans without a valuation allowance				
Commercial real estate	3,084	12	1,576	19
Commercial other	1,301	2	119	2
Agricultural real estate	7,610	237	5,937	58
Agricultural other	3,933	115	2,401	33
Home equity lines of credit	68	—	126	5
Consumer secured	12	—	22	—
Total impaired loans without a valuation allowance	16,008	366	10,181	117
Impaired loans				
Commercial	10,854	42	7,482	128
Agricultural	12,182	354	8,338	91
Residential real estate	7,845	16	8,623	89
Consumer	12	—	22	—
Total impaired loans	\$30,893	\$ 412	\$24,465	\$ 308

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	Six Months Ended June 30			
	2018		2017	
	Average Interest	Average Interest	Average Interest	Average Interest
	RecordedIncome	RecordedIncome	RecordedIncome	RecordedIncome
	Balance	Recognized	Balance	Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$5,012	\$ 104	\$4,825	\$ 157
Commercial other	1,505	39	1,211	47
Agricultural real estate	540	6	—	—
Agricultural other	—	—	34	—
Residential real estate senior liens	7,785	90	8,403	166
Residential real estate junior liens	35	—	76	1
Home equity lines of credit	—	—	18	—
Total impaired loans with a valuation allowance	14,877	239	14,567	371
Impaired loans without a valuation allowance				
Commercial real estate	2,606	47	1,451	52
Commercial other	1,248	19	117	4
Agricultural real estate	7,804	277	4,990	120
Agricultural other	3,264	151	1,920	46
Home equity lines of credit	72	5	129	10
Consumer secured	13	—	23	—
Total impaired loans without a valuation allowance	15,007	499	8,630	232
Impaired loans				
Commercial	10,371	209	7,604	260
Agricultural	11,608	434	6,944	166
Residential real estate	7,892	95	8,626	177
Consumer	13	—	23	—
Total impaired loans	\$29,884	\$ 738	\$23,197	\$ 603

We had committed to advance \$105 and \$472 in connection with impaired loans, which includes TDRs, as of June 30, 2018 and December 31, 2017, respectively.

**Troubled Debt Restructurings**

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

Typical concessions granted include, but are not limited to:

- Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
- Extending the amortization period beyond typical lending guidelines for loans with similar risk characteristics.
- Agreeing to an interest only payment structure and delaying principal payments.
- Forgiving principal.
- Forgiving accrued interest.

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

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

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The following is a summary of information pertaining to TDRs granted for the:

	Three Months Ended June 30			2017		
	2018			2017		
	Number of Loans	Pre-Modification Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Investment	Post-Modification Recorded Investment
Commercial other	1	\$ 105	\$ 105	1	\$ 86	\$ 86
Agricultural other	13	3,330	3,306	7	5,445	5,445
Residential real estate						
Senior liens	5	327	327	3	255	255
Junior liens	—	—	—	—	—	—
Total residential real estate	5	327	327	3	255	255
Consumer unsecured	—	—	—	—	—	—
Total	19	\$ 3,762	\$ 3,738	11	\$ 5,786	\$ 5,786

	Six Months Ended June 30			2017		
	2018			2017		
	Number of Loans	Pre-Modification Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Investment	Post-Modification Recorded Investment
Commercial other	4	\$ 1,360	\$ 1,360	3	\$ 313	\$ 313
Agricultural other	15	4,391	4,368	7	5,445	5,445
Residential real estate						
Senior liens	7	493	493	3	255	255
Junior liens	—	—	—	1	8	8
Total residential real estate	7	493	493	4	263	263
Consumer unsecured	—	—	—	—	—	—
Total	26	\$ 6,244	\$ 6,221	14	\$ 6,021	\$ 6,021

The following table summarizes concessions we granted to borrowers in financial difficulty for the:

	Three Months Ended June 30			2017		
	2018			2017		
	Number of Loans	Pre-Modification Investment	Below Market Interest Rate and Extension of Amortization Period	Number of Loans	Pre-Modification Investment	Below Market Interest Rate and Extension of Amortization Period
Commercial other	—	\$ —	1 \$ 105	—	\$ —	1 \$ 86
Agricultural other	6	1,770	7 1,560	4	1,349	3 4,096
Residential real estate						
Senior liens	1	56	4 271	—	—	3 255
Junior liens	—	—	— —	—	—	— —
Total residential real estate	1	56	4 271	—	—	3 255
Consumer unsecured	—	—	— —	—	—	— —
Total	7	\$ 1,826	12 \$ 1,936	4	\$ 1,349	7 \$ 4,437

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	Six Months Ended June 30 2018		2017	
	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period
	Number of Loans Investment	Number of Loans Investment	Number of Loans Investment	Number of Loans Investment
Commercial other	1 \$ 174	3 \$ 1,186	— \$ —	3 \$ 313
Agricultural other	7 1,868	8 2,523	4 1,349	3 4,096
Residential real estate				
Senior liens	1 56	6 437	—	3 255
Junior liens	—	—	1 8	—
Total residential real estate	1 56	6 437	1 8	3 255
Consumer unsecured	—	—	—	—
Total	9 \$ 2,098	17 \$ 4,146	5 \$ 1,357	9 \$ 4,664

We did not restructure any loans by forgiving principal or accrued interest in the three and six month periods ended June 30, 2018 or 2017.

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

We had no loans that defaulted in the three and six month periods ended June 30, 2018 and June 30, 2017 which were modified within 12 months prior to the default date.

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

	June 30, 2018	December 31, 2017
TDRs	\$27,801	\$ 26,197

Note 5 – Equity Securities Without Readily Determinable Fair Values

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

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

	June 30 2018	December 31 2017
FHLB Stock	\$13,925	\$ 13,700
Corporate Settlement Solutions, LLC	7,485	7,421
FRB Stock	1,999	1,999
Other	334	334
Total	\$23,743	\$ 23,454

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Note 6 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	June 30, 2018		December 31, 2017	
	Amount	Rate	Amount	Rate
FHLB advances	\$315,000	2.09%	\$290,000	1.94%
Securities sold under agreements to repurchase without stated maturity dates	31,296	0.10%	54,878	0.12%
Federal funds purchased	16,200	2.14%	—	—%
Total	\$362,496	1.92%	\$344,878	1.65%

FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans, specific AFS securities, and FHLB stock.

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

	June 30, 2018		December 31, 2017	
	Amount	Rate	Amount	Rate
Fixed rate due 2018	\$40,000	1.90%	\$70,000	1.96%
Fixed rate due 2019	100,000	1.94%	85,000	1.87%
Fixed rate due 2020	55,000	2.18%	35,000	1.80%
Fixed rate due 2021	50,000	1.91%	50,000	1.91%
Variable rate due 2021 <sup>1</sup>	10,000	2.63%	10,000	1.72%
Fixed rate due 2022	20,000	1.97%	20,000	1.97%
Fixed rate due 2023	20,000	3.36%	10,000	3.90%
Fixed rate due 2024	10,000	2.97%	—	—%
Fixed rate due 2026	10,000	1.17%	10,000	1.17%
Total	\$315,000	2.09%	\$290,000	1.94%

<sup>(1)</sup> Hedged advance (see "Derivative Instruments" section below)

Securities sold under agreements to repurchase are classified as secured borrowings and are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$31,315 and \$54,898 at June 30, 2018 and December 31, 2017, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities. Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following table provides a summary of securities sold under repurchase agreements without stated maturity dates and federal funds purchased. We had no FRB Discount Window advances during the three and six month periods ended June 30, 2018.

	Three Months Ended June 30								
	2018		2017		2018		2017		
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$34,242	\$32,957	0.09%	\$55,731	\$53,841	0.13%	\$55,731	\$53,841	0.13%
Federal funds purchased	16,200	9,199	1.82%	5,965	7,496	1.13%	—	88	1.48%
FRB Discount Window	—	—	—%	—	—	—%	—	—	—%



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	Six Months Ended June 30							
	2018			2017				
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period		
Securities sold under agreements to repurchase without stated maturity dates	\$38,967	\$34,467	0.09 %	\$61,131	\$55,663	0.13 %		
Federal funds purchased	16,200	6,843	1.77 %	27,300	4,197	1.11 %		
FRB Discount Window	—	—	— %	—	44	1.48 %		

We had pledged AFS securities and 1-4 family residential real estate loans in the following amounts at:

	June 30 2018	December 31 2017
Pledged to secure borrowed funds	\$423,968	\$ 410,988
Pledged to secure repurchase agreements	31,315	54,898
Pledged for public deposits and for other purposes necessary or required by law	34,386	27,976
Total	\$489,669	\$ 493,862

AFS securities pledged to repurchase agreements without stated maturity dates consisted of the following at:

	June 30 2018	December 31 2017
States and political subdivisions	\$3,346	\$ 7,332
Mortgage-backed securities	6,537	13,199
Collateralized mortgage obligations	21,432	34,367
Total	\$31,315	\$ 54,898

AFS securities pledged to repurchase agreements are monitored to ensure the appropriate level is collateralized. In the event of maturities, calls, significant principal repayments, or significant decline in market values, we have adequate levels of AFS securities to pledge to satisfy required collateral.

As of June 30, 2018, we had the ability to borrow up to an additional \$112,113, based on assets pledged as collateral. We had no investment securities that were restricted to be pledged for specific purposes.

#### Derivative Instruments

We enter into interest rate swaps to manage exposure to interest rate risk and variability in cash flows. The interest rate swaps, associated with our variable rate borrowings, are designated upon inception as cash flow hedges of forecasted interest payments. We enter into LIBOR-based interest rate swaps that involve the receipt of variable amounts in exchange for fixed rate payments, in effect converting variable rate debt to fixed rate debt.

Cash flow hedges are assessed for effectiveness using regression analysis. The effective portion of changes in fair value are recorded in OCI and subsequently reclassified into interest expense in the same period in which the related interest on the variable rate borrowings affects earnings. In the event that a portion of the changes in fair value were determined to be ineffective, the ineffective amount would be recorded in earnings.

The following tables provide information on derivatives related to variable rate borrowings as of:

	June 30, 2018		Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value
	Pay Rate	Receive Rate				
Derivatives designated as hedging instruments						
Cash Flow Hedges:						
Interest rate swaps	1.56 %	3-Month LIBOR	2.7	\$ 10,000	Other Assets	\$ 444



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	December 31, 2017		Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value
	Pay Rate	Receive Rate				
Derivatives designated as hedging instruments						
Cash Flow Hedges:						
Interest rate swaps	1.56%	3-Month LIBOR	3.3	\$ 10,000	Other Assets	\$ 291

Derivatives contain an element of credit risk which arises from the possibility that we will incur a loss as a result of a counterparty failing to meet its contractual obligations. Credit risk is minimized through counterparty collateral, transaction limits and monitoring procedures. We also manage dealer credit risk by entering into interest rate derivatives only with primary and highly rated counterparties, the use of ISDA master agreements and counterparty limits. We do not anticipate any losses from failure of interest rate derivative counterparties to honor their obligations.

Note 7 – Revenue

Our revenue is comprised primarily of interest income, service charges and fees, gains on the sale of loans and AFS securities, earnings on corporate owned life insurance policies, and other noninterest income. Other noninterest income is typically service and performance driven in nature and comprised primarily of trust and brokerage advisory fees. We recognize revenue, excluding interest income, in accordance with ASC 606, Revenue From Contracts with Customers. Revenue is recognized when our performance obligation has been satisfied according to our contractual obligation.

We record receivables when revenue is unpaid and collectability is reasonably assured. Accounts receivable balances primarily represent amounts due from customers for which revenue has been recognized. Accounts receivable balances are recorded in the consolidated balance sheets in accrued interest receivable and other assets. For the three and six month periods ended June 30, 2018 and 2017, we satisfied our performance obligations pursuant to contracts with customers. As a result, we have not recorded contract assets or liabilities. We estimate no returns or allowances for the three and six month periods ended June 30, 2018 and 2017.

Our contracts with customers define our performance obligations with clearly established pricing which did not require us to allocate or disaggregate revenue by performance obligation. A summary of revenue recognized for each major category of contracts with customers, subject to ASC 606, is as follows for the:

	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
Debit card income	\$621	\$594	\$1,209	\$1,124
Trust service fees	434	500	936	911
Brokerage advisory fees	174	166	330	326
Service charges and fees related to deposit accounts	82	86	167	171
Total	\$1,311	\$1,346	\$2,642	\$2,532

A large portion of our revenue consists of interest income which is not subject to the requirements set forth in ASC 606. This recently adopted guidance required us to review our other noninterest revenue sources within the scope of the guidance to ensure appropriate recognition of revenue from contracts with customers. This review process did not identify significant changes related to revenue recognition. As such, we did not record or disclose transactions related to the adoption of this guidance.

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## Note 8 – Other Noninterest Expenses

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

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2018	2017	2018	2017
Consulting fees	\$359	\$208	\$609	\$413
ATM and debit card fees	234	404	466	620
Audit and related fees	258	237	460	435
Director fees	222	213	431	422
Donations and community relations	210	168	361	298
FDIC insurance premiums	156	155	320	308
Loan underwriting fees	165	192	314	309
Marketing costs	149	100	259	189
Postage and freight	91	110	222	219
Education and travel	101	93	216	189
Printing and supplies	145	103	205	210
All other	637	540	1,163	1,124
Total other	\$2,727	\$2,523	\$5,026	\$4,736

## Note 9 – Federal Income Taxes

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of income before federal income tax expense, which has significantly changed as a result of 2017 Tax Act, is as follows for the:

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2018	2017	2018	2017
Income taxes at statutory rate (21% in 2018 and 34% in 2017)	\$755	\$1,612	\$1,538	\$2,859
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(264 )	(454 )	(538 )	(909 )
Earnings on corporate owned life insurance policies	(38 )	(62 )	(74 )	(123 )
Effect of tax credits	(201 )	(191 )	(401 )	(380 )
Other	(8 )	(18 )	(19 )	(36 )
Total effect of nontaxable income	(511 )	(725 )	(1,032 )	(1,448 )
Effect of nondeductible expenses	19	11	22	19
Federal income tax expense	\$263	\$898	\$528	\$1,430

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Note 10 – Computation of Earnings Per Common Share

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

	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
Average number of common shares outstanding for basic calculation	7,912,377	7,841,822	7,887,967	7,834,523
Average potential effect of common shares in the Directors Plan (1)	173,222	190,528	186,174	191,028
Average number of common shares outstanding used to calculate diluted earnings per common share	8,085,599	8,032,350	8,074,135	8,025,551
Net income	\$3,333	\$ 3,844	\$6,795	\$ 6,980
Earnings per common share				
Basic	\$0.42	\$ 0.49	\$0.86	\$ 0.89
Diluted	\$0.41	\$ 0.48	\$0.84	\$ 0.87

(1) Exclusive of shares held in the Rabbi Trust

Note 11 – Accumulated Other Comprehensive Income

The following table summarizes the changes in AOCI by component for the:

	Three Months Ended June 30 2018				2017			
	Unrealized Holding (Losses) on AFS Securities	Unrealized Gains on Derivative Instruments	Defined Benefit Pension Plan	Total	Unrealized Holding (Losses) on AFS Securities	Unrealized Gains on Derivative Instruments	Defined Benefit Pension Plan	Total
Balance, April 1	\$(5,759)	\$ 326	\$ (3,223 )	\$(8,656 )	\$1,257	\$ 175	\$ (2,972 )	(1,540)
OCI before reclassifications	(1,978 )	31	—	(1,947 )	2,570	(61 )	—	2,509
Amounts reclassified from AOCI	—	—	—	—	(142 )	—	—	(142 )
Subtotal	(1,978 )	31	—	(1,947 )	2,428	(61 )	—	2,367
Tax effect	442	(6 )	—	436	(762 )	21	—	(741 )
OCI, net of tax	(1,536 )	25	—	(1,511 )	1,666	(40 )	—	1,626
Balance, June 30	\$(7,295)	\$ 351	\$ (3,223 )	\$(10,167)	\$2,923	\$ 135	\$ (2,972 )	\$ 86

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	Six Months Ended June 30 2018				2017			
	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total
Balance, January 1	\$391	\$ 230	\$ (3,223 )	\$ (2,602 )	\$30	\$ 164	\$ (2,972 )	\$ (2,778 )
OCI before reclassifications	(10,035 )	153	—	(9,882 )	4,247	(44 )	—	4,203
Amounts reclassified from AOCI	—	—	—	—	(142 )	—	—	(142 )
Subtotal	(10,035 )	153	—	(9,882 )	4,105	(44 )	—	4,061
Tax effect	2,126	(32 )	—	2,094	(1,212 )	15	—	(1,197 )
OCI, net of tax	(7,909 )	121	—	(7,788 )	2,893	(29 )	—	2,864
Adoption of ASU 2016-01	223	—	—	223	—	—	—	—
Balance, June 30	\$(7,295)	\$ 351	\$ (3,223 )	\$(10,167)	\$2,923	\$ 135	\$ (2,972 )	\$86

Included in OCI for the three and six month period ended June 30, 2018 are changes in unrealized holding gains and losses related to auction rate money market preferred stocks. For the three and six month periods ended June 30, 2017, OCI includes changes in unrealized holding gains and losses related to auction rate money market preferred stocks and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

A summary of the components of unrealized holding gains on AFS securities included in OCI follows for the:

	Three Months Ended June 30 2018			2017		
	Auction Rate Money Market Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferred Stocks	All Other AFS Securities	Total
Unrealized gains (losses) arising during the period	\$123	\$(2,101 )	\$(1,978)	\$186	\$ 2,384	\$2,570
Reclassification adjustment for net (gains) losses included in net income	—	—	—	—	(142 )	(142 )
Net unrealized gains (losses)	123	(2,101 )	(1,978 )	186	2,242	2,428
Tax effect	—	442	442	—	(762 )	(762 )
Unrealized gains (losses), net of tax	\$123	\$(1,659 )	\$(1,536)	\$186	\$ 1,480	\$1,666

	Six Months Ended June 30 2018			2017		
	Auction Rate Money Market Preferred Stocks	All Other AFS Securities	Total	Auction Rate Money Market Preferred Stocks	All Other AFS Securities	Total
Unrealized gains (losses) arising during the period	\$123	\$(2,101 )	\$(1,978)	\$186	\$ 2,384	\$2,570
Reclassification adjustment for net (gains) losses included in net income	—	—	—	—	(142 )	(142 )
Net unrealized gains (losses)	123	(2,101 )	(1,978 )	186	2,242	2,428
Tax effect	—	442	442	—	(762 )	(762 )
Unrealized gains (losses), net of tax	\$123	\$(1,659 )	\$(1,536)	\$186	\$ 1,480	\$1,666

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Unrealized gains (losses) arising during the period	\$86	\$(10,121 )	\$(10,035 )	\$541	\$ 3,706	\$4,247
Reclassification adjustment for net (gains) losses included in net income	—	—	\$—	—	(142 )	\$(142 )
Net unrealized gains (losses)	86	(10,121 )	(10,035 )	541	3,564	4,105
Tax effect	—	2,126	2,126	—	(1,212 )	(1,212 )
Unrealized gains (losses), net of tax	\$86	\$(7,995 )	\$(7,909 )	\$541	\$ 2,352	\$2,893

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Note 12 – Fair Value

Under fair value measurement and disclosure authoritative guidance, we group assets and liabilities measured at fair value into three levels, based on the markets in which the assets and liabilities are traded, and the reliability of the assumptions used to determine fair value, based on the prioritization of inputs in the valuation techniques. These levels are:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or

Level 2: similar instruments in markets that are not active and model based valuation techniques for which all significant assumptions are observable in the market.

Valuation is generated from model based techniques that use at least one significant assumption not

Level 3: observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. Transfers between measurement levels are recognized at the end of reporting periods.

Fair value measurement requires the use of an exit price notion which may differ from entrance pricing. Generally we believe our assets and liabilities classified as Level 1 or Level 2 approximate an exit price notion.

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

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

Equity securities, at fair value: Equity securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. The values for Level 1 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

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

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





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The following tables list the quantitative fair value information about impaired loans as of:

June 30, 2018

Valuation Technique	Fair Value	Unobservable Input	Actual Range
		Discount applied to collateral:	
		Real Estate	20% - 30%
		Equipment	20% - 40%
		Cash crop inventory	30% - 40%
Discounted value	\$28,624	Livestock	30%
		Other inventory	50% - 75%
		Accounts receivable	25% - 50%
		Liquor license	75%
		Furniture, fixtures & equipment	35% - 45%

December 31, 2017

Valuation Technique	Fair Value	Unobservable Input	Actual Range
		Discount applied to collateral:	
		Real Estate	20% - 30%
		Equipment	20% - 35%
		Cash crop inventory	30% - 40%
Discounted value	\$15,956	Livestock	30%
		Other inventory	50% - 75%
		Accounts receivable	50%
		Liquor license	75%
		Furniture, fixtures & equipment	35% - 45%

Collateral discount rates may have ranges to accommodate differences in the age of the independent appraisal, broker price opinion, or internal evaluation.

Derivative instruments: Derivative instruments, consisting solely of interest rate swaps, are recorded at fair value on a recurring basis. Derivatives qualifying as cash flow hedges, when highly effective, are reported at fair value in other assets or other liabilities on our Consolidated Balance Sheets with changes in value recorded in OCI. Should the hedge no longer be considered effective, the ineffective portion of the change in fair value is recorded directly in earnings in the period in which the change occurs. The fair value of a derivative is determined by quoted market prices and model based valuation techniques. As such, we classify derivative instruments as Level 2.

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

Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis  
Disclosure of the estimated fair values of financial instruments, which differs from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

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The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis were as follows as of:

	June 30, 2018				
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
<b>ASSETS</b>					
Cash and cash equivalents	\$22,213	\$ 22,213	\$22,213	\$ —	—
Mortgage loans AFS	1,420	1,440	—	1,440	—
Gross loans	1,151,756	1,151,688	—	—	1,151,688
Less allowance for loan and lease losses	8,200	8,200	—	—	8,200
Net loans	1,143,556	1,143,488	—	—	1,143,488
Accrued interest receivable	5,684	5,684	5,684	—	—
Equity securities without readily determinable fair values (1)	23,743	N/A	—	—	—
OMSR	2,398	2,400	—	2,400	—
<b>LIABILITIES</b>					
Deposits without stated maturities	821,442	821,442	821,442	—	—
Deposits with stated maturities	453,320	441,266	—	441,266	—
Borrowed funds	362,496	357,079	—	357,079	—
Accrued interest payable	702	702	702	—	—
<b>December 31, 2017</b>					
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
<b>ASSETS</b>					
Cash and cash equivalents	\$30,848	\$ 30,848	\$30,848	\$ —	—
Mortgage loans AFS	1,560	1,587	—	1,587	—
Gross loans	1,091,519	1,056,906	—	—	1,056,906
Less allowance for loan and lease losses	7,700	7,700	—	—	7,700
Net loans	1,083,819	1,049,206	—	—	1,049,206
Accrued interest receivable	7,063	7,063	7,063	—	—
Equity securities without readily determinable fair values (1)	23,454	N/A	—	—	—
OMSR	2,409	2,409	—	2,409	—
<b>LIABILITIES</b>					
Deposits without stated maturities	811,992	811,992	811,992	—	—
Deposits with stated maturities	453,266	443,892	—	443,892	—
Borrowed funds	344,878	342,089	—	342,089	—
Accrued interest payable	680	680	680	—	—

Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under (1) a specific fair value hierarchy. If we were to record an impairment adjustment related to these securities, such amount would be classified as a nonrecurring Level 3 fair value adjustment.

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## Financial Instruments Recorded at Fair Value

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

	June 30, 2018				December 31, 2017				
	Total	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	
Recurring items									
AFS securities									
Government-sponsored enterprises	\$ 190	\$ —	\$ 190	\$—	\$ 216	\$—	\$ 216	\$—	
States and political subdivisions	202,273	—	202,273	—	208,474	—	208,474	—	
Auction rate money market preferred	3,135	—	3,135	—	3,049	—	3,049	—	
Mortgage-backed securities	197,637	—	197,637	—	208,797	—	208,797	—	
Collateralized mortgage obligations	120,873	—	120,873	—	128,194	—	128,194	—	
Total AFS securities	524,108	—	524,108	—	548,730	—	548,730	—	
Equity securities	—	—	—	—	3,577	3,577	—	—	
Derivative instruments	444	—	444	—	291	—	291	—	
Nonrecurring items									
Impaired loans (net of the ALLL)	28,624	—	—	28,624	15,956	—	—	15,956	
Total	\$ 553,176	\$ —	\$ 524,552	\$ 28,624	\$ 568,554	\$ 3,577	\$ 549,021	\$ 15,956	
Percent of assets and liabilities measured at fair value		—%	94.83	% 5.17	%	0.63	% 96.56	% 2.81	%

Equity securities are recorded at fair value with changes in fair value recognized through earnings on a recurring basis. For the six month period ended June 30, 2018, we recorded a loss of \$41 through earnings. We had no other assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a recurring basis or nonrecurring basis, as of June 30, 2018.

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Interim Condensed Balance Sheets

	June 30 2018	December 31 2017
<b>ASSETS</b>		
Cash on deposit at the Bank	\$3,008	\$ 185
Investments in subsidiaries	140,413	145,962
Premises and equipment	1,902	1,950
Other assets	51,234	52,253
<b>TOTAL ASSETS</b>	<b>\$196,557</b>	<b>\$ 200,350</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$4,608	\$ 5,445
Shareholders' equity	191,949	194,905
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$196,557</b>	<b>\$ 200,350</b>

## Interim Condensed Statements of Income

	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
<b>Income</b>				
Dividends from subsidiaries	\$3,900	\$2,600	\$6,000	\$4,300
Interest income	—	—	—	2
Management fee and other	855	1,691	1,530	3,241
<b>Total income</b>	<b>4,755</b>	<b>4,291</b>	<b>7,530</b>	<b>7,543</b>
<b>Expenses</b>				
Compensation and benefits	1,175	1,118	2,159	2,490
Occupancy and equipment	126	432	249	876
Audit and related fees	104	140	173	264
Other	380	634	774	1,175
<b>Total expenses</b>	<b>1,785</b>	<b>2,324</b>	<b>3,355</b>	<b>4,805</b>
Income before income tax benefit and equity in undistributed earnings of subsidiaries	2,970	1,967	4,175	2,738
Federal income tax benefit	192	212	380	528
Income before equity in undistributed earnings of subsidiaries	3,162	2,179	4,555	3,266
Undistributed earnings of subsidiaries	171	1,665	2,240	3,714
<b>Net income</b>	<b>\$3,333</b>	<b>\$3,844</b>	<b>\$6,795</b>	<b>\$6,980</b>

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## Interim Condensed Statements of Cash Flows

	Six Months Ended June 30	
	2018	2017
Operating activities		
Net income	\$6,795	\$6,980
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(2,240 )	(3,714 )
Undistributed earnings of equity securities without readily determinable fair values	(64 )	93
Share-based payment awards under equity compensation plan	304	302
Depreciation	64	77
Changes in operating assets and liabilities which provided (used) cash		
Other assets	1,084	80
Accrued interest and other liabilities	(837 )	(1,219 )
Net cash provided by (used in) operating activities	5,106	2,599
Investing activities		
Maturities, calls, principal payments, and sales of AFS securities	—	249
Sales (purchases) of premises and equipment	(16 )	(26 )
Net cash provided by (used in) investing activities	(16 )	223
Financing activities		
Cash dividends paid on common stock	(4,096 )	(3,920 )
Proceeds from the issuance of common stock	3,272	3,764
Common stock repurchased	(1,238 )	(2,622 )
Common stock purchased for deferred compensation obligations	(205 )	(197 )
Net cash provided by (used in) financing activities	(2,267 )	(2,975 )
Increase (decrease) in cash and cash equivalents	2,823	(153 )
Cash and cash equivalents at beginning of period	185	1,297
Cash and cash equivalents at end of period	\$3,008	\$1,144

## Note 14 – Operating Segments

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of June 30, 2018 and 2017 and each of the three and six month periods then ended, represent approximately 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(Dollars in thousands except per share amounts)

This section reviews our financial condition and results of our operations for the unaudited three and six month periods ended June 30, 2018 and 2017. This analysis should be read in conjunction with our 2017 Annual Report on Form 10-K and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

Executive Summary

During the three and six months ended June 30, 2018, we reported net income of \$3,333 and \$6,795 and earnings per common share of \$0.42 and \$0.86, respectively. Net income and earnings per common share for the same periods of 2017 were \$3,844 and \$6,980 and \$0.49 and \$0.89, respectively. Interest income for the first six months of 2018 increased when compared to the same period of 2017 as the result of strong loan growth, which totaled \$103,259 during the past 12 months. Net interest income increased by \$1,192 for the first six months of 2018 in comparison to the same period in 2017. Primarily as a result of loan growth, provision for loan losses increased by \$676 for the first six months of 2018 in comparison to the same period in 2017. Noninterest expenses for the first six months of 2018, in comparison to the same period in 2017, increased due to a \$525 settlement during 2017 with an insurance claim administrator in favor of Isabella Bank, increased consulting fees in 2018 related to income tax strategies, and increased costs related to upgrades to technology and network security. Net income in 2018 has benefited from the lower federal statutory tax rate established by the 2017 Tax Act.

As of June 30, 2018, total assets and assets under management were \$1,836,955 and \$2,589,353, respectively, with both increasing from December 31, 2017. Assets under management include loans sold and serviced of \$257,865 and assets managed by our Investment and Trust Services Department of \$494,533, in addition to assets on our consolidated balance sheet. Loans outstanding as of June 30, 2018 totaled \$1,151,756. During the first six months of 2018, gross loans increased \$60,237. This growth was funded through maturities and the receipt of principal payments in the AFS securities portfolio, and growth in total deposits and borrowed funds which increased \$27,122. All regulatory capital ratios for the Bank exceeded the minimum thresholds to be considered a "well capitalized" institution.

Our net yield on interest earning assets (FTE) was 2.95% for the six month period ended June 30, 2018. The FRB increased short-term interest rates during the first and second quarters of 2018 and project further increases in 2018. We anticipate marginal improvement in our net yield on interest earning assets as a result of a combination of projected FRB short-term rate increases, our asset mix shifting to an increasing percentage of loans compared to investment securities, and strategic growth in loans and other income earning assets. We are committed to increasing earnings and shareholder value through growth in our loan portfolio, growth in our investment and trust services, and increasing our geographical presence while managing operating costs.

Recent Legislation

On December 22, 2017, the Tax Cuts and Jobs Act was enacted. The new law establishes a flat corporate federal statutory income tax rate of 21%, a decline from 34%, and eliminates the corporate alternative minimum tax. The new tax law provides for a wide array of changes with only some believed to have a direct impact on our federal income tax expense. Some of these changes include, but are not limited to, the following items: limits to the deductions for net interest expense, immediate expense (for tax purposes) for certain qualified depreciable assets, elimination or reduction of certain deductions related to meals and entertainment expenses, and limits to the deductibility of deposit insurance premiums.

Reclassifications: Certain amounts reported in the 2017 consolidated financial statements have been reclassified to conform to the 2018 presentation.

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## Results of Operations

The following table outlines our quarter-to-date results of operations and provides certain performance measures as of, and for the three month periods ended:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$ 15,713	\$ 15,121	\$ 15,078	\$ 14,976	\$ 14,498	
Interest expense	3,741	3,401	3,435	3,200	3,028	
Net interest income	11,972	11,720	11,643	11,776	11,470	
Provision for loan losses	328	384	168	49	9	
Noninterest income	2,736	2,487	2,710	2,698	2,788	
Noninterest expenses	10,784	10,096	10,628	10,139	9,507	
Federal income tax expense**	263	265	836	750	898	
Net income	\$ 3,333	\$ 3,462	\$ 2,721	\$ 3,536	\$ 3,844	
<b>PER SHARE</b>						
Basic earnings	\$ 0.42	\$ 0.44	\$ 0.35	\$ 0.45	\$ 0.49	
Diluted earnings	\$ 0.41	\$ 0.43	\$ 0.34	\$ 0.44	\$ 0.48	
Dividends	\$ 0.26	\$ 0.26	\$ 0.26	\$ 0.26	\$ 0.25	
Tangible book value*	\$ 19.36	\$ 19.16	\$ 18.96	\$ 18.82	\$ 18.62	
Quoted market value						
High	\$ 27.25	\$ 28.25	\$ 29.95	\$ 29.10	\$ 28.45	
Low	\$ 26.25	\$ 26.11	\$ 27.99	\$ 27.65	\$ 27.60	
Close*	\$ 26.65	\$ 27.40	\$ 28.25	\$ 29.00	\$ 28.00	
Common shares outstanding*	7,933,250	7,894,341	7,857,293	7,856,664	7,862,553	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.74	% 0.77	% 0.61	% 0.79	% 0.87	%
Return on average shareholders' equity	6.89	% 7.11	% 5.48	% 7.11	% 7.85	%
Return on average tangible shareholders' equity	8.75	% 9.23	% 7.33	% 9.61	% 10.59	%
Net interest margin yield (FTE)**	2.95	% 2.95	% 3.02	% 3.08	% 3.03	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$ 1,151,756	\$ 1,093,002	\$ 1,091,519	\$ 1,077,544	\$ 1,048,497	
AFS securities	\$ 524,108	\$ 547,762	\$ 548,730	\$ 549,274	\$ 564,197	
Total assets	\$ 1,836,955	\$ 1,799,592	\$ 1,813,130	\$ 1,791,967	\$ 1,777,298	
Deposits	\$ 1,274,762	\$ 1,297,868	\$ 1,265,258	\$ 1,216,062	\$ 1,210,152	
Borrowed funds	\$ 362,496	\$ 303,113	\$ 344,878	\$ 367,027	\$ 360,940	
Shareholders' equity	\$ 191,949	\$ 191,090	\$ 194,905	\$ 196,463	\$ 195,070	
Gross loans to deposits	90.35	% 84.22	% 86.27	% 88.61	% 86.64	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$ 257,865	\$ 262,541	\$ 266,789	\$ 268,817	\$ 269,595	
Assets managed by our Investment and Trust Services Department	\$ 494,533	\$ 470,578	\$ 478,146	\$ 467,601	\$ 454,294	
Total assets under management	\$ 2,589,353	\$ 2,532,711	\$ 2,558,065	\$ 2,528,385	\$ 2,501,187	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.58	% 0.63	% 0.31	% 0.21	% 0.26	%
Nonperforming assets to total assets	0.37	% 0.40	% 0.20	% 0.14	% 0.17	%
ALLL to gross loans	0.71	% 0.75	% 0.71	% 0.71	% 0.72	%
<b>CAPITAL RATIOS*</b>						
Shareholders' equity to assets	10.45	% 10.62	% 10.75	% 10.96	% 10.98	%



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Tier 1 leverage	8.71	% 8.69	% 8.54	% 8.50	% 8.50	%
Common equity tier 1 capital	12.11	% 12.34	% 12.23	% 12.20	% 12.43	%
Tier 1 risk-based capital	12.11	% 12.34	% 12.23	% 12.20	% 12.43	%
Total risk-based capital	12.76	% 13.01	% 12.86	% 12.84	% 13.07	%

\* At end of period

\*\* Calculations are based on a federal income tax rate of 21% in 2018 and 34% for all other periods.

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The following table outlines our year-to-date results of operations and provides certain performance measures as of, and for the six month periods ended:

	June 30 2018	June 30 2017	June 30 2016	June 30 2015	June 30 2014	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$30,834	\$28,359	\$26,299	\$25,512	\$25,318	
Interest expense	7,142	5,859	5,292	5,006	4,968	
Net interest income	23,692	22,500	21,007	20,506	20,350	
Provision for loan losses	712	36	168	(1,261)	(442)	)
Noninterest income	5,223	5,404	4,975	4,757	4,683	
Noninterest expenses	20,880	19,458	18,298	17,005	17,349	
Federal income tax expense**	528	1,430	1,092	1,748	1,252	
Net income	\$6,795	\$6,980	\$6,424	\$7,771	\$6,874	
<b>PER SHARE</b>						
Basic earnings	\$0.86	\$0.89	\$0.82	\$1.00	\$0.89	
Diluted earnings	\$0.84	\$0.87	\$0.80	\$0.98	\$0.87	
Dividends	\$0.52	\$0.50	\$0.48	\$0.46	\$0.44	
Tangible book value*	\$19.36	\$18.62	\$17.72	\$17.17	\$16.08	
<b>Quoted market value</b>						
High	\$28.25	\$29.00	\$29.90	\$23.80	\$23.94	
Low	\$26.11	\$27.60	\$27.25	\$22.00	\$22.52	
Close*	\$26.65	\$28.00	\$27.90	\$23.75	\$22.95	
Common shares outstanding*	7,933,250	7,862,553	7,836,442	7,797,188	7,735,156	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.75	% 0.80	% 0.77	% 1.00	% 0.91	%
Return on average shareholders' equity	7.00	% 7.21	% 6.71	% 8.69	% 8.24	%
Return on average tangible shareholders' equity	8.92	% 9.67	% 9.37	% 11.71	% 11.17	%
Net interest margin yield (FTE)**	2.95	% 3.01	% 2.97	% 3.15	% 3.21	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$1,151,756	\$1,048,497	\$919,594	\$831,831	\$819,253	
AFS securities	\$524,108	\$564,197	\$602,463	\$595,318	\$550,518	
Total assets	\$1,836,955	\$1,777,298	\$1,680,359	\$1,586,975	\$1,522,135	
Deposits	\$1,274,762	\$1,210,152	\$1,156,870	\$1,090,469	\$1,060,928	
Borrowed funds	\$362,496	\$360,940	\$318,596	\$307,599	\$279,457	
Shareholders' equity	\$191,949	\$195,070	\$195,133	\$178,025	\$171,099	
Gross loans to deposits	90.35	% 86.64	% 79.49	% 76.28	% 77.22	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$257,865	\$269,595	\$275,958	\$289,089	\$290,590	
Assets managed by our Investment and Trust Services Department	\$494,533	\$454,294	\$415,762	\$400,827	\$374,092	
Total assets under management	\$2,589,353	\$2,501,187	\$2,372,079	\$2,276,891	\$2,186,817	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.58	% 0.26	% 0.13	% 0.19	% 0.57	%
Nonperforming assets to total assets	0.37	% 0.17	% 0.09	% 0.15	% 0.38	%
ALLL to gross loans	0.71	% 0.72	% 0.83	% 1.08	% 1.31	%
<b>CAPITAL RATIOS*</b>						
Shareholders' equity to assets	10.45	% 10.98	% 11.61	% 11.22	% 11.24	%
Tier 1 leverage	8.71	% 8.50	% 8.50	% 8.77	% 8.50	%

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Common equity tier 1 capital	12.11	% 12.43	% 13.08	% 13.94	% N/A	
Tier 1 risk-based capital	12.11	% 12.43	% 13.08	% 13.94	% 13.86	%
Total risk-based capital	12.76	% 13.07	% 13.80	% 14.88	% 15.11	%

\* At end of period

\*\* Calculations are based on a federal income tax rate of 21% in 2018 and 34% for all other periods.

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## Average Balances, Interest Rate, and Net Interest Income

The following schedules present the daily average amount outstanding for each major category of interest earning assets, non-earning assets, interest bearing liabilities, and noninterest bearing liabilities. These schedules also present an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a federal income tax rate of 21% in 2018 and 34% in 2017. Loans in nonaccrual status, for the purpose of the following computations, are included in the average loan balances. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

	Three Months Ended								
	June 30, 2018			March 31, 2018			June 30, 2017		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>									
Loans	\$1,114,669	\$12,076	4.33 %	\$1,076,667	\$11,296	4.20 %	\$1,028,875	\$10,685	4.15 %
Taxable investment securities (1)	350,449	2,127	2.43 %	355,867	2,160	2.43 %	374,156	2,226	2.38 %
Nontaxable investment securities	196,773	1,809	3.68 %	197,519	1,892	3.83 %	206,668	2,314	4.48 %
Fed Funds Sold	1	—	— %	—	—	— %	95	—	— %
Other	24,095	179	2.97 %	27,160	283	4.17 %	23,299	174	2.99 %
Total earning assets	1,685,987	16,191	3.84 %	1,657,213	15,631	3.77 %	1,633,093	15,399	3.77 %
<b>NONEARNING ASSETS</b>									
Allowance for loan losses	(8,240 )			(7,771 )			(7,554 )		
Cash and demand deposits due from banks	18,744			19,437			18,425		
Premises and equipment	28,473			28,578			28,895		
Accrued income and other assets	86,441			91,471			99,468		
Total assets	\$1,811,405			\$1,788,928			\$1,772,327		
<b>INTEREST BEARING LIABILITIES</b>									
Interest bearing demand deposits	\$226,309	\$61	0.11 %	\$231,308	\$71	0.12 %	\$209,638	\$55	0.10 %
Savings deposits	363,842	397	0.44 %	354,445	322	0.36 %	360,870	259	0.29 %
Time deposits	465,745	1,772	1.52 %	463,236	1,653	1.43 %	436,716	1,301	1.19 %
Borrowed funds	334,573	1,511	1.81 %	319,789	1,355	1.69 %	356,096	1,413	1.59 %
Total interest bearing liabilities	1,390,469	3,741	1.08 %	1,368,778	3,401	0.99 %	1,363,320	3,028	0.89 %
<b>NONINTEREST BEARING LIABILITIES</b>									
Demand deposits	220,293			217,658			202,597		
Other	7,108			7,793			10,579		

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Shareholders' equity	193,535	194,699	195,831
Total liabilities and shareholders' equity	\$1,811,405	\$1,788,928	\$1,772,327
Net interest income (FTE)	\$ 12,450	\$ 12,230	\$ 12,371
Net yield on interest earning assets (FTE)	2.95 %	2.95 %	3.03 %

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	Six Months Ended					
	June 30, 2018			June 30, 2017		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>						
Loans	\$1,095,773	\$ 23,372	4.27 %	\$1,013,248	\$ 20,805	4.11 %
Taxable investment securities (1)	353,143	4,287	2.43 %	369,231	4,377	2.37 %
Nontaxable investment securities	197,144	3,701	3.75 %	206,023	4,627	4.49 %
Fed Funds Sold	—	—	— %	1,240	4	0.65 %
Other	25,639	462	3.60 %	25,128	345	2.75 %
Total earning assets	1,671,699	31,822	3.81 %	1,614,870	30,158	3.74 %
<b>NONEARNING ASSETS</b>						
Allowance for loan losses	(8,009 )			(7,517 )		
Cash and demand deposits due from banks	19,068			18,551		
Premises and equipment	28,525			29,068		
Accrued income and other assets	88,945			98,588		
Total assets	\$1,800,228			\$1,753,560		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing demand deposits	\$228,794	\$ 132	0.12 %	\$211,616	\$ 108	0.10 %
Savings deposits	359,170	719	0.40 %	357,456	481	0.27 %
Time deposits	464,497	3,425	1.47 %	436,362	2,566	1.18 %
Borrowed funds	327,222	2,866	1.75 %	342,307	2,704	1.58 %
Total interest bearing liabilities	1,379,683	7,142	1.04 %	1,347,741	5,859	0.87 %
<b>NONINTEREST BEARING LIABILITIES</b>						
Demand deposits	218,977			201,613		
Other	7,461			10,707		
Shareholders' equity	194,107			193,499		
Total liabilities and shareholders' equity	\$1,800,228			\$1,753,560		
Net interest income (FTE)		\$ 24,680			\$ 24,299	
Net yield on interest earning assets (FTE)			2.95 %			3.01 %

(1) Includes taxable AFS securities and equity securities

**Net Interest Income**

Net interest income is the amount by which interest income on earning assets exceeds the interest expenses on interest bearing liabilities. Net interest income, which includes loan fees, is influenced by changes in the balance and mix of assets and liabilities and market interest rates. We exert some control over these factors; however, FRB monetary policy and competition have a significant impact. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans, and nontaxable investment securities, thus making year to year comparisons more meaningful.

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Volume and Rate Variance Analysis

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

Volume—change in volume multiplied by the previous period's rate.

Rate—change in the FTE rate multiplied by the previous period's volume.

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

	Three Months Ended June 30, 2018 Compared to March 31, 2018 Increase (Decrease) Due to			Three Months Ended June 30, 2018 Compared to June 30, 2017 Increase (Decrease) Due to			Six Months Ended June 30, 2018 Compared to June 30, 2017 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net	Volume	Rate	Net
Changes in interest income									
Loans	\$405	\$375	\$780	\$916	\$475	\$1,391	\$1,739	\$828	\$2,567
Taxable investment securities	(33 )	—	(33 )	(143 )	44	(99 )	(194 )	104	(90 )
Nontaxable investment securities	(7 )	(76 )	(83 )	(107 )	(398 )	(505 )	(193 )	(733 )	(926 )
Fed Funds Sold	—	—	—	—	—	—	—	(4 )	(4 )
Other	(29 )	(75 )	(104 )	6	(1 )	5	7	110	117
Total changes in interest income	336	224	560	672	120	792	1,359	305	1,664
Changes in interest expense									
Interest bearing demand deposits	(2 )	(8 )	(10 )	4	2	6	9	15	24
Savings deposits	9	66	75	2	136	138	2	236	238
Time deposits	9	110	119	91	380	471	174	685	859
Borrowed funds	64	92	156	(89 )	187	98	(123 )	285	162
Total changes in interest expense	80	260	340	8	705	713	62	1,221	1,283
Net change in interest margin (FTE)	\$256	\$(36)	\$220	\$664	\$(585)	\$79	\$1,297	\$(916)	\$381

Our net yield on interest earning assets remained the same during the quarter with yields remaining at low levels. The persistent low interest rate environment coupled with a high concentration of AFS securities as a percentage of earning assets has also placed pressure on net interest margin. While we do not anticipate significant improvement in our net yield on interest earning assets, we do expect marginal improvement as a result of loan growth throughout 2018.

Average Yield / Rate for the Three Month Periods Ended:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Total earning assets	3.84 %	3.77 %	3.86 %	3.86 %	3.77 %
Total interest bearing liabilities	1.08 %	0.99 %	1.01 %	0.93 %	0.89 %
Net yield on interest earning assets (FTE)	2.95 %	2.95 %	3.02 %	3.08 %	3.03 %

Quarter to Date Net Interest Income (FTE)

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Total interest income (FTE)	\$16,191	\$15,631	\$15,939	\$15,872	\$15,399
Total interest expense	3,741	3,401	3,435	3,200	3,028
Net interest income (FTE)	\$12,450	\$12,230	\$12,504	\$12,672	\$12,371





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## Allowance for Loan and Lease Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans represent our single largest concentration of risk. The ALLL is our estimation of incurred losses within the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment valuation allowances, historical charge-offs, internally assigned credit risk ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a representation of other qualitative risks that reflect the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the:

	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
ALLL at beginning of period	\$8,200	\$7,500	\$7,700	\$7,400
Charge-offs				
Commercial and agricultural	489	25	494	52
Residential real estate	29	—	39	43
Consumer	48	44	136	118
Total charge-offs	566	69	669	213
Recoveries				
Commercial and agricultural	101	55	204	188
Residential real estate	69	63	125	99
Consumer	68	42	128	90
Total recoveries	238	160	457	377
Net loan charge-offs (recoveries)	328	(91 )	212	(164 )
Provision for loan losses	328	9	712	36
ALLL at end of period	\$8,200	\$7,600	\$8,200	\$7,600
Net loan charge-offs (recoveries) to average loans outstanding	0.03 %	(0.01 )%	0.02 %	(0.02 )%

The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the three month periods ended:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Total charge-offs	\$566	\$103	\$401	\$157	\$69
Total recoveries	238	219	233	208	160
Net loan charge-offs (recoveries)	328	(116 )	168	(51 )	(91 )
Net loan charge-offs (recoveries) to average loans outstanding	0.03 %	(0.01 )%	0.02 %	— %	(0.01 )%
Provision for loan losses	\$328	\$384	\$168	\$49	\$9
Provision for loan losses to average loans outstanding	0.03 %	0.04 %	0.02 %	— %	— %
ALLL	\$8,200	\$8,200	\$7,700	\$7,700	\$7,600
ALLL as a % of loans at end of period	0.71 %	0.75 %	0.71 %	0.71 %	0.72 %

During the quarter, we experienced higher levels of charge-offs and experienced deterioration in credit quality indicators. The majority of the charge-offs recognized during the quarter were related to one borrower and are therefore, not indicative of a trend in charge-off activity. As such, the ALLL remained at \$8,200 and we recorded a provision for loan losses of \$328 as result of the loan growth during the quarter. Overall, our levels of required reserve are modest due to strong credit quality indicators, low historical loss factors, and net loan recoveries in recent periods. The ALLL as a percentage of loans has remained consistent with an increase in the balance of the ALLL being a result

of our strong loan growth.

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The following table illustrates our changes within the two main components of the ALLL as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
<b>ALLL</b>					
Individually evaluated for impairment	\$2,059	\$2,503	\$ 2,130	\$ 2,551	\$2,455
Collectively evaluated for impairment	6,141	5,697	5,570	5,149	5,145
<b>Total</b>	<b>\$8,200</b>	<b>\$8,200</b>	<b>\$ 7,700</b>	<b>\$ 7,700</b>	<b>\$7,600</b>
<b>ALLL to gross loans</b>					
Individually evaluated for impairment	0.18 %	0.23 %	0.20 %	0.24 %	0.23 %
Collectively evaluated for impairment	0.53 %	0.52 %	0.51 %	0.47 %	0.49 %
<b>Total</b>	<b>0.71 %</b>	<b>0.75 %</b>	<b>0.71 %</b>	<b>0.71 %</b>	<b>0.72 %</b>

For further discussion of the allocation of the ALLL, see “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Loans Past Due and Loans in Nonaccrual Status**

Fluctuations in past due and nonaccrual status loans can have a significant impact on the ALLL. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due greater than 30 days and nonaccrual status loans. We monitor all loans that are past due and in nonaccrual status for indications of additional deterioration.

	Total Past Due and Nonaccrual Loans				
	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Commercial and agricultural	\$9,980	\$9,398	\$ 4,885	\$ 3,600	\$4,920
Residential real estate	2,452	4,614	4,881	2,201	2,358
Consumer	43	115	70	52	64
<b>Total</b>	<b>\$12,475</b>	<b>\$14,127</b>	<b>\$ 9,836</b>	<b>\$ 5,853</b>	<b>\$7,342</b>
Total past due and nonaccrual loans to gross loans	1.08 %	1.29 %	0.90 %	0.54 %	0.70 %

While past due and nonaccrual status loans have fluctuated over the last year, they continue to reflect strong loan performance. The recent increase resulted primarily from commercial and agricultural loan activity, which is being closely monitored. A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual status loans by type, is included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has permitted certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant level of loans classified as TDR. The modifications have been successful for us and our customers as very few of the modified loans have resulted in foreclosures. At the time of the TDR, the loan is reviewed to determine whether or not to classify the loan as accrual or nonaccrual status. The majority of new modifications result in terms that satisfy our criteria for continued interest accrual. TDRs that have been placed on nonaccrual status may be placed back on accrual status after six months of continued performance and achievement of current payment status.

We restructure debt with borrowers who, due to financial difficulties, are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, allow interest only payment structures, forgive principal, forgive interest, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There were no TDRs that were government sponsored as of June 30, 2018 or December 31, 2017.

Losses associated with TDRs, if any, are included in the estimation of the ALLL in the quarter in which a loan is identified as a TDR, and we review the analysis of the ALLL estimation each reporting period thereafter to ensure its continued appropriateness.



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The following tables provide a roll-forward of TDRs for the:

	Three Months Ended June 30, 2018					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of	of	of	of	of	of
	Loans	Loans	Loans	Loans	Loans	Loans
April 1, 2018	143	\$24,350	15	\$3,190	158	\$27,540
New modifications	15	3,081	4	657	19	3,738
Principal advances (payments)	—	66	—	(483 )	—	(417 )
Loans paid off	(13 )	(3,037 )	(1 )	(23 )	(14 )	(3,060 )
Partial charge-offs	—	—	—	—	—	—
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	—	—	—	—
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	(3 )	(730 )	3	730	—	—
June 30, 2018	142	\$23,730	21	\$4,071	163	\$27,801
	Six Months Ended June 30, 2018					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of	of	of	of	of	of
	Loans	Loans	Loans	Loans	Loans	Loans
January 1, 2018	147	\$23,284	13	\$2,913	160	\$26,197
New modifications	22	5,564	4	657	26	6,221
Principal advances (payments)	—	(321 )	—	(575 )	—	(896 )
Loans paid off	(22 )	(3,698 )	(1 )	(23 )	(23 )	(3,721 )
Partial charge-offs	—	—	—	—	—	—
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	—	—	—	—
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	(5 )	(1,099 )	5	1,099	—	—
June 30, 2018	142	\$23,730	21	\$4,071	163	\$27,801
	Three Months Ended June 30, 2017					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of	of	of	of	of	of
	Loans	Loans	Loans	Loans	Loans	Loans
April 1, 2017	150	\$20,251	6	\$800	156	\$21,051
New modifications	10	5,320	1	466	11	5,786
Principal advances (payments)	—	(113 )	—	(16 )	—	(129 )
Loans paid off	(5 )	(276 )	—	—	(5 )	(276 )
Partial charge-offs	—	—	—	—	—	—
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(2)	(91 )	(2 )	(91 )
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	—	—	—	—	—	—
June 30, 2017	155	\$25,182	5	\$1,159	160	\$26,341



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## Six Months Ended June 30, 2017

	Accruing Interest		Nonaccrual		Total	
	Number of Loans	Balance	Number of Loans	Balance	Number of Loans	Balance
January 1, 2017	153	\$20,593	5	\$789	158	\$21,382
New modifications	13	5,555	1	466	14	6,021
Principal advances (payments)	—	(422 )	—	(22 )	—	(444 )
Loans paid off	(10 )	(527 )	—	—	(10 )	(527 )
Partial charge-offs	—	—	—	—	—	—
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(2)	(91 )	(2 )	(91 )
Transfers to accrual status	1	75	(1)	(75 )	—	—
Transfers to nonaccrual status	(2 )	(92 )	2	92	—	—
June 30, 2017	155	\$25,182	5	\$1,159	160	\$26,341

The following table summarizes our TDRs as of:

	June 30, 2018			December 31, 2017			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$21,999	\$ 2,892	\$24,891	\$21,234	\$ —	\$21,234	\$3,657
Past due 30-59 days	598	57	655	1,778	805	2,583	(1,928 )
Past due 60-89 days	1,008	13	1,021	219	708	927	94
Past due 90 days or more	125	1,109	1,234	53	1,400	1,453	(219 )
Total	\$23,730	\$ 4,071	\$27,801	\$23,284	\$ 2,913	\$26,197	\$1,604

Additional disclosures about TDRs are included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

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## Impaired Loans

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

	June 30, 2018			December 31, 2017		
	Recorded Balance	Unpaid Principal Balance	Valuation Allowance	Recorded Balance	Unpaid Principal Balance	Valuation Allowance
<b>TDRs</b>						
Commercial real estate	\$6,721	\$7,022	\$ 492	\$5,780	\$6,082	\$ 626
Commercial other	1,964	1,964	14	2,219	2,219	24
Agricultural real estate	6,913	6,913	102	7,913	7,913	—
Agricultural other	5,020	5,020	—	2,685	2,685	—
Residential real estate senior liens	7,096	7,458	1,341	7,460	7,839	1,406
Residential real estate junior liens	13	13	2	44	44	7
Home equity lines of credit	63	363	—	79	379	—
Consumer secured	11	11	—	17	17	—
<b>Total TDRs</b>	<b>27,801</b>	<b>28,764</b>	<b>1,951</b>	<b>26,197</b>	<b>27,178</b>	<b>2,063</b>
<b>Other impaired loans</b>						
Commercial real estate	1,045	1,148	—	100	161	—
Commercial other	300	344	—	—	—	—
Agricultural real estate	620	620	—	—	—	—
Agricultural other	341	341	—	—	—	—
Residential real estate senior liens	566	774	106	356	620	67
Residential real estate junior liens	10	10	2	—	—	—
Home equity lines of credit	—	—	—	—	—	—
Consumer secured	—	—	—	—	—	—
<b>Total other impaired loans</b>	<b>2,882</b>	<b>3,237</b>	<b>108</b>	<b>456</b>	<b>781</b>	<b>67</b>
<b>Total impaired loans</b>	<b>\$30,683</b>	<b>\$32,001</b>	<b>\$ 2,059</b>	<b>\$26,653</b>	<b>\$27,959</b>	<b>\$ 2,130</b>

Additional disclosure related to impaired loans is included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Nonaccrual status loans	\$6,492	\$6,237	\$ 3,027	\$ 1,605	\$1,563
Accruing loans past due 90 days or more	154	664	395	646	1,203
<b>Total nonperforming loans</b>	<b>6,646</b>	<b>6,901</b>	<b>3,422</b>	<b>2,251</b>	<b>2,766</b>
Foreclosed assets	167	229	291	240	229
<b>Total nonperforming assets</b>	<b>\$6,813</b>	<b>\$7,130</b>	<b>\$ 3,713</b>	<b>\$ 2,491</b>	<b>\$2,995</b>
Nonperforming loans as a % of total loans	0.58 %	0.63 %	0.31 %	0.21 %	0.26 %
Nonperforming assets as a % of total assets	0.37 %	0.40 %	0.20 %	0.14 %	0.17 %

Typically after a loan is 90 days past due, it is placed on nonaccrual status unless it is well secured and in the process of collection. Upon transferring the loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Loans may be placed back on accrual status after six months of continued performance and achievement of current payment status. While nonperforming loans have increased in recent periods, they remain at low levels.



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Included in the nonaccrual loan balances above were loans currently classified as TDR as of:

	June 30	December 31
	2018	2017
Commercial and agricultural	\$3,489	\$ 2,679
Residential real estate	582	234
Total	\$4,071	\$ 2,913

Additional disclosures about nonaccrual status loans are included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge-off. We believe that we have identified all impaired loans as of June 30, 2018.

We believe that the level of the ALLL is appropriate as of June 30, 2018. We will continue to closely monitor overall credit quality indicators and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains at the appropriate level.

#### Noninterest Income and Noninterest Expenses

Significant noninterest income account balances are highlighted in the following tables with additional descriptions of significant fluctuations:

	Three Months Ended June 30			
	2018	2017	Change	
			\$	%
Service charges and fees				
ATM and debit card fees	\$708	\$675	\$33	4.89 %
NSF and overdraft fees	465	461	4	0.87 %
Freddie Mac servicing fee	163	170	(7 )	(4.12 )%
Service charges on deposit accounts	82	86	(4 )	(4.65 )%
Paper statement fees	63	—	63	— %
Net OMSR income (loss)	(23 )	(17 )	(6 )	(35.29 )%
All other	30	30	—	— %
Total service charges and fees	1,488	1,405	83	5.91 %
Net gain on sale of mortgage loans	87	199	(112 )	(56.28 )%
Earnings on corporate owned life insurance policies	181	183	(2 )	(1.09 )%
Net gains on sale of AFS securities	—	142	(142 )	(100.00)%
Other				
Trust and brokerage advisory fees	738	666	72	10.81 %
Other	242	193	49	25.39 %
Total other	980	859	121	14.09 %
Total noninterest income	\$2,736	\$2,788	\$(52)	(1.87 )%

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	Six Months Ended June 30			
	2018	2017	Change	
			\$	%
Service charges and fees				
ATM and debit card fees	\$1,377	\$1,278	\$99	7.75 %
NSF and overdraft fees	924	902	22	2.44 %
Freddie Mac servicing fee	325	339	(14 )	(4.13 )%
Service charges on deposit accounts	167	171	(4 )	(2.34 )%
Paper statement fees	133	—	133	— %
Net OMSR income (loss)	(11 )	184	(195 )	(105.98)%
All other	61	61	—	— %
Total service charges and fees	2,976	2,935	41	1.40 %
Net gain on sale of mortgage loans	168	354	(186 )	(52.54 )%
Earnings on corporate owned life insurance policies	351	363	(12 )	(3.31 )%
Net gains on sale of AFS securities	—	142	(142 )	(100.00)%
Other				
Trust and brokerage advisory fees	1,396	1,237	159	12.85 %
Other	332	373	(41 )	(10.99 )%
Total other	1,728	1,610	118	7.33 %
Total noninterest income	\$5,223	\$5,404	\$(181)	(3.35 )%

Significant changes in noninterest income are detailed below:

ATM and debit card fees fluctuate from period-to-period based primarily on usage of ATM and debit cards. While we do not anticipate significant changes to our ATM and debit card fee transaction charges, we do expect that fee income will continue to increase in 2018 as the trend of ATM and debit card usage continues to increase.

Paper statement fees were implemented during the third quarter of 2017; therefore, there was no paper statement fee income for the three and six month periods ended June 30, 2017.

OMSR income (loss) results are based on OMSR valuation changes which are driven, in part, by changes in offering rates on residential mortgage loans, prepayments in the servicing-retained portfolio, and volume of loans within the servicing-retained portfolio. OMSR income during the remainder of 2018 will be based on valuation changes and may not exceed 2017 OMSR income based on changes in offering rates.

We anticipate increases in our originations in purchase money mortgage activity as a result of our various initiatives to drive growth. Additionally, we anticipate selling more residential mortgage loan originations as opposed carrying them in our residential real estate portfolio. As a result, we expect net gains on the sale of mortgage loans to increase during the remainder of 2018 but may not exceed 2017 levels.

We are continually analyzing our AFS securities for potential sale opportunities. Securities with unrealized gains and less than desirable yields may be sold for funding and profitability purposes. During 2017, we identified several mortgage-backed securities that were desirable to be sold and recognized gains with these sales. We will continue to analyze our AFS securities portfolio for potential sale opportunities in 2018 and sell AFS securities when appropriate. In recent periods, we have invested considerable efforts to increase our market penetration with investment and trust services. We anticipate that fee income will continue to increase during the remainder of 2018 and exceed 2017 levels.

The fluctuations in all other income are spread throughout various categories, none of which are individually significant.

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Significant noninterest expense account balances are highlighted in the following tables with additional descriptions of significant fluctuations:

	Three Months Ended June 30			
	2018	2017	Change	
			\$	%
Compensation and benefits				
Employee salaries	\$4,077	\$3,961	\$116	2.93 %
Employee benefits	1,602	856	746	87.15 %
Total compensation and benefits	5,679	4,817	862	17.89 %
Furniture and equipment				
Service contracts	533	471	62	13.16 %
Computer expense	458	313	145	46.33 %
Depreciation	512	508	4	0.79 %
All other	68	60	8	13.33 %
Total furniture and equipment	1,571	1,352	219	16.20 %
Occupancy				
Outside services	176	200	(24)	(12.00)%
Depreciation	219	210	9	4.29 %
Utilities	126	115	11	9.57 %
Property taxes	146	146	—	— %
All other	140	144	(4)	(2.78)%
Total occupancy	807	815	(8)	(0.98)%
Other				
Consulting fees	359	208	151	72.60 %
ATM and debit card fees	234	404	(170)	(42.08)%
Director fees	222	213	9	4.23 %
Audit and related fees	258	237	21	8.86 %
FDIC insurance premiums	156	155	1	0.65 %
Donations and community relations	210	168	42	25.00 %
Loan underwriting fees	165	192	(27)	(14.06)%
Printing and supplies	145	103	42	40.78 %
Postage and freight	91	110	(19)	(17.27)%
Education and travel	101	93	8	8.60 %
Marketing costs	149	100	49	49.00 %
All other	637	540	97	17.96 %
Total other	2,727	2,523	204	8.09 %
Total noninterest expenses	\$10,784	\$9,507	\$1,277	13.43 %

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	Six Months Ended June 30				
	2018	2017	Change		
			\$	%	
Compensation and benefits					
Employee salaries	\$8,261	\$8,122	\$139	1.71	%
Employee benefits	2,912	2,252	660	29.31	%
Total compensation and benefits	11,173	10,374	799	7.70	%
Furniture and equipment					
Service contracts	1,039	949	90	9.48	%
Depreciation	1,010	1,020	(10)	(0.98)	%
Computer expense	882	623	259	41.57	%
All other	119	104	15	14.42	%
Total furniture and equipment	3,050	2,696	354	13.13	%
Occupancy					
Depreciation	438	420	18	4.29	%
Outside services	361	399	(38)	(9.52)	%
Utilities	278	258	20	7.75	%
Property taxes	291	292	(1)	(0.34)	%
All other	263	283	(20)	(7.07)	%
Total occupancy	1,631	1,652	(21)	(1.27)	%
Other					
Consulting fees	609	413	196	47.46	%
ATM and debit card fees	466	620	(154)	(24.84)	%
Director fees	431	422	9	2.13	%
Audit and related fees	460	435	25	5.75	%
FDIC insurance premiums	320	308	12	3.90	%
Donations and community relations	361	298	63	21.14	%
Loan underwriting fees	314	309	5	1.62	%
Printing and supplies	205	210	(5)	(2.38)	%
Postage and freight	222	219	3	1.37	%
Education and travel	216	189	27	14.29	%
Marketing costs	259	189	70	37.04	%
All other	1,163	1,124	39	3.47	%
Total other	5,026	4,736	290	6.12	%
Total noninterest expenses	\$20,880	\$19,458	\$1,422	7.31	%

Significant changes in noninterest expenses are detailed below:

- The increase in employee benefits is primarily related to a settlement with an insurance claim administrator in 2017 in favor of Isabella Bank. Additional expenses are related to our pension plan as a result of early distributions. Employee benefits are expected to increase moderately during the remainder of 2018 due to anticipated increases in health care costs and exceed 2017 levels as a result of the settlement.
- Computer expense increased in 2018 due to data and system upgrades, additional network security costs, and one-time implementation costs. Expenses in 2018 are expected to continue to exceed 2017 levels.
- Consulting fees have increased, in part, due to professional services related to income tax strategies. As result, consulting fees are expected to exceed 2017 levels for the remainder of 2018.
- ATM and debit card fees decreased primarily as a result of recognition of an early contract termination fee in the second quarter of 2017. As a result, these expenses in 2018 are not expected to exceed 2017 levels.
- The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.



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## Analysis of Changes in Financial Condition

	June 30 2018	December 31 2017	\$ Change	% Change (unannualized)	
<b>ASSETS</b>					
Cash and cash equivalents	\$22,213	\$ 30,848	\$(8,635 )	(27.99 )	%
AFS securities					
Amortized cost of AFS securities	533,325	547,912	(14,587 )	(2.66 )	%
Unrealized gains (losses) on AFS securities	(9,217 )	818	(10,035 )	N/M	
AFS securities	524,108	548,730	(24,622 )	(4.49 )	%
Equity securities, at fair value	—	3,577	(3,577 )	(100.00 )	%
Mortgage loans AFS	1,420	1,560	(140 )	(8.97 )	%
Loans					
Gross loans	1,151,756	1,091,519	60,237	5.52	%
Less allowance for loan and lease losses	8,200	7,700	500	6.49	%
Net loans	1,143,556	1,083,819	59,737	5.51	%
Premises and equipment	28,267	28,450	(183 )	(0.64 )	%
Corporate owned life insurance policies	27,377	27,026	351	1.30	%
Accrued interest receivable	5,684	7,063	(1,379 )	(19.52 )	%
Equity securities without readily determinable fair values	23,743	23,454	289	1.23	%
Goodwill and other intangible assets	48,497	48,547	(50 )	(0.10 )	%
Other assets	12,090	10,056	2,034	20.23	%
<b>TOTAL ASSETS</b>	<b>\$1,836,955</b>	<b>\$ 1,813,130</b>	<b>\$23,825</b>	<b>1.31</b>	<b>%</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
<b>Liabilities</b>					
Deposits	\$1,274,762	\$ 1,265,258	\$9,504	0.75	%
Borrowed funds	362,496	344,878	17,618	5.11	%
Accrued interest payable and other liabilities	7,748	8,089	(341 )	(4.22 )	%
Total liabilities	1,645,006	1,618,225	26,781	1.65	%
Shareholders' equity	191,949	194,905	(2,956 )	(1.52 )	%
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,836,955</b>	<b>\$ 1,813,130</b>	<b>\$23,825</b>	<b>1.31</b>	<b>%</b>

As shown above, total assets have increased since December 31, 2017. Gross loans increased 5.52% during the first six months of 2018. While generating quality loans in a competitive market continues to be challenging, we expect that loans will continue to grow in 2018 due to efforts to identify new lending opportunities and provide lending to existing customers. During the first six months of 2018, we have experienced deposit growth; however, it was outpaced by loan growth. To fund the loan growth, principal payments and maturities of AFS securities have not been replaced and borrowed funds were increased during 2018.

The following table outlines the changes in loans:

	June 30 2018	December 31 2017	\$ Change	% Change (unannualized)	
Commercial	\$691,623	\$ 634,759	\$56,864	8.96	%
Agricultural	125,249	128,269	(3,020 )	(2.35 )	%
Residential real estate	273,607	272,368	1,239	0.45	%
Consumer	61,277	56,123	5,154	9.18	%
Total	\$1,151,756	\$ 1,091,519	\$60,237	5.52	%

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The following table displays loan balances as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Commercial	\$691,623	\$643,636	\$ 634,759	\$ 620,135	\$600,584
Agricultural	125,249	122,330	128,269	132,998	130,954
Residential real estate	273,607	270,150	272,368	271,480	270,207
Consumer	61,277	56,886	56,123	52,931	46,752
Total	\$1,151,756	\$1,093,002	\$ 1,091,519	\$ 1,077,544	\$1,048,497

While competition for commercial loans continues to be strong, we experienced significant growth in this segment of the portfolio during the last 12 months and anticipate continued growth during the remainder of 2018. Agricultural and residential real estate loans have fluctuated in recent periods and are both expected to grow modestly during the remainder of 2018. Consumer loans have experienced growth over the last year and are expected to continue to increase during the remainder of 2018.

The following table outlines the changes in deposits:

	June 30 2018	December 31 2017	\$ Change	% Change (unannualized)
Noninterest bearing demand deposits	\$234,377	\$ 237,511	\$(3,134)	(1.32)%
Interest bearing demand deposits	222,678	231,666	(8,988)	(3.88)%
Savings deposits	364,387	342,815	21,572	6.29%
Certificates of deposit	340,247	331,718	8,529	2.57%
Brokered certificates of deposit	98,734	102,808	(4,074)	(3.96)%
Internet certificates of deposit	14,339	18,740	(4,401)	(23.48)%
Total	\$1,274,762	\$ 1,265,258	\$9,504	0.75%

The following table displays deposit balances as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Noninterest bearing demand deposits	\$234,377	\$223,798	\$ 237,511	\$ 212,608	\$210,122
Interest bearing demand deposits	222,678	235,965	231,666	220,601	212,365
Savings deposits	364,387	366,045	342,815	358,358	357,756
Certificates of deposit	340,247	338,219	331,718	309,778	314,482
Brokered certificates of deposit	98,734	114,656	102,808	95,979	94,948
Internet certificates of deposit	14,339	19,185	18,740	18,738	20,479
Total	\$1,274,762	\$1,297,868	\$ 1,265,258	\$ 1,216,062	\$1,210,152

Deposit demand declined during the quarter as evidenced in our levels of non-contractual deposits, such as interest bearing demand and savings deposits. Certificates of deposit accounts have experienced marginal growth in recent periods. Brokered certificates of deposit offer another source of funding and fluctuate from period-to-period based on our funding needs.

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The balance of AFS securities fluctuates from period-to-period based on loan demand and deposit growth. While loan growth has been strong over the last year, we have purchased AFS securities in periods when deposit growth outpaced loan demand. Conversely, we have allowed AFS securities to decline through principal payments and maturities and have also sold AFS securities in periods when loan demand has outpaced deposit growth. We remain active in investments with our local schools and municipalities. The following table displays fair values of AFS securities as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
Government sponsored enterprises	\$ 190	\$ 202	\$ 216	\$ 232	\$ 281
States and political subdivisions	202,273	211,633	208,474	213,457	222,093
Auction rate money market preferred	3,135	3,012	3,049	3,172	3,095
Mortgage-backed securities	197,637	206,861	208,797	215,914	221,957
Collateralized mortgage obligations	120,873	126,054	128,194	116,499	116,771
Total	\$524,108	\$547,762	\$ 548,730	\$ 549,274	\$564,197

Borrowed funds include FHLB advances, securities sold under agreements to repurchase, and federal funds purchased. The balance of borrowed funds fluctuates from period-to-period based on our funding needs including changes in loans, investments, and deposits. To provide balance sheet growth, we utilize borrowings and brokered deposits to fund earning assets. The following table displays borrowed funds balances as of:

	June 30 2018	March 31 2018	December 31 2017	September 30 2017	June 30 2017
FHLB advances	\$315,000	\$260,000	\$ 290,000	\$ 310,000	\$310,000
Securities sold under agreements to repurchase without stated maturity dates	31,296	32,913	54,878	54,977	49,950
Federal funds purchased	16,200	10,200	—	2,050	990
Total	\$362,496	\$303,113	\$ 344,878	\$ 367,027	\$360,940

**Contractual Obligations and Loan Commitments**

We are party to credit related financial instruments with off-balance-sheet risk. These financial instruments are entered into in the normal course of business to meet the financing needs of our customers. These financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of involvement we have in a particular class of financial instrument.

The following table summarizes our credit related financial instruments with off-balance-sheet risk as of:

	June 30 2018	December 31 2017
Unfunded commitments under lines of credit	\$ 164,436	\$ 184,317
Commitments to grant loans	45,730	24,782
Commercial and standby letters of credit	1,612	1,622
Total	\$211,778	\$ 210,721

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. These commitments may expire without being drawn upon and do not necessarily represent future cash requirements. Advances to mortgage brokers are also included in unfunded commitments under lines of credit. The unfunded commitment amount is the difference between our outstanding balances and the maximum outstanding aggregate amount.

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if it is deemed necessary, is based on management's credit evaluation of the customer. Commitments to grant loans include residential mortgage loans that may be committed to be sold to the secondary market.

Commercial and standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements, including



commercial paper, bond financing, and similar transactions. These commitments to extend credit and letters of credit generally mature within one year. The credit risk involved in these transactions is essentially the same as that involved in extending loans to customers. We

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evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon the extension of credit, is based on a credit evaluation of the borrower. While we consider standby letters of credit to be guarantees, the amount of the liability related to such guarantees on the commitment date is not significant and a liability related to such guarantees is not recorded on the consolidated balance sheets.

Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are anticipated as a result of these commitments.

**Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income (loss). We are authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 121,437 shares or \$3,272 of common stock during the first six months of 2018, as compared to 135,516 shares or \$3,764 of common stock during the same period in 2017. We also offer the Directors Plan in which participants either directly purchase stock or purchase stock units through deferred fees, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$304 and \$302 during the six month periods ended June 30, 2018 and 2017, respectively.

We have a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 45,480 shares or \$1,238 of common stock during the first six months of 2018 and 94,032 shares or \$2,622 during the first six months of 2017. As of June 30, 2018, we were authorized to repurchase up to an additional 170,191 shares of common stock.

The FRB has established minimum risk based capital guidelines. Pursuant to these guidelines, a framework has been established that assigns risk weights to each category of on and off-balance-sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. On July 2, 2013, the FRB published revised BASEL III Capital standards for banks. The final rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital conservation buffer. The rules, which are being gradually phased in between 2015 and 2019, are not expected to have a material impact on the Corporation but will require us to hold more capital than has historically been required.

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.00%. Our primary capital to adjusted average assets, or tier 1 leverage ratio, was 8.71% as of June 30, 2018.

Effective January 1, 2015, the minimum standard for primary, or Tier 1 capital, increased from 4.00% to 6.00%. The minimum standard for total capital is 8.00%. Also effective January 1, 2015 was the new common equity tier 1 capital ratio which had a minimum requirement of 4.50%. Beginning on January 1, 2016 the capital conservation buffer went into effect which will further increase the required levels each year through 2019. The following table sets forth the percentages required under the Risk Based Capital guidelines and our ratios as of:

	June 30, 2018		December 31, 2017	
	Actual	Minimum Required	Actual	Minimum Required
Common equity tier 1 capital	12.110%	6.375 %	12.230%	5.750 %
Tier 1 capital	12.110%	7.875 %	12.230%	7.250 %
Tier 2 capital	0.650 %	2.000 %	0.630 %	2.000 %
Total Capital	12.760%	9.875 %	12.860%	9.250 %

Tier 2 capital, or secondary capital, includes only the ALLL. The percentage for the secondary capital under the required column is the maximum amount allowed from all sources.

The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At June 30, 2018, the Bank exceeded these minimum capital requirements.



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## Fair Value

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. AFS securities, cash flow hedge derivative instruments and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time-to-time, we may be required to record at fair value other assets on a nonrecurring basis, such as mortgage loans AFS, impaired loans, goodwill, foreclosed assets, OMSR, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

For further information regarding fair value measurements see “Note 12 – Fair Value” of our notes to the interim condensed consolidated financial statements.

## Liquidity

Liquidity is monitored regularly by our Market Risk Committee, which consists of members of senior management. The committee reviews projected cash flows, key ratios, and liquidity available from both primary and secondary sources.

Our primary sources of liquidity are cash and cash equivalents and unencumbered AFS securities. These categories totaled \$256,361 or 13.96% of assets as of June 30, 2018, compared to \$293,188 or 16.17% as of December 31, 2017. The decrease in primary liquidity is a direct result of our unencumbered AFS securities activity during 2018 and 2017. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity could vary significantly daily, based on customer activity.

Our primary source of funds is through deposit accounts. We also have the ability to borrow from the FHLB, the FRB, and through various correspondent banks in the form of federal funds purchased and a line of credit. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB advances, FRB Discount Window advances, and repurchase agreements, require us to pledge assets, typically in the form of AFS securities or loans, as collateral. As of June 30, 2018, we had available lines of credit of \$112,113.

The following table summarizes our sources and uses of cash for the six month period ended June 30:

	2018	2017	\$ Variance
Net cash provided by (used in) operating activities	\$10,945	\$8,687	\$ 2,258
Net cash provided by (used in) investing activities	(44,435 )	(45,130 )	695
Net cash provided by (used in) financing activities	24,855	35,383	(10,528 )
Increase (decrease) in cash and cash equivalents	(8,635 )	(1,060 )	(7,575 )
Cash and cash equivalents January 1	30,848	22,894	7,954
Cash and cash equivalents June 30	\$22,213	\$21,834	\$ 379

## Market Risk

Our primary market risks are interest rate risk and liquidity risk. We have no significant foreign exchange risk in the management of IRR. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on our interest income and cash flows.

IRR is the exposure of our net interest income to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. IRR is the fundamental method by which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to our earnings and capital.

The FRB has adopted a policy requiring us to effectively manage the various risks that can have a material impact on our safety and soundness. The risks include credit, interest rate, liquidity, operational, and reputational. We have policies, procedures, and internal controls for measuring and managing these risks. Specifically, our Funds Management policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to our Board.

The primary technique to measure IRR is simulation analysis. Simulation analysis forecasts the effects on the balance sheet structure and net interest income under a variety of scenarios that incorporate changes in interest rates, the shape of yield

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curves, interest rate relationships, loan prepayments, and changes in funding sources. These forecasts are compared against net interest income projected in a stable interest rate environment. While many assets and liabilities reprice either at maturity or in accordance with their contractual terms, several balance sheet components demonstrate characteristics that require an evaluation to more accurately reflect their repricing behavior. Key assumptions in the simulation analysis include prepayments on loans, probable calls of investment securities, changes in market conditions, loan volumes and loan pricing, deposit sensitivity, and customer preferences. These assumptions are inherently uncertain as they are subject to fluctuation and revision in a dynamic environment. As a result, the simulation analysis cannot precisely forecast the impact of rising and falling interest rates on net interest income. Actual results will differ from simulated results due to many other factors, including changes in balance sheet components, interest rate changes, changes in market conditions, and management strategies.

Our interest rate sensitivity is estimated by first forecasting the next 12 and 24 months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At June 30, 2018, we projected the change in net interest income during the next 12 and 24 months assuming market interest rates were to immediately decrease by 100 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. We did not report scenarios showing 200 basis point decreases in interest rates as this is considered extremely unlikely given current interest rate levels. These projections were based on our assets and liabilities remaining static over the next 12 and 24 months, while factoring in probable calls and prepayments of certain investment securities and residential real estate and consumer loans. While it is extremely unlikely that interest rates would immediately increase to these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our projected net interest income sensitivity to ensure that it remains within established limits. As of June 30, 2018, our interest rate sensitivity results were within Board approved limits.

The following tables summarize our interest rate sensitivity for the next 12 and 24 months as of:

	June 30, 2018					24 Months				
	12 Months					24 Months				
Immediate basis point change assumption (short-term)	-100	+100	+200	+300	+400	-100	+100	+200	+300	+400
Percent change in net interest income vs. constant rates	(2.35)%	1.39%	2.62%	4.70%	5.49%	(2.66)%	1.45%	2.32%	3.79%	2.88%
	December 31, 2017					24 Months				
	12 Months					24 Months				
Immediate basis point change assumption (short-term)	-100	+100	+200	+300	+400	-100	+100	+200	+300	+400
Percent change in net interest income vs. constant rates	(2.43)%	2.36%	4.18%	5.99%	7.94%	(2.29)%	2.61%	4.17%	5.39%	6.09%

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The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of June 30, 2018 and December 31, 2017. The principal amounts of investments, loans, other interest earning assets, borrowings, and time deposits maturing were calculated based on the contractual maturity dates. Estimated cash flows for savings and NOW accounts are based on our estimated deposit decay rates.

	June 30, 2018						Total	Fair Value
	2019	2020	2021	2022	2023	Thereafter		
Rate sensitive assets								
Other interest bearing assets	\$58	\$100	\$—	\$—	\$—	\$—	\$158	\$159
Average interest rates	2.56	% 1.72	% —	% —	% —	% —	% 2.03	%
AFS securities	\$94,232	\$82,429	\$70,077	\$60,782	\$71,837	\$144,751	\$524,108	\$524,108
Average interest rates	2.32	% 2.57	% 2.54	% 2.44	% 2.50	% 2.78	% 2.55	%
Fixed interest rate loans (1)	\$163,208	\$123,885	\$121,901	\$125,638	\$118,530	\$215,090	\$868,252	\$827,882
Average interest rates	4.20	% 4.36	% 4.34	% 4.26	% 4.43	% 4.06	% 4.25	%
Variable interest rate loans (1)	\$99,556	\$24,988	\$33,567	\$29,638	\$19,014	\$76,741	\$283,504	\$276,590
Average interest rates	5.51	% 5.17	% 5.45	% 4.89	% 4.63	% 3.73	% 4.87	%
Rate sensitive liabilities								
Fixed rate borrowed funds	\$152,496	\$75,000	\$25,000	\$50,000	\$30,000	\$20,000	\$352,496	\$347,079
Average interest rates	1.65	% 1.99	% 1.54	% 2.07	% 2.86	% 2.07	% 1.90	%
Variable rate borrowed funds	\$—	\$—	\$10,000	\$—	\$—	\$—	\$10,000	\$10,000
Average interest rates	—	% —	% 2.63	% —	% —	% —	% 2.63	%
Savings and NOW accounts	\$51,470	\$46,568	\$41,765	\$37,492	\$33,688	\$376,082	\$587,065	\$587,065
Average interest rates	0.33	% 0.33	% 0.32	% 0.32	% 0.32	% 0.33	% 0.33	%
Fixed interest rate certificates of deposit	\$228,784	\$76,830	\$49,078	\$43,648	\$32,459	\$15,404	\$446,203	\$434,186
Average interest rates	1.37	% 1.64	% 1.70	% 1.81	% 1.92	% 2.00	% 1.56	%
Variable interest rate certificates of deposit	\$3,129	\$3,988	\$—	\$—	\$—	\$—	\$7,117	\$7,080
Average interest rates	1.88	% 2.23	% —	% —	% —	% —	% 2.07	%





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	December 31, 2017							Fair Value
	2018	2019	2020	2021	2022	Thereafter	Total	
Rate sensitive assets								
Other interest bearing assets	\$5,481	\$—	\$100	\$—	\$—	\$—	\$5,581	\$5,581
Average interest rates	1.65	% —	% 0.35	% —	% —	% —	% 1.63	%
AFS securities	\$95,000	\$72,551	\$71,591	\$68,127	\$60,607	\$180,854	\$548,730	\$548,730
Average interest rates	2.33	% 2.46	% 2.59	% 2.58	% 2.38	% 2.56	% 2.49	%
Equity securities	\$—	\$—	\$—	\$—	\$—	\$3,577	\$3,577	\$3,577
Average interest rates	—	% —	% —	% —	% —	% 4.00	% 4.00	%
Fixed interest rate loans (1)	\$153,100	\$118,068	\$114,872	\$129,992	\$116,779	\$222,971	\$855,782	\$825,855
Average interest rates	4.12	% 4.34	% 4.24	% 4.16	% 4.34	% 4.01	% 4.17	%
Variable interest rate loans (1)	\$70,738	\$35,473	\$27,164	\$25,494	\$20,158	\$56,710	\$235,737	\$231,051
Average interest rates	5.48	% 4.79	% 4.91	% 4.43	% 4.39	% 3.72	% 4.68	%
Rate sensitive liabilities								
Fixed rate borrowed funds	\$124,878	\$85,000	\$35,000	\$50,000	\$20,000	\$20,000	\$334,878	\$332,146
Average interest rates	1.15	% 1.87	% 1.80	% 1.91	% 1.97	% 2.54	% 1.65	%
Variable rate borrowed funds	\$—	\$—	\$—	\$10,000	\$—	\$—	\$10,000	\$9,943
Average interest rates	—	% —	% —	% 1.72	% —	% —	% 1.72	%
Savings and NOW accounts	\$49,140	\$44,096	\$39,607	\$35,611	\$32,051	\$373,976	\$574,481	\$574,481
Average interest rates	0.22	% 0.22	% 0.22	% 0.22	% 0.21	% 0.27	% 0.25	%
Fixed interest rate certificates of deposit	\$188,598	\$109,047	\$37,604	\$50,814	\$38,843	\$21,840	\$446,746	\$437,400
Average interest rates	1.05	% 1.57	% 1.62	% 1.76	% 1.85	% 2.05	% 1.42	%
Variable interest rate certificates of deposit	\$2,414	\$4,106	\$—	\$—	\$—	\$—	\$6,520	\$6,492
Average interest rates	1.40	% 1.66	% —	% —	% —	% —	% 1.56	%

(1) The fair value reported is exclusive of the allocation of the ALLL.

We do not believe that there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. As of the date of this report, we do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term and we do not expect to make material changes in those methods used to measure and assess market risk in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The information presented in the section captioned “Market Risk” in Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 4. Controls and Procedures.

#### DISCLOSURE CONTROLS AND PROCEDURES

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of June 30, 2018, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of June 30, 2018, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

#### CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

During the most recent fiscal quarter, no change occurred in our internal control over financial reporting that materially affected, or is likely to materially affect, our internal control over financial reporting.

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## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings.

We are not involved in any material legal proceedings. We are involved in ordinary, routine litigation incidental to our business; however, no such routine proceedings are expected to result in any material adverse effect on operations, earnings, financial condition, or cash flows.

## Item 1A. Risk Factors.

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2017.

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

(A) None

(B) None

## (C) Repurchases of Common Stock

We have adopted and publicly announced a common stock repurchase plan. The plan was last amended on December 20, 2017, to allow for the repurchase of an additional 200,000 shares of common stock after that date. These authorizations do not have expiration dates. As common shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued common shares.

The following table provides information for the three month period ended June 30, 2018, with respect to this plan:

	Common Shares Repurchased	Average Price Number Per Common Share	Total Number of Common Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Common Shares That May Yet Be Purchased Under the Plans or Programs
Balance, March 31				193,159
April 1 - 30	9,223	\$ 27.00	9,223	183,936
May 1 - 31	7,201	26.94	7,201	176,735
June 1 - 30	6,544	26.74	6,544	170,191
Balance, June 30	22,968	\$ 26.91	22,968	170,191

## Item 3. Defaults Upon Senior Securities.

Not applicable.

## Item 4. Mine Safety Disclosures.

Not applicable.

## Item 5. Other Information.

Not applicable.

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Item 6. Exhibits.

(a) Exhibits

Exhibit Number	Exhibits
<u>31(a)</u>	<u>Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer</u>
<u>31(b)</u>	<u>Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer</u>
<u>32</u>	<u>Section 1350 Certification of Principal Executive Officer and Principal Financial Officer</u>
101.1*	101.INS (XBRL Instance Document)
	101.SCH (XBRL Taxonomy Extension Schema Document)
	101.CAL (XBRL Calculation Linkbase Document)
	101.LAB (XBRL Taxonomy Label Linkbase Document)
	101.DEF (XBRL Taxonomy Linkbase Document)
	101.PRE (XBRL Taxonomy Presentation Linkbase Document)

In accordance with Rule 406T of Regulations S-T, the XBRL related information shall not be deemed to be “filed” for \*purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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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.

Isabella Bank Corporation

Date: August 6, 2018 /s/ Jae A. Evans  
Jae A. Evans  
President, Chief Executive Officer  
(Principal Executive Officer)

Date: August 6, 2018 /s/ Neil M. McDonnell  
Neil M. McDonnell  
Chief Financial Officer  
(Principal Financial Officer)