

Edgar Filing: ISABELLA BANK Corp - Form 10-Q

ISABELLA BANK Corp  
Form 10-Q  
August 04, 2017  
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, 2017

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 7,884,003 as of August 2, 2017.

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Table of Contents

ISABELLA BANK CORPORATION  
QUARTERLY REPORT ON FORM 10-Q  
Table of Contents

|                                       |  |           |
|---------------------------------------|--|-----------|
| <u>PART I – FINANCIAL INFORMATION</u> |  | <u>4</u>  |
| Item 1.                               | <u>Financial Statements</u>  | <u>4</u>  |
| Item 2.                               | <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>39</u> |
| Item 3.                               | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | <u>62</u> |
| Item 4.                               | <u>Controls and Procedures</u>   | <u>62</u> |
| <u>PART II – OTHER INFORMATION</u>    |  | <u>63</u> |
| Item 1.                               | <u>Legal Proceedings</u>   | <u>63</u> |
| Item 1A.                              | <u>Risk Factors</u>  | <u>63</u> |
| Item 2.                               | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | <u>63</u> |
| Item 3.                               | <u>Defaults Upon Senior Securities</u>   | <u>63</u> |
| Item 4.                               | <u>Mine Safety Disclosures</u>   | <u>63</u> |
| Item 5.                               | <u>Other Information</u>   | <u>63</u> |
| Item 6.                               | <u>Exhibits</u>  | <u>64</u> |
| <u>SIGNATURES</u>                     |  | <u>65</u> |

Table of Contents

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 Section 21E of the Securities Exchange Act of 1934, as amended. 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” and 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, 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, 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                  |
| CFPB: Consumer Financial Protection Bureau  | N/A: Not applicable                                   |
| CIK: Central Index Key  | N/M: Not meaningful                                   |
| CRA: Community Reinvestment Act   | NASDAQ: NASDAQ Stock Market Index                     |
| DIF: Deposit Insurance Fund   | NASDAQ Banks: NASDAQ Bank Stock Index                 |
| DIFS: Department of Insurance and Financial Services  | NAV: Net asset value                                  |
| Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors                      | NOW: Negotiable order of withdrawal                   |
| Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan | NSF: Non-sufficient funds                             |
| Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010   | OCI: Other comprehensive income (loss)                |
| ESOP: Employee Stock Ownership Plan   | OMSR: Originated mortgage servicing rights            |
| Exchange Act: Securities Exchange Act of 1934   | OREO: Other real estate owned                         |
| FASB: Financial Accounting Standards Board  | OTTI: Other-than-temporary impairment                 |
| FDI Act: Federal Deposit Insurance Act  | PBO: Projected benefit obligation                     |

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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 & Exchange Commission

SOX: Sarbanes-Oxley Act of 2002

TDR: Troubled debt restructuring

XBRL: eXtensible Business Reporting Language

Table of Contents

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

## INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

|  | June 30<br>2017     | December 31<br>2016 |
|--|---------------------|---------------------|
| <b>ASSETS</b>  |                     |                     |
| Cash and cash equivalents  |                     |                     |
| Cash and demand deposits due from banks  | \$21,485            | \$ 20,167           |
| Interest bearing balances due from banks   | 349                 | 2,727               |
| Total cash and cash equivalents  | 21,834              | 22,894              |
| AFS securities (amortized cost of \$563,309 in 2017 and \$557,648 in 2016)   | 567,862             | 558,096             |
| Mortgage loans AFS   | 1,482               | 1,816               |
| Loans  |                     |                     |
| Commercial   | 600,584             | 575,664             |
| Agricultural   | 130,954             | 126,492             |
| Residential real estate  | 270,207             | 266,050             |
| Consumer   | 46,752              | 42,409              |
| Gross loans  | 1,048,497           | 1,010,615           |
| Less allowance for loan and lease losses   | 7,600               | 7,400               |
| Net loans  | 1,040,897           | 1,003,215           |
| Premises and equipment   | 28,679              | 29,314              |
| Corporate owned life insurance policies  | 26,663              | 26,300              |
| Accrued interest receivable  | 5,686               | 6,580               |
| Equity securities without readily determinable fair values   | 23,401              | 21,694              |
| Goodwill and other intangible assets   | 48,604              | 48,666              |
| Other assets   | 12,190              | 13,576              |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,777,298</b> | <b>\$ 1,732,151</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                     |                     |
| <b>Deposits</b>  |                     |                     |
| Noninterest bearing  | \$210,122           | \$ 205,071          |
| NOW accounts   | 212,365             | 209,325             |
| Certificates of deposit under \$250 and other savings  | 725,748             | 717,078             |
| Certificates of deposit over \$250   | 61,917              | 63,566              |
| Total deposits   | 1,210,152           | 1,195,040           |
| Borrowed funds   | 360,940             | 337,694             |
| Accrued interest payable and other liabilities   | 11,136              | 11,518              |
| Total liabilities  | 1,582,228           | 1,544,252           |
| <b>Shareholders' equity</b>  |                     |                     |
| Common stock — no par value 15,000,000 shares authorized; issued and outstanding<br>7,862,553 shares (including 23,925 shares held in the Rabbi Trust) in 2017 and 7,821,069<br>shares (including 26,042 shares held in the Rabbi Trust) in 2016 | 140,646             | 139,525             |
| Shares to be issued for deferred compensation obligations  | 5,164               | 5,038               |
| Retained earnings  | 49,174              | 46,114              |
| Accumulated other comprehensive income (loss)  | 86                  | (2,778)             |
| Total shareholders' equity   | 195,070             | 187,899             |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 1,777,298</b> | <b>\$ 1,732,151</b> |

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

4

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Table of Contents

## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands except per share amounts)

|   | Three Months |         | Six Months |          |
|---|--------------|---------|------------|----------|
|   | Ended        |         | Ended      |          |
|   | June 30      |         | June 30    |          |
|   | 2017         | 2016    | 2017       | 2016     |
| Interest income                                     |              |         |            |          |
| Loans, including fees                               | \$10,685     | \$9,317 | \$20,805   | \$18,355 |
| AFS securities                                      |              |         |            |          |
| Taxable   | 2,226        | 2,303   | 4,377      | 4,703    |
| Nontaxable  | 1,413        | 1,441   | 2,828      | 2,926    |
| Federal funds sold and other                        | 174          | 157     | 349        | 315      |
| Total interest income                               | 14,498       | 13,218  | 28,359     | 26,299   |
| Interest expense                                    |              |         |            |          |
| Deposits  | 1,615        | 1,418   | 3,155      | 2,817    |
| Borrowings  | 1,413        | 1,260   | 2,704      | 2,475    |
| Total interest expense                              | 3,028        | 2,678   | 5,859      | 5,292    |
| Net interest income                                 | 11,470       | 10,540  | 22,500     | 21,007   |
| Provision for loan losses                           | 9            | 12      | 36         | 168      |
| Net interest income after provision for loan losses | 11,461       | 10,528  | 22,464     | 20,839   |
| Noninterest income                                  |              |         |            |          |
| Service charges and fees                            | 1,405        | 1,163   | 2,935      | 2,376    |
| Net gain on sale of mortgage loans                  | 199          | 127     | 354        | 209      |
| Earnings on corporate owned life insurance policies | 183          | 195     | 363        | 383      |
| Net gains on sale of AFS securities                 | 142          | 245     | 142        | 245      |
| Other   | 859          | 1,022   | 1,610      | 1,762    |
| Total noninterest income                            | 2,788        | 2,752   | 5,404      | 4,975    |
| Noninterest expenses                                |              |         |            |          |
| Compensation and benefits                           | 4,833        | 4,684   | 10,509     | 9,472    |
| Furniture and equipment                             | 1,352        | 1,340   | 2,696      | 2,635    |
| Occupancy   | 815          | 788     | 1,652      | 1,598    |
| Other   | 2,507        | 2,406   | 4,601      | 4,593    |
| Total noninterest expenses                          | 9,507        | 9,218   | 19,458     | 18,298   |
| Income before federal income tax expense            | 4,742        | 4,062   | 8,410      | 7,516    |
| Federal income tax expense                          | 898          | 655     | 1,430      | 1,092    |
| NET INCOME  | \$3,844      | \$3,407 | \$6,980    | \$6,424  |
| Earnings per common share                           |              |         |            |          |
| Basic   | \$0.49       | \$0.44  | \$0.89     | \$0.82   |
| Diluted   | \$0.48       | \$0.43  | \$0.87     | \$0.80   |
| Cash dividends per common share                     | \$0.25       | \$0.24  | \$0.50     | \$0.48   |

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





Table of ContentsINTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)  
(Dollars in thousands)

|  | Three Months |          | Six Months |          |
|--|--------------|----------|------------|----------|
|  | Ended        |          | Ended      |          |
|  | June 30      |          | June 30    |          |
|  | 2017         | 2016     | 2017       | 2016     |
| Net income   | \$3,844      | \$3,407  | \$6,980    | \$6,424  |
| Unrealized gains (losses) on AFS securities  |              |          |            |          |
| Unrealized gains (losses) on AFS securities arising during the period              | 2,570        | 4,067    | 4,247      | 11,341   |
| Reclassification adjustment for net realized (gains) losses included in net income | (142 )       | (245 )   | (142 )     | (245 )   |
| Tax effect (1)   | (762 )       | (1,173 ) | (1,212 )   | (3,650 ) |
| Unrealized gains (losses) on AFS securities, net of tax                            | 1,666        | 2,649    | 2,893      | 7,446    |
| Unrealized gains (losses) on derivative instruments arising during the period      | (61 )        | (152 )   | (44 )      | (152 )   |
| Tax effect (1)   | 21           | 52       | 15         | 52       |
| Unrealized gains (losses) on derivative instruments, net of tax                    | (40 )        | (100 )   | (29 )      | (100 )   |
| Other comprehensive income, net of tax   | 1,626        | 2,549    | 2,864      | 7,346    |
| Comprehensive income   | \$5,470      | \$5,956  | \$9,844    | \$13,770 |

(1) See "Note 12 – Accumulated Other Comprehensive Income" for tax effect reconciliation.

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

Table of ContentsINTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)

(Dollars in thousands except per share amounts)

|  | Common Stock                    |           | Common<br>Shares to be<br>Issued for<br>Deferred<br>Compensation<br>Obligations | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Totals    |
|--|---------------------------------|-----------|---|----------------------|---|-----------|
|  | Common<br>Shares<br>Outstanding | Amount    |   |                      |   |           |
| Balance, January 1, 2016   | 7,799,867                       | \$139,198 | \$ 4,592  | \$39,960             | \$ 221  | \$183,971 |
| Comprehensive income (loss)  | —                               | —         | —   | 6,424                | 7,346   | 13,770    |
| Issuance of common stock   | 88,486                          | 2,489     | —   | —                    | —   | 2,489     |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations | —                               | 127       | (127 )  | —                    | —   | —         |
| Share-based payment awards under equity compensation plan                                  | —                               | —         | 273   | —                    | —   | 273       |
| Common stock purchased for deferred compensation obligations                               | —                               | (164 )    | —   | —                    | —   | (164 )    |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (51,911 )                       | (1,462 )  | —   | —                    | —   | (1,462 )  |
| Cash dividends paid (\$0.48 per common share)  | —                               | —         | —   | (3,744 )             | —   | (3,744 )  |
| Balance, June 30, 2016   | 7,836,442                       | \$140,188 | \$ 4,738  | \$42,640             | \$ 7,567  | \$195,133 |
| 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 |

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

7

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Table of Contents

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

(Dollars in thousands)

|   | Six Months<br>Ended<br>June 30 |          |
|---|--------------------------------|----------|
|   | 2017                           | 2016     |
| <b>OPERATING ACTIVITIES</b>   |                                |          |
| Net income  | \$6,980                        | \$6,424  |
| Reconciliation of net income to net cash provided by operating activities:  |                                |          |
| Provision for loan losses   | 36                             | 168      |
| Impairment of foreclosed assets   | 28                             | —        |
| Depreciation  | 1,440                          | 1,438    |
| Amortization of OMSR  | 170                            | 165      |
| Amortization of acquisition intangibles                                     | 62                             | 87       |
| Net amortization of AFS securities  | 1,062                          | 1,427    |
| Net (gains) losses on sale of AFS securities                                | (142 )                         | (245 )   |
| Net gain on sale of mortgage loans  | (354 )                         | (209 )   |
| Increase in cash value of corporate owned life insurance policies           | (363 )                         | (383 )   |
| Share-based payment awards under equity compensation plan                   | 302                            | 273      |
| Origination of loans held-for-sale  | (19,081)                       | (10,810) |
| Proceeds from loan sales  | 19,769                         | 10,925   |
| Net changes in operating assets and liabilities which provided (used) cash: |                                |          |
| Accrued interest receivable   | 894                            | 478      |
| Other assets  | (1,734 )                       | (667 )   |
| Accrued interest payable and other liabilities                              | (382 )                         | (238 )   |
| Net cash provided by (used in) operating activities                         | 8,687                          | 8,833    |
| <b>INVESTING ACTIVITIES</b>   |                                |          |
| Activity in AFS securities  |                                |          |
| Sales   | 12,827                         | 35,664   |
| Maturities, calls, and principal payments                                   | 45,021                         | 58,145   |
| Purchases   | (64,429)                       | (26,222) |
| Net loan principal (originations) collections                               | (37,842)                       | (69,186) |
| Proceeds from sales of foreclosed assets                                    | 98                             | 288      |
| Purchases of premises and equipment   | (805 )                         | (1,351 ) |
| Proceeds from redemption of corporate owned life insurance policies         | —                              | 1,004    |
| Net cash provided by (used in) investing activities                         | (45,130)                       | (1,658 ) |

Table of Contents

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

(Dollars in thousands)

|  | Six Months Ended |           |
|--|------------------|-----------|
|  | June 30          |           |
|  | 2017             | 2016      |
| <b>FINANCING ACTIVITIES</b>                                  |                  |           |
| Net increase (decrease) in deposits                          | \$15,112         | \$(7,693) |
| Net increase (decrease) in borrowed funds                    | 23,246           | 8,864     |
| Cash dividends paid on common stock                          | (3,920)          | (3,744)   |
| Proceeds from issuance of common stock                       | 3,764            | 2,489     |
| Common stock repurchased                                     | (2,622)          | (1,462)   |
| Common stock purchased for deferred compensation obligations | (197)            | (164)     |
| Net cash provided by (used in) financing activities          | 35,383           | (1,710)   |
| Increase (decrease) in cash and cash equivalents             | (1,060)          | 5,465     |
| Cash and cash equivalents at beginning of period             | 22,894           | 21,569    |
| Cash and cash equivalents at end of period                   | \$21,834         | \$27,034  |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                  |                  |           |
| Interest paid  | \$5,872          | \$5,286   |
| Income taxes paid  | \$1,630          | \$600     |
| <b>SUPPLEMENTAL NONCASH INFORMATION:</b>                     |                  |           |
| Transfers of loans to foreclosed assets                      | \$124            | \$116     |

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

Table of Contents

## 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" refer 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, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2016.

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, 2016.

Reclassifications: Certain amounts reported in the interim 2016 consolidated financial statements have been reclassified to conform with the 2017 presentation.

## Note 2 – 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<br>Ended<br>June 30 |           | Six Months<br>Ended<br>June 30 |           |
|---|----------------------------------|-----------|--------------------------------|-----------|
|   | 2017                             | 2016      | 2017                           | 2016      |
| Average number of common shares outstanding for basic calculation                               | 7,841,822                        | 7,819,080 | 7,834,523                      | 7,807,187 |
| Average potential effect of common shares in the Directors Plan (1)                             | 190,528                          | 183,842   | 191,028                        | 184,152   |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 8,032,350                        | 8,002,922 | 8,025,551                      | 7,991,339 |
| Net income  | \$3,844                          | \$ 3,407  | \$6,980                        | \$ 6,424  |
| Earnings per common share   |                                  |           |                                |           |
| Basic   | \$0.49                           | \$ 0.44   | \$0.89                         | \$ 0.82   |
| Diluted   | \$0.48                           | \$ 0.43   | \$0.87                         | \$ 0.80   |

(1) Exclusive of shares held in the Rabbi Trust

## Note 3 – Accounting Standards Updates

## Pending Accounting Standards Updates

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

In May 2017, ASU No. 2017-09 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 updated. 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.





Table of Contents

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 is not expected to have a significant impact on our operating results or financial statement disclosures.

## Note 4 – AFS Securities

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

June 30, 2017

|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Government sponsored enterprises    | \$280             | \$ 1                         | \$ —                          | \$281         |
| States and political subdivisions   | 215,999           | 6,121                        | 27                            | 222,093       |
| Auction rate money market preferred | 3,200             | —                            | 105                           | 3,095         |
| Preferred stocks                    | 3,800             | —                            | 135                           | 3,665         |
| Mortgage-backed securities          | 223,225           | 701                          | 1,969                         | 221,957       |
| Collateralized mortgage obligations | 116,805           | 705                          | 739                           | 116,771       |
| Total                               | \$563,309         | \$ 7,528                     | \$ 2,975                      | \$567,862     |

December 31, 2016

|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Government sponsored enterprises    | \$10,258          | \$ 3                         | \$ 2                          | \$10,259      |
| States and political subdivisions   | 208,977           | 4,262                        | 320                           | 212,919       |
| Auction rate money market preferred | 3,200             | —                            | 406                           | 2,794         |
| Preferred stocks                    | 3,800             | —                            | 375                           | 3,425         |
| Mortgage-backed securities          | 229,593           | 581                          | 2,918                         | 227,256       |
| Collateralized mortgage obligations | 101,820           | 600                          | 977                           | 101,443       |
| Total                               | \$557,648         | \$ 5,446                     | \$ 4,998                      | \$558,096     |

The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2017 are as follows:

Maturing

|                                     | Due in<br>One<br>Year<br>or Less | After One<br>Year But<br>Within<br>Five Years | After<br>Five<br>Years<br>But<br>Within<br>Ten<br>Years | After<br>Ten Years | Securities with<br>Variable<br>Monthly<br>Payments or<br>Noncontractual<br>Maturities | Total     |
|-------------------------------------|----------------------------------|---|---|--------------------|---|-----------|
| Government sponsored enterprises    | \$32                             | \$ 248  | \$—   | \$ —               | \$ —  | \$280     |
| States and political subdivisions   | 32,000                           | 74,710  | 76,716  | 32,573             | —   | 215,999   |
| Auction rate money market preferred | —                                | —   | —   | —                  | 3,200   | 3,200     |
| Preferred stocks                    | —                                | —   | —   | —                  | 3,800   | 3,800     |
| Mortgage-backed securities          | —                                | —   | —   | —                  | 223,225   | 223,225   |
| Collateralized mortgage obligations | —                                | —   | —   | —                  | 116,805   | 116,805   |
| Total amortized cost                | \$32,032                         | \$ 74,958                                     | \$76,716  | \$ 32,573          | \$ 347,030  | \$563,309 |
| Fair value                          | \$32,105                         | \$ 77,118                                     | \$79,668  | \$ 33,483          | \$ 345,488  | \$567,862 |

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.



Table of Contents

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

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

|   | Three Months<br>Ended June 30<br>2017 |          | Six Months<br>Ended June 30<br>2016 |          |
|---|---------------------------------------|----------|-------------------------------------|----------|
| Proceeds from sales of AFS securities   | \$12,827                              | \$35,664 | \$12,827                            | \$35,664 |
| Gross realized gains (losses)           | \$142                                 | \$245    | \$142                               | \$245    |
| Applicable income tax expense (benefit) | \$48                                  | \$83     | \$48                                | \$83     |

The following information pertains to AFS securities with gross unrealized losses at June 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position.

|  | June 30, 2017                 |                       | December 31, 2016             |                       | Total<br>Unrealized<br>Losses |
|--|-------------------------------|-----------------------|-------------------------------|-----------------------|-------------------------------|
|  | Less Than Twelve<br>Months    | Twelve Months or More | Less Than Twelve<br>Months    | Twelve Months or More |                               |
|  | Gross<br>Unrealized<br>Losses | Fair<br>Value         | Gross<br>Unrealized<br>Losses | Fair<br>Value         |                               |
| Government sponsored enterprises                     | \$—                           | \$—                   | \$—                           | \$—                   | \$—                           |
| States and political subdivisions                    | 25                            | 4,049                 | 2                             | 263                   | 27                            |
| Auction rate money market preferred                  | —                             | —                     | 105                           | 3,095                 | 105                           |
| Preferred stocks                                     | —                             | —                     | 135                           | 3,665                 | 135                           |
| Mortgage-backed securities                           | 1,969                         | 126,883               | —                             | —                     | 1,969                         |
| Collateralized mortgage obligations                  | 444                           | 36,057                | 295                           | 10,413                | 739                           |
| Total  | \$2,438                       | \$166,989             | \$ 537                        | \$ 17,436             | \$ 2,975                      |
| Number of securities in an unrealized loss position: |                               | 41                    |                               | 9                     | 50                            |

|  | June 30, 2017                 |                       | December 31, 2016             |                       | Total<br>Unrealized<br>Losses |
|--|-------------------------------|-----------------------|-------------------------------|-----------------------|-------------------------------|
|  | Less Than Twelve<br>Months    | Twelve Months or More | Less Than Twelve<br>Months    | Twelve Months or More |                               |
|  | Gross<br>Unrealized<br>Losses | Fair<br>Value         | Gross<br>Unrealized<br>Losses | Fair<br>Value         |                               |
| Government sponsored enterprises                     | \$2                           | \$9,936               | \$—                           | \$—                   | \$ 2                          |
| States and political subdivisions                    | 311                           | 21,800                | 9                             | 355                   | 320                           |
| Auction rate money market preferred                  | —                             | —                     | 406                           | 2,794                 | 406                           |
| Preferred stocks                                     | —                             | —                     | 375                           | 3,425                 | 375                           |
| Mortgage-backed securities                           | 2,918                         | 175,212               | —                             | —                     | 2,918                         |
| Collateralized mortgage obligations                  | 628                           | 51,466                | 349                           | 11,381                | 977                           |
| Total  | \$3,859                       | \$258,414             | \$ 1,139                      | \$ 17,955             | \$ 4,998                      |
| Number of securities in an unrealized loss position: |                               | 104                   |                               | 9                     | 113                           |

As of June 30, 2017 and December 31, 2016, 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

12

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Table of Contents

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 recognized an OTTI of \$770 in earnings for the year ended December 31, 2016. Based on analysis of this bond, there was no additional OTTI recognized as of June 30, 2017. Based on our analyses, 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 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, 2017 or December 31, 2016, with the exception of the one municipal bond discussed above.

Note 5 – 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. A portion of loans are unsecured.

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income 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. Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, advances to mortgage brokers, farmland and agricultural production, and 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 payoff 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 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.

Table of Contents

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, 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 97% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan-to-value ratios in excess of 80%.

Underwriting criteria for originated residential real estate loans 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 36% 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 originated 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 12 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, 2017 |              |                            |          |             |         |
|                           | Commercial                       | Agricultural | Residential<br>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       |

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|               |         |        |          |        |          |         |
|---------------|---------|--------|----------|--------|----------|---------|
| June 30, 2017 | \$1,978 | \$ 475 | \$ 2,598 | \$ 583 | \$ 1,966 | \$7,600 |
|---------------|---------|--------|----------|--------|----------|---------|

14

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Table of Contents

## Allowance for Loan Losses

## Six Months Ended June 30, 2017

|                           | Commercial | Agricultural | Residential<br>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  
June 30, 2017

|                                       | Commercial | Agricultural | Residential<br>Real Estate | Consumer  | Unallocated | Total        |
|---------------------------------------|------------|--------------|----------------------------|-----------|-------------|--------------|
| ALLL                                  |            |              |                            |           |             |              |
| Individually evaluated for impairment | \$ 783     | \$ —         | \$ 1,672                   | \$ —      | \$ —        | \$ 2,455     |
| Collectively evaluated for impairment | 1,195      | 475          | 926                        | 583       | 1,966       | 5,145        |
| Total                                 | \$ 1,978   | \$ 475       | \$ 2,598                   | \$ 583    | \$ 1,966    | \$ 7,600     |
| Loans                                 |            |              |                            |           |             |              |
| Individually evaluated for impairment | \$ 7,362   | \$ 11,125    | \$ 8,628                   | \$ 20     |             | \$ 27,135    |
| Collectively evaluated for impairment | 593,222    | 119,829      | 261,579                    | 46,732    |             | 1,021,362    |
| Total                                 | \$ 600,584 | \$ 130,954   | \$ 270,207                 | \$ 46,752 |             | \$ 1,048,497 |

## Allowance for Loan Losses

## Three Months Ended June 30, 2016

|                           | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|------------|--------------|----------------------------|----------|-------------|----------|
| April 1, 2016             | \$ 2,421   | \$ 336       | \$ 3,130                   | \$ 540   | \$ 1,073    | \$ 7,500 |
| Charge-offs               | (32 )      | —            | (128 )                     | (48 )    | —           | (208 )   |
| Recoveries                | 189        | —            | 45                         | 62       | —           | 296      |
| Provision for loan losses | (459 )     | 198          | 83                         | (13 )    | 203         | 12       |
| June 30, 2016             | \$ 2,119   | \$ 534       | \$ 3,130                   | \$ 541   | \$ 1,276    | \$ 7,600 |

## Allowance for Loan Losses

## Six Months Ended June 30, 2016

|                           | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|------------|--------------|----------------------------|----------|-------------|----------|
| January 1, 2016           | \$ 2,171   | \$ 329       | \$ 3,330                   | \$ 522   | \$ 1,048    | \$ 7,400 |
| Charge-offs               | (48 )      | —            | (369 )                     | (132 )   | —           | (549 )   |
| Recoveries                | 278        | 92           | 95                         | 116      | —           | 581      |
| Provision for loan losses | (282 )     | 113          | 74                         | 35       | 228         | 168      |
| June 30, 2016             | \$ 2,119   | \$ 534       | \$ 3,130                   | \$ 541   | \$ 1,276    | \$ 7,600 |

Table of Contents

Allowance for Loan Losses and Recorded Investment in Loans  
December 31, 2016

|                                       | Commercial | Agricultural | Residential<br>Real Estate | Consumer  | Unallocated | Total       |
|---------------------------------------|------------|--------------|----------------------------|-----------|-------------|-------------|
| ALLL                                  |            |              |                            |           |             |             |
| Individually evaluated for impairment | \$741      | \$ 1         | \$ 1,629                   | \$ —      | \$ —        | \$2,371     |
| Collectively evaluated for impairment | 1,073      | 883          | 1,035                      | 624       | 1,414       | 5,029       |
| Total                                 | \$1,814    | \$ 884       | \$ 2,664                   | \$ 624    | \$ 1,414    | \$7,400     |
| Loans                                 |            |              |                            |           |             |             |
| Individually evaluated for impairment | \$7,859    | \$ 5,545     | \$ 8,638                   | \$ 26     |             | \$22,068    |
| Collectively evaluated for impairment | 567,805    | 120,947      | 257,412                    | 42,383    |             | 988,547     |
| Total                                 | \$575,664  | \$ 126,492   | \$ 266,050                 | \$ 42,409 |             | \$1,010,615 |

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

June 30, 2017

| Rating                | Commercial  |           |                                       | Agricultural |          |          | Total     |
|-----------------------|-------------|-----------|---------------------------------------|--------------|----------|----------|-----------|
|                       | Real Estate | Other     | Advances<br>to<br>Mortgage<br>Brokers | Real Estate  | Other    | Total    |           |
| 1 - Excellent         | \$26        | \$232     | \$ —                                  | \$258        | \$—      | \$—      | \$258     |
| 2 - High quality      | 7,479       | 15,878    | —                                     | 23,357       | 3,088    | 1,006    | 27,451    |
| 3 - High satisfactory | 103,672     | 45,853    | 19,914                                | 169,439      | 21,435   | 9,306    | 200,180   |
| 4 - Low satisfactory  | 320,610     | 71,958    | —                                     | 392,568      | 48,109   | 20,740   | 461,417   |
| 5 - Special mention   | 4,253       | 1,899     | —                                     | 6,152        | 11,015   | 9,054    | 26,221    |
| 6 - Substandard       | 6,343       | 2,450     | —                                     | 8,793        | 4,379    | 1,830    | 15,002    |
| 7 - Vulnerable        | 17          | —         | —                                     | 17           | 466      | 526      | 1,009     |
| 8 - Doubtful          | —           | —         | —                                     | —            | —        | —        | —         |
| Total                 | \$442,400   | \$138,270 | \$ 19,914                             | \$600,584    | \$88,492 | \$42,462 | \$731,538 |

December 31, 2016

| Rating                | Commercial  |           |                                       | Agricultural |          |          | Total     |
|-----------------------|-------------|-----------|---------------------------------------|--------------|----------|----------|-----------|
|                       | Real Estate | Other     | Advances<br>to<br>Mortgage<br>Brokers | Real Estate  | Other    | Total    |           |
| 1 - Excellent         | \$28        | \$438     | \$ —                                  | \$466        | \$—      | \$—      | \$466     |
| 2 - High quality      | 11,821      | 12,091    | 19,688                                | 43,600       | 3,566    | 1,426    | 48,592    |
| 3 - High satisfactory | 103,529     | 41,982    | —                                     | 145,511      | 21,657   | 11,388   | 178,556   |
| 4 - Low satisfactory  | 299,317     | 74,432    | —                                     | 373,749      | 48,955   | 22,715   | 445,419   |
| 5 - Special mention   | 3,781       | 1,178     | —                                     | 4,959        | 6,009    | 3,085    | 14,053    |
| 6 - Substandard       | 5,901       | 1,474     | —                                     | 7,375        | 3,650    | 3,508    | 14,533    |
| 7 - Vulnerable        | 4           | —         | —                                     | 4            | —        | 533      | 537       |
| 8 - Doubtful          | —           | —         | —                                     | —            | —        | —        | —         |
| Total                 | \$424,381   | \$131,595 | \$ 19,688                             | \$575,664    | \$83,837 | \$42,655 | \$702,156 |

Table of Contents

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.

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.

17

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Table of Contents

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Collateral or guaranty offers limited protection.

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

6. SUBSTANDARD – Classified

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

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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.

Table of Contents

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, 2017                      |               |                    |                 | Total<br>Past Due<br>and<br>Nonaccrual | Current             | Total               |
|--------------------------------------|------------------------------------|---------------|--------------------|-----------------|--|---------------------|---------------------|
|                                      | Accruing Interest<br>and Past Due: |               |                    |                 |  |                     |                     |
|                                      | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or More | Nonaccrual      |  |                     |                     |
| <b>Commercial</b>                    |                                    |               |                    |                 |  |                     |                     |
| Commercial real estate               | \$1,301                            | \$—           | \$ 55              | \$ 17           | \$ 1,373                               | \$441,027           | \$442,400           |
| Commercial other                     | 981                                | 103           | —                  | —               | 1,084                                  | 137,186             | 138,270             |
| Advances to mortgage brokers         | —                                  | —             | —                  | —               | —                                      | 19,914              | 19,914              |
| <b>Total commercial</b>              | <b>2,282</b>                       | <b>103</b>    | <b>55</b>          | <b>17</b>       | <b>2,457</b>                           | <b>598,127</b>      | <b>600,584</b>      |
| <b>Agricultural</b>                  |                                    |               |                    |                 |  |                     |                     |
| Agricultural real estate             | 343                                | —             | 1,099              | 466             | 1,908                                  | 86,584              | 88,492              |
| Agricultural other                   | 29                                 | —             | —                  | 526             | 555                                    | 41,907              | 42,462              |
| <b>Total agricultural</b>            | <b>372</b>                         | <b>—</b>      | <b>1,099</b>       | <b>992</b>      | <b>2,463</b>                           | <b>128,491</b>      | <b>130,954</b>      |
| <b>Residential real estate</b>       |                                    |               |                    |                 |  |                     |                     |
| Senior liens                         | 1,033                              | 426           | 49                 | 460             | 1,968                                  | 221,433             | 223,401             |
| Junior liens                         | —                                  | —             | —                  | 24              | 24                                     | 7,746               | 7,770               |
| Home equity lines of credit          | 123                                | 173           | —                  | 70              | 366                                    | 38,670              | 39,036              |
| <b>Total residential real estate</b> | <b>1,156</b>                       | <b>599</b>    | <b>49</b>          | <b>554</b>      | <b>2,358</b>                           | <b>267,849</b>      | <b>270,207</b>      |
| <b>Consumer</b>                      |                                    |               |                    |                 |  |                     |                     |
| Secured                              | 63                                 | —             | —                  | —               | 63                                     | 43,109              | 43,172              |
| Unsecured                            | 1                                  | —             | —                  | —               | 1                                      | 3,579               | 3,580               |
| <b>Total consumer</b>                | <b>64</b>                          | <b>—</b>      | <b>—</b>           | <b>—</b>        | <b>64</b>                              | <b>46,688</b>       | <b>46,752</b>       |
| <b>Total</b>                         | <b>\$3,874</b>                     | <b>\$ 702</b> | <b>\$ 1,203</b>    | <b>\$ 1,563</b> | <b>\$ 7,342</b>                        | <b>\$ 1,041,155</b> | <b>\$ 1,048,497</b> |

Table of Contents

|                                      | December 31, 2016                  |               |                    |                 | Total<br>Past Due<br>and<br>Nonaccrual | Current             | Total               |
|--------------------------------------|------------------------------------|---------------|--------------------|-----------------|--|---------------------|---------------------|
|                                      | Accruing Interest<br>and Past Due: |               |                    |                 |  |                     |                     |
|                                      | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or More | Nonaccrual      |  |                     |                     |
| <b>Commercial</b>                    |                                    |               |                    |                 |  |                     |                     |
| Commercial real estate               | \$ 1,580                           | \$ —          | \$ 35              | \$ 4            | \$ 1,619                               | \$ 422,762          | \$ 424,381          |
| Commercial other                     | 1,693                              | 35            | —                  | —               | 1,728                                  | 129,867             | 131,595             |
| Advances to mortgage brokers         | —                                  | —             | —                  | —               | —                                      | 19,688              | 19,688              |
| <b>Total commercial</b>              | <b>3,273</b>                       | <b>35</b>     | <b>35</b>          | <b>4</b>        | <b>3,347</b>                           | <b>572,317</b>      | <b>575,664</b>      |
| <b>Agricultural</b>                  |                                    |               |                    |                 |  |                     |                     |
| Agricultural real estate             | 191                                | —             | 508                | —               | 699                                    | 83,138              | 83,837              |
| Agricultural other                   | 19                                 | —             | —                  | 533             | 552                                    | 42,103              | 42,655              |
| <b>Total agricultural</b>            | <b>210</b>                         | <b>—</b>      | <b>508</b>         | <b>533</b>      | <b>1,251</b>                           | <b>125,241</b>      | <b>126,492</b>      |
| <b>Residential real estate</b>       |                                    |               |                    |                 |  |                     |                     |
| Senior liens                         | 1,638                              | 174           | 22                 | 498             | 2,332                                  | 216,681             | 219,013             |
| Junior liens                         | 15                                 | —             | —                  | 25              | 40                                     | 8,317               | 8,357               |
| Home equity lines of credit          | 270                                | 6             | 68                 | —               | 344                                    | 38,336              | 38,680              |
| <b>Total residential real estate</b> | <b>1,923</b>                       | <b>180</b>    | <b>90</b>          | <b>523</b>      | <b>2,716</b>                           | <b>263,334</b>      | <b>266,050</b>      |
| <b>Consumer</b>                      |                                    |               |                    |                 |  |                     |                     |
| Secured                              | 110                                | —             | —                  | —               | 110                                    | 38,582              | 38,692              |
| Unsecured                            | 5                                  | —             | —                  | —               | 5                                      | 3,712               | 3,717               |
| <b>Total consumer</b>                | <b>115</b>                         | <b>—</b>      | <b>—</b>           | <b>—</b>        | <b>115</b>                             | <b>42,294</b>       | <b>42,409</b>       |
| <b>Total</b>                         | <b>\$ 5,521</b>                    | <b>\$ 215</b> | <b>\$ 633</b>      | <b>\$ 1,060</b> | <b>\$ 7,429</b>                        | <b>\$ 1,003,186</b> | <b>\$ 1,010,615</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.

Table of Contents

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, 2017       |                                |                        | December 31, 2016   |                                |                        |
|--|---------------------|--------------------------------|------------------------|---------------------|--------------------------------|------------------------|
|  | Recorded<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Recorded<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| Impaired loans with a valuation allowance          |                     |                                |                        |                     |                                |                        |
| Commercial real estate                             | \$5,063             | \$ 5,183                       | \$ 733                 | \$5,811             | \$ 5,992                       | \$ 716                 |
| Commercial other                                   | 1,099               | 1,099                          | 50                     | 1,358               | 1,358                          | 25                     |
| Agricultural real estate                           | —                   | —                              | —                      | —                   | —                              | —                      |
| Agricultural other                                 | —                   | —                              | —                      | 134                 | 134                            | 1                      |
| Residential real estate senior liens               | 8,393               | 8,977                          | 1,649                  | 8,464               | 9,049                          | 1,615                  |
| Residential real estate junior liens               | 76                  | 76                             | 15                     | 72                  | 82                             | 14                     |
| Home equity lines of credit                        | 70                  | 70                             | 8                      | —                   | —                              | —                      |
| Consumer secured                                   | —                   | —                              | —                      | —                   | —                              | —                      |
| Total impaired loans with a valuation allowance    | 14,701              | 15,405                         | 2,455                  | 15,839              | 16,615                         | 2,371                  |
| Impaired loans without a valuation allowance       |                     |                                |                        |                     |                                |                        |
| Commercial real estate                             | 1,104               | 1,191                          |                        | 604                 | 617                            |                        |
| Commercial other                                   | 96                  | 96                             |                        | 86                  | 97                             |                        |
| Agricultural real estate                           | 7,826               | 7,826                          |                        | 4,037               | 4,037                          |                        |
| Agricultural other                                 | 3,299               | 3,299                          |                        | 1,374               | 1,374                          |                        |
| Home equity lines of credit                        | 89                  | 389                            |                        | 102                 | 402                            |                        |
| Consumer secured                                   | 20                  | 20                             |                        | 26                  | 26                             |                        |
| Total impaired loans without a valuation allowance | 12,434              | 12,821                         |                        | 6,229               | 6,553                          |                        |
| Impaired loans                                     |                     |                                |                        |                     |                                |                        |
| Commercial   | 7,362               | 7,569                          | 783                    | 7,859               | 8,064                          | 741                    |
| Agricultural                                       | 11,125              | 11,125                         | —                      | 5,545               | 5,545                          | 1                      |
| Residential real estate                            | 8,628               | 9,512                          | 1,672                  | 8,638               | 9,533                          | 1,629                  |
| Consumer   | 20                  | 20                             | —                      | 26                  | 26                             | —                      |
| Total impaired loans                               | \$27,135            | \$ 28,226                      | \$ 2,455               | \$22,068            | \$ 23,168                      | \$ 2,371               |



Table of Contents

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

|  | Three Months Ended June 30 |                  |                  |                  |
|--|----------------------------|------------------|------------------|------------------|
|  | 2017                       |                  | 2016             |                  |
|  | Average Interest           | Average Interest | Average Interest | Average Interest |
|  | Recorded Income            | Recorded Income  | Recorded Income  | Recorded Income  |
|  | Balance                    | Recognized       | Balance          | Recognized       |
| Impaired loans with a valuation allowance          |                            |                  |                  |                  |
| Commercial real estate                             | \$4,641                    | \$ 84            | \$5,793          | \$ 85            |
| Commercial other                                   | 1,146                      | 23               | 95               | 2                |
| Agricultural real estate                           | —                          | —                | 91               | 2                |
| Agricultural other                                 | —                          | —                | —                | —                |
| Residential real estate senior liens               | 8,385                      | 83               | 9,508            | 93               |
| Residential real estate junior liens               | 77                         | 1                | 134              | 1                |
| Home equity lines of credit                        | 35                         | —                | —                | —                |
| Consumer secured                                   | —                          | —                | —                | —                |
| Total impaired loans with a valuation allowance    | 14,284                     | 191              | 15,621           | 183              |
| Impaired loans without a valuation allowance       |                            |                  |                  |                  |
| Commercial real estate                             | 1,576                      | 19               | 814              | 28               |
| Commercial other                                   | 119                        | 2                | 77               | 2                |
| Agricultural real estate                           | 5,937                      | 58               | 3,454            | 43               |
| Agricultural other                                 | 2,401                      | 33               | 603              | 10               |
| Home equity lines of credit                        | 126                        | 5                | 118              | 4                |
| Consumer secured                                   | 22                         | —                | 33               | 1                |
| Total impaired loans without a valuation allowance | 10,181                     | 117              | 5,099            | 88               |
| Impaired loans                                     |                            |                  |                  |                  |
| Commercial   | 7,482                      | 128              | 6,779            | 117              |
| Agricultural                                       | 8,338                      | 91               | 4,148            | 55               |
| Residential real estate                            | 8,623                      | 89               | 9,760            | 98               |
| Consumer   | 22                         | —                | 33               | 1                |
| Total impaired loans                               | \$24,465                   | \$ 308           | \$20,720         | \$ 271           |

Table of Contents

|  | Six Months Ended June 30                      |            |   |            |
|--|---|------------|---|------------|
|  | 2017  |            | 2016  |            |
|  | Average Interest<br>RecordedIncome<br>Balance | Recognized | Average Interest<br>RecordedIncome<br>Balance | Recognized |
| Impaired loans with a valuation allowance          |   |            |   |            |
| Commercial real estate                             | \$4,825                                       | \$ 157     | \$5,773                                       | \$ 169     |
| Commercial other                                   | 1,211   | 47         | 74  | 3          |
| Agricultural real estate                           | —   | —          | 46  | 2          |
| Agricultural other                                 | 34  | —          | 84  | —          |
| Residential real estate senior liens               | 8,403   | 166        | 9,711   | 193        |
| Residential real estate junior liens               | 76  | 1          | 137   | 2          |
| Home equity lines of credit                        | 18  | —          | —   | —          |
| Consumer secured                                   | —   | —          | —   | —          |
| Total impaired loans with a valuation allowance    | 14,567  | 371        | 15,825  | 369        |
| Impaired loans without a valuation allowance       |   |            |   |            |
| Commercial real estate                             | 1,451   | 52         | 1,139   | 47         |
| Commercial other                                   | 117   | 4          | 104   | 4          |
| Agricultural real estate                           | 4,990   | 120        | 3,501   | 88         |
| Agricultural other                                 | 1,920   | 46         | 477   | 16         |
| Home equity lines of credit                        | 129   | 10         | 121   | 8          |
| Consumer secured                                   | 23  | —          | 34  | 2          |
| Total impaired loans without a valuation allowance | 8,630   | 232        | 5,376   | 165        |
| Impaired loans                                     |   |            |   |            |
| Commercial   | 7,604   | 260        | 7,090   | 223        |
| Agricultural                                       | 6,944   | 166        | 4,108   | 106        |
| Residential real estate                            | 8,626   | 177        | 9,969   | 203        |
| Consumer   | 23  | —          | 34  | 2          |
| Total impaired loans                               | \$23,197                                      | \$ 603     | \$21,201                                      | \$ 534     |

We had committed to advance \$124 and \$117 in connection with impaired loans, which include TDRs, as of June 30, 2017 and December 31, 2016, 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.
- 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).

Table of Contents

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

|                               | Three Months Ended June 30 |                   |                   | 2016        |                   |                   |
|-------------------------------|----------------------------|-------------------|-------------------|-------------|-------------------|-------------------|
|                               | 2017                       |                   |                   | 2016        |                   |                   |
|                               | Number                     | Post-Modification | Post-Modification | Number      | Post-Modification | Post-Modification |
|                               | of Recorded                | Recorded          | Recorded          | of Recorded | Recorded          | Recorded          |
|                               | Loans                      | Investment        | Investment        | Loans       | Investment        | Investment        |
| Commercial other              | 1                          | \$ 86             | \$ 86             | —           | \$ —              | \$ —              |
| Agricultural other            | 7                          | 5,445             | 5,445             | 3           | 201               | 201               |
| Residential real estate       |                            |                   |                   |             |                   |                   |
| Senior liens                  | 3                          | 255               | 255               | —           | —                 | —                 |
| Junior liens                  | —                          | —                 | —                 | —           | —                 | —                 |
| Total residential real estate | 3                          | 255               | 255               | —           | —                 | —                 |
| Consumer unsecured            | —                          | —                 | —                 | —           | —                 | —                 |
| Total                         | 11                         | \$ 5,786          | \$ 5,786          | 3           | \$ 201            | \$ 201            |

|                               | Six Months Ended June 30 |                   |                   | 2016        |                   |                   |
|-------------------------------|--------------------------|-------------------|-------------------|-------------|-------------------|-------------------|
|                               | 2017                     |                   |                   | 2016        |                   |                   |
|                               | Number                   | Post-Modification | Post-Modification | Number      | Post-Modification | Post-Modification |
|                               | of Recorded              | Recorded          | Recorded          | of Recorded | Recorded          | Recorded          |
|                               | Loans                    | Investment        | Investment        | Loans       | Investment        | Investment        |
| Commercial other              | 3                        | \$ 313            | \$ 313            | —           | \$ —              | \$ —              |
| Agricultural other            | 7                        | 5,445             | 5,445             | 3           | 201               | 201               |
| Residential real estate       |                          |                   |                   |             |                   |                   |
| Senior liens                  | 3                        | 255               | 255               | 2           | 26                | 26                |
| Junior liens                  | 1                        | 8                 | 8                 | —           | —                 | —                 |
| Total residential real estate | 4                        | 263               | 263               | 2           | 26                | 26                |
| Consumer unsecured            | —                        | —                 | —                 | 1           | 2                 | 2                 |
| Total                         | 14                       | \$ 6,021          | \$ 6,021          | 6           | \$ 229            | \$ 229            |

The following tables summarize concessions we granted to borrowers in financial difficulty for the:

|                               | Three Months Ended June 30 |                     | 2016          |                     |
|-------------------------------|----------------------------|---------------------|---------------|---------------------|
|                               | 2017                       |                     | 2016          |                     |
|                               | Below Market               | Below Market        | Below Market  | Below Market        |
|                               | Interest Rate              | Interest Rate and   | Interest Rate | Interest Rate and   |
|                               |                            | Extension of        |               | Extension of        |
|                               |                            | Amortization Period |               | Amortization Period |
|                               | Number                     | Number              | Number        | Number              |
|                               | of Recorded                | of Recorded         | of Recorded   | of Recorded         |
|                               | Loans                      | Loans               | Loans         | Loans               |
|                               | Investment                 | Investment          | Investment    | Investment          |
| Commercial other              | —                          | \$ —                | 1             | \$ 86               |
| Agricultural other            | 4                          | 1,349               | 3             | 4,096               |
| Residential real estate       |                            |                     |               |                     |
| Senior liens                  | —                          | —                   | 3             | 255                 |
| Junior liens                  | —                          | —                   | —             | —                   |
| Total residential real estate | —                          | —                   | 3             | 255                 |
| Consumer unsecured            | —                          | —                   | —             | —                   |
| Total                         | 4                          | \$ 1,349            | 7             | \$ 4,437            |

Table of Contents

|                               | Six Months Ended June 30<br>2017             |  | 2016   |  |
|-------------------------------|--|--|--|--|
|                               | Below Market<br>Interest Rate                | Below Market<br>Interest Rate and<br>Extension of<br>Amortization Period | Below Market<br>Interest Rate                | Below Market<br>Interest Rate and<br>Extension of<br>Amortization Period |
|                               | Number of<br>Recorded<br>Loans<br>Investment | Number of<br>Recorded<br>Loans<br>Investment                             | Number of<br>Recorded<br>Loans<br>Investment | Number of<br>Recorded<br>Loans<br>Investment                             |
| Commercial other              | — \$ —                                       | 3 \$ 313   | — \$ —                                       | — \$ —   |
| Agricultural other            | 4 1,349                                      | 3 4,096  | —  | 3 201  |
| Residential real estate       |  |  |  |  |
| Senior liens                  | —  | 3 255  | 2 26   | — —  |
| Junior liens                  | 1 8  | — —  | —  | — —  |
| Total residential real estate | 1 8  | 3 255  | 2 26   | — —  |
| Consumer unsecured            | —  | — —  | —  | 1 2  |
| Total                         | 5 \$ 1,357                                   | 9 \$ 4,664   | 2 \$ 26                                      | 4 \$ 203   |

We did not restructure any loans by forgiving principal or accrued interest in the three and six month periods ended June 30, 2017 or 2016.

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, 2017 and June 30, 2016 which were modified within 12 months prior to the default date.

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

|      | June 30,<br>2017 | December 31,<br>2016 |
|------|------------------|----------------------|
| TDRs | \$26,341         | \$ 21,382            |

Table of Contents

## Note 6 – 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  | December 31 |
|-------------------------------------|----------|-------------|
|                                     | 2017     | 2016        |
| FHLB Stock                          | \$13,700 | \$ 11,900   |
| Corporate Settlement Solutions, LLC | 7,368    | 7,461       |
| FRB Stock                           | 1,999    | 1,999       |
| Other                               | 334      | 334         |
| Total                               | \$23,401 | \$ 21,694   |

## Note 7 – Foreclosed Assets

Foreclosed assets are included in other assets in the consolidated balance sheets and consist of other real estate owned and repossessed assets. The following is a summary of foreclosed assets as of:

|   | June 30 | December 31 |
|---|---------|-------------|
|   | 2017    | 2016        |
| Consumer mortgage loans collateralized by residential real estate foreclosed as a result of obtaining physical possession | \$ 16   | \$ 18       |
| All other foreclosed assets   | 213     | 213         |
| Total   | \$ 229  | \$ 231      |

There were \$411 and \$18 of consumer mortgage loans collateralized by residential real estate in the process of foreclosure as of June 30, 2017 and December 31, 2016.

Below is a summary of changes in foreclosed assets during the:

|                        | Three      | Months     |
|------------------------|------------|------------|
|                        | Ended June | 30         |
|                        | 2017       | 2016       |
| Balance, April 1       | \$158      | \$276      |
| Properties transferred | 98         | 27         |
| Impairments            | —          | —          |
| Proceeds from sale     | (27 )      | (54 )      |
| Balance, June 30       | \$229      | \$249      |
|                        | Six Months | Ended June |
|                        | 2017       | 2016       |
| Balance, January 1     | \$231      | \$421      |
| Properties transferred | 124        | 116        |
| Impairments            | (28 )      | —          |
| Proceeds from sale     | (98 )      | (288 )     |
| Balance, June 30       | \$229      | \$249      |

Table of Contents

Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

|  | June 30, 2017 |        | December 31, 2016 |        |
|--|---------------|--------|-------------------|--------|
|  | Amount        | Rate   | Amount            | Rate   |
| FHLB advances  | \$310,000     | 1.81 % | \$270,000         | 1.82 % |
| Securities sold under agreements to repurchase without stated maturity dates | 49,950        | 0.13 % | 60,894            | 0.13 % |
| Federal funds purchased  | 990           | 1.39 % | 6,800             | 1.00 % |
| Total  | \$360,940     | 1.57 % | \$337,694         | 1.50 % |

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, 2017 |        | December 31, 2016 |        |
|-------------------------------------|---------------|--------|-------------------|--------|
|                                     | Amount        | Rate   | Amount            | Rate   |
| Fixed rate due 2017                 | \$65,000      | 1.28 % | \$70,000          | 1.39 % |
| Fixed rate due 2018                 | 50,000        | 2.16 % | 50,000            | 2.16 % |
| Fixed rate due 2019                 | 70,000        | 1.93 % | 60,000            | 1.99 % |
| Fixed rate due 2020                 | 35,000        | 1.52 % | 10,000            | 1.98 % |
| Fixed rate due 2021                 | 50,000        | 1.91 % | 50,000            | 1.91 % |
| Variable rate due 2021 <sup>1</sup> | 10,000        | 1.48 % | 10,000            | 1.21 % |
| Fixed rate due 2022                 | 10,000        | 2.07 % | —                 | — %    |
| Fixed rate due 2023                 | 10,000        | 3.90 % | 10,000            | 3.90 % |
| Fixed rate due 2026                 | 10,000        | 1.17 % | 10,000            | 1.17 % |
| Total                               | \$310,000     | 1.81 % | \$270,000         | 1.82 % |

<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 \$49,969 and \$60,918 at June 30, 2017 and December 31, 2016, 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, federal funds purchased, and FRB Discount Window advances.

|  | Three Months Ended June 30 |                 |  |                           |                 |  |
|--|----------------------------|-----------------|--|---------------------------|-----------------|--|
|  | 2017                       |                 | 2016   |                           |                 |  |
|  | 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 | \$55,731                   | \$53,841        | 0.13 %   | \$57,032                  | \$56,010        | 0.13 %   |
| Federal funds purchased  | 5,965                      | 7,496           | 1.13 %   | 11,800                    | 12,294          | 0.69 %   |
| FRB Discount Window  | —                          | 88              | 1.48 %   | —                         | —               | — %  |

Table of Contents

|  | Six Months Ended June 30           |                    |  |  |                                    |                    |  |  |
|--|------------------------------------|--------------------|--|--|------------------------------------|--------------------|--|--|
|  | 2017                               |                    |  |  | 2016                               |                    |  |  |
|  | Maximum<br>Month<br>End<br>Balance | Average<br>Balance | Weighted<br>Average<br>Interest Rate<br>During the<br>Period |  | Maximum<br>Month<br>End<br>Balance | Average<br>Balance | Weighted<br>Average<br>Interest Rate<br>During the<br>Period |  |
| Securities sold under agreements to repurchase without stated maturity dates | \$61,131                           | \$55,663           | 0.13 %   |  | \$61,783                           | \$58,531           | 0.13 %   |  |
| Federal funds purchased  | 27,300                             | 4,197              | 1.11 %   |  | 11,800                             | 8,495              | 0.69 %   |  |
| 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   | December 31 |
|---|-----------|-------------|
|   | 2017      | 2016        |
| Pledged to secure borrowed funds  | \$418,917 | \$ 363,427  |
| Pledged to secure repurchase agreements   | 49,969    | 60,918      |
| Pledged for public deposits and for other purposes necessary or required by law | 31,429    | 33,916      |
| Total   | \$500,315 | \$ 458,261  |

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

|                                     | June 30  | December 31 |
|-------------------------------------|----------|-------------|
|                                     | 2017     | 2016        |
| States and political subdivisions   | \$2,784  | \$ 5,676    |
| Mortgage-backed securities          | 14,813   | 11,383      |
| Collateralized mortgage obligations | 32,372   | 43,859      |
| Total                               | \$49,969 | \$ 60,918   |

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, 2017, we had the ability to borrow up to an additional \$119,462, based on assets pledged as collateral.

We had no investment securities that are 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, 2017 |                  | Remaining Life<br>(Years) | Notional<br>Amount | Balance Sheet<br>Location | Fair<br>Value |
|---|---------------|------------------|---------------------------|--------------------|---------------------------|---------------|
|   | Pay<br>Rate   | Receive Rate     |                           |                    |                           |               |
| Derivatives designated as hedging instruments |               |                  |                           |                    |                           |               |
| Cash Flow Hedges:                             |               |                  |                           |                    |                           |               |
| Interest rate swaps                           | 1.56 %        | 3-Month<br>LIBOR | 3.8                       | \$ 10,000          | Other Assets              | \$ 204        |





Table of Contents

|   | December 31, 2016 |                  | Remaining Life<br>(Years) | Notional Amount | Balance Sheet<br>Location | Fair<br>Value |
|---|-------------------|------------------|---------------------------|-----------------|---------------------------|---------------|
|   | Pay<br>Rate       | Receive Rate     |                           |                 |                           |               |
| Derivatives designated as hedging instruments |                   |                  |                           |                 |                           |               |
| Cash Flow Hedges:                             |                   |                  |                           |                 |                           |               |
| Interest rate swaps                           | 1.56%             | 3-Month<br>LIBOR | 4.3                       | \$ 10,000       | Other Assets              | \$ 248        |

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 counterparties limits. We do not anticipate any losses from failure of interest rate derivative counterparties to honor their obligations.

## Note 9 – Other Noninterest Expenses

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

|                                   | Three Months<br>Ended<br>June 30 |         | Six Months<br>Ended<br>June 30 |         |
|-----------------------------------|----------------------------------|---------|--------------------------------|---------|
|                                   | 2017                             | 2016    | 2017                           | 2016    |
| ATM and debit card fees           | \$404                            | \$228   | \$620                          | \$417   |
| Audit and related fees            | 237                              | 186     | 435                            | 345     |
| Director fees                     | 213                              | 214     | 422                            | 423     |
| Consulting fees                   | 208                              | 196     | 413                            | 369     |
| Loan underwriting fees            | 192                              | 127     | 309                            | 235     |
| FDIC insurance premiums           | 155                              | 217     | 308                            | 422     |
| Donations and community relations | 168                              | 146     | 298                            | 265     |
| Postage and freight               | 110                              | 91      | 219                            | 197     |
| Printing and supplies             | 103                              | 129     | 210                            | 220     |
| Marketing costs                   | 100                              | 103     | 189                            | 258     |
| Education and travel              | 93                               | 125     | 189                            | 236     |
| All other                         | 524                              | 644     | 989                            | 1,206   |
| Total other                       | \$2,507                          | \$2,406 | \$4,601                        | \$4,593 |

## Note 10 – Federal Income Taxes

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the:

|   | Three Months<br>Ended<br>June 30 |         | Six Months<br>Ended<br>June 30 |          |
|---|----------------------------------|---------|--------------------------------|----------|
|   | 2017                             | 2016    | 2017                           | 2016     |
| Income taxes at 34% statutory rate                  | \$1,612                          | \$1,381 | \$2,859                        | \$2,555  |
| Effect of nontaxable income                         |                                  |         |                                |          |
| Interest income on tax exempt municipal securities  | (454 )                           | (465 )  | (909 )                         | (943 )   |
| Earnings on corporate owned life insurance policies | (62 )                            | (66 )   | (123 )                         | (130 )   |
| Effect of tax credits                               | (191 )                           | (193 )  | (380 )                         | (387 )   |
| Other   | (18 )                            | (18 )   | (36 )                          | (36 )    |
| Total effect of nontaxable income                   | (725 )                           | (742 )  | (1,448 )                       | (1,496 ) |
| Effect of nondeductible expenses                    | 11                               | 16      | 19                             | 33       |
| Federal income tax expense                          | \$898                            | \$655   | \$1,430                        | \$1,092  |



Table of Contents

## Note 11 – Fair Value

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

Cash and cash equivalents: The carrying amounts of cash and demand deposits due from banks and interest bearing balances due from banks approximate fair values. As such, we classify cash and cash equivalents as Level 1.

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.

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

Loans: For variable rate loans with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated. As such, we classify loans as Level 3 assets.

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 cost 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.

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

June 30, 2017

| Valuation Technique | Fair Value | Unobservable Input              | Range     |
|---------------------|------------|---------------------------------|-----------|
|                     |            | Discount applied to collateral: |           |
|                     |            | Real Estate                     | 20% - 30% |
|                     |            | Equipment                       | 20% - 45% |
| Discounted value    | \$15,117   | Cash crop inventory             | 30% - 40% |
|                     |            | Liquor license                  | 75%       |
|                     |            | Furniture, fixtures & equipment | 40% - 45% |

Table of Contents

December 31, 2016

| Valuation Technique | Fair Value | Unobservable Input              | Range     |
|---------------------|------------|---------------------------------|-----------|
|                     |            | Discount applied to collateral: |           |
|                     |            | Real Estate                     | 20% - 30% |
|                     |            | Equipment                       | 20% - 45% |
| Discounted value    | \$9,166    | Cash crop inventory             | 30% - 40% |
|                     |            | Liquor license                  | 75%       |
|                     |            | Furniture, fixtures & equipment | 45%       |

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluation.

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

Equity securities without readily determinable fair values: Included in equity securities without readily determinable fair values are FHLB stock and FRB stock as well as our minority ownership interest in Corporate Settlement Solutions, LLC. The investment in Corporate Settlement Solutions, LLC, a title insurance agency, was made in the first quarter 2008 and we account for our investment under the equity method of accounting.

The lack of an active market, or other independent sources to validate fair value estimates coupled with the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. As the fair values of these investments are not readily determinable, they are not disclosed under a specific fair value hierarchy; however, they are reviewed quarterly for impairment. If we were to record an impairment adjustment related to these securities, it would be classified as a nonrecurring Level 3 fair value adjustment. During 2017 and 2016, there were no impairments recorded on equity securities without readily determinable fair values.

Foreclosed assets: Upon transfer from the loan portfolio, foreclosed assets (which are included in other assets) are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. Due to the inherent level of estimation in the valuation process, we classify foreclosed assets as nonrecurring Level 3.

The table below lists the quantitative fair value information related to foreclosed assets as of:

June 30, 2017

| Valuation Technique | Fair Value | Unobservable Input              | Range     |
|---------------------|------------|---------------------------------|-----------|
|                     |            | Discount applied to collateral: |           |
| Discounted value    | \$229      | Real Estate                     | 20% - 30% |

December 31, 2016

| Valuation Technique | Fair Value | Unobservable Input              | Range     |
|---------------------|------------|---------------------------------|-----------|
|                     |            | Discount applied to collateral: |           |
| Discounted value    | \$231      | Real Estate                     | 20% - 30% |

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

Goodwill and other intangible assets: Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Acquisition intangibles and goodwill are typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of acquisition intangibles or goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2017 and 2016, there were no impairments recorded on goodwill and other acquisition intangibles.

OMSR: OMSR (which are included in other assets) are subject to impairment testing. To test for impairment, we utilize a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for

comparable instruments and discount rates. If the valuation model reflects a value less than the carrying value, OMSR are adjusted to fair

31

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Table of Contents

value through a valuation allowance as determined by the model. As such, we classify OMSR subject to nonrecurring fair value adjustments as Level 2.

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

Borrowed funds: The carrying amounts of federal funds purchased, borrowings under overnight repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. The fair values of other borrowed funds are estimated using discounted cash flow analyses based on current incremental borrowing arrangements. As such, borrowed funds are classified as Level 2.

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

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.

Commitments to extend credit, standby letters of credit, and undisbursed loans: Our commitments to extend credit, standby letters of credit, and undisbursed funds have no carrying amount and are estimated to have no realizable fair value. Historically, a majority of the unused commitments to extend credit have not been drawn upon and, generally, we do not receive fees in connection with these commitments other than standby letter of credit fees, which are not significant.

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.

Table of Contents

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

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, 2017     |                      |           |           |           |
|--|-------------------|----------------------|-----------|-----------|-----------|
|  | Carrying Value    | Estimated Fair Value | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                   |                      |           |           |           |
| Cash and cash equivalents                                      | \$21,834          | \$ 21,834            | \$21,834  | \$ —      | —         |
| Mortgage loans AFS   | 1,482             | 1,493                | —         | 1,493     | —         |
| Gross loans  | 1,048,497         | 1,029,290            | —         | —         | 1,029,290 |
| Less allowance for loan and lease losses                       | 7,600             | 7,600                | —         | —         | 7,600     |
| Net loans  | 1,040,897         | 1,021,690            | —         | —         | 1,021,690 |
| Accrued interest receivable                                    | 5,686             | 5,686                | 5,686     | —         | —         |
| Equity securities without readily determinable fair values (1) | 23,401            | N/A                  | —         | —         | —         |
| OMSR   | 2,490             | 2,499                | —         | 2,499     | —         |
| <b>LIABILITIES</b>   |                   |                      |           |           |           |
| Deposits without stated maturities                             | 780,243           | 780,243              | 780,243   | —         | —         |
| Deposits with stated maturities                                | 429,909           | 427,877              | —         | 427,877   | —         |
| Borrowed funds   | 360,940           | 361,076              | —         | 361,076   | —         |
| Accrued interest payable                                       | 561               | 561                  | 561       | —         | —         |
|  | December 31, 2016 |                      |           |           |           |
|  | Carrying Value    | Estimated Fair Value | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                   |                      |           |           |           |
| Cash and cash equivalents                                      | \$22,894          | \$ 22,894            | \$22,894  | \$ —      | —         |
| Mortgage loans AFS   | 1,816             | 1,836                | —         | 1,836     | —         |
| Gross loans  | 1,010,619         | 991,009              | —         | —         | 991,009   |
| Less allowance for loan and lease losses                       | 7,400             | 7,400                | —         | —         | 7,400     |
| Net loans  | 1,003,219         | 983,609              | —         | —         | 983,609   |
| Accrued interest receivable                                    | 6,580             | 6,580                | 6,580     | —         | —         |
| Equity securities without readily determinable fair values (1) | 21,694            | N/A                  | —         | —         | —         |
| OMSR   | 2,306             | 2,306                | —         | 2,306     | —         |
| <b>LIABILITIES</b>   |                   |                      |           |           |           |
| Deposits without stated maturities                             | 761,626           | 761,626              | 761,626   | —         | —         |
| Deposits with stated maturities                                | 433,414           | 430,088              | —         | 430,088   | —         |
| Borrowed funds   | 337,694           | 336,975              | —         | 336,975   | —         |
| Accrued interest payable                                       | 574               | 574                  | 574       | —         | —         |

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.





Table of Contents

## Financial Instruments Recorded at Fair Value

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

|  | June 30, 2017 |           |           |           | December 31, 2016 |           |           |           |
|--|---------------|-----------|-----------|-----------|-------------------|-----------|-----------|-----------|
|  | Total         | (Level 1) | (Level 2) | (Level 3) | Total             | (Level 1) | (Level 2) | (Level 3) |
| Recurring items  |               |           |           |           |                   |           |           |           |
| AFS securities   |               |           |           |           |                   |           |           |           |
| Government-sponsored enterprises                         | \$281         | \$—       | \$281     | \$—       | \$10,259          | \$—       | \$10,259  | \$—       |
| States and political subdivisions                        | 222,093       | —         | 222,093   | —         | 212,919           | —         | 212,919   | —         |
| Auction rate money market preferred                      | 3,095         | —         | 3,095     | —         | 2,794             | —         | 2,794     | —         |
| Preferred stocks   | 3,665         | 3,665     | —         | —         | 3,425             | 3,425     | —         | —         |
| Mortgage-backed securities                               | 221,957       | —         | 221,957   | —         | 227,256           | —         | 227,256   | —         |
| Collateralized mortgage obligations                      | 116,771       | —         | 116,771   | —         | 101,443           | —         | 101,443   | —         |
| Total AFS securities                                     | 567,862       | 3,665     | 564,197   | —         | 558,096           | 3,425     | 554,671   | —         |
| Derivative instruments                                   | 204           | —         | 204       | —         | 248               | —         | 248       | —         |
| Nonrecurring items                                       |               |           |           |           |                   |           |           |           |
| Impaired loans (net of the ALLL)                         | 15,117        | —         | —         | 15,117    | 9,166             | —         | —         | 9,166     |
| Foreclosed assets  | 229           | —         | —         | 229       | 231               | —         | —         | 231       |
| Total  | \$583,412     | \$3,665   | \$564,401 | \$15,346  | \$567,741         | \$3,425   | \$554,919 | \$9,397   |
| Percent of assets and liabilities measured at fair value |               | 0.63 %    | 96.74 %   | 2.63 %    |                   | 0.60 %    | 97.74 %   | 1.66 %    |

We had no assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a recurring basis, as of June 30, 2017. Foreclosed assets, which are recorded at fair value with changes in fair value recognized through earnings on a nonrecurring basis, were written down to \$229 as of June 30, 2017 which resulted in an impairment recorded through earnings in the amount of \$28 for the six month period ended June 30, 2017. We had no other assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a nonrecurring basis, as of June 30, 2017.

Table of Contents

## Note 12 – Accumulated Other Comprehensive Income

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

|                                | Three Months Ended June 30                          |   |                              |           | 2016  |   |                              |          |
|--------------------------------|---|---|------------------------------|-----------|---|---|------------------------------|----------|
|                                | 2017  |   | 2016                         |           | 2016  |   | 2016                         |          |
|                                | Unrealized Holding Gains (Losses) on AFS Securities | Unrealized Holding Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total     | Unrealized Holding Gains (Losses) on AFS Securities | Unrealized Holding Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total    |
| Balance, April 1               | \$1,257   | \$ 175  | \$ (2,972 )                  | \$(1,540) | \$8,333   | \$ —  | \$ (3,315 )                  | \$5,018  |
| OCI before reclassifications   | 2,570   | (61 )   | —                            | 2,509     | 4,067   | (152 )  | —                            | 3,915    |
| Amounts reclassified from AOCI | (142 )  | —   | —                            | (142 )    | (245 )  | —   | —                            | (245 )   |
| Subtotal                       | 2,428   | (61 )   | —                            | 2,367     | 3,822   | (152 )  | —                            | 3,670    |
| Tax effect                     | (762 )  | 21  | —                            | (741 )    | (1,173 )  | 52  | —                            | (1,121 ) |
| OCI, net of tax                | 1,666   | (40 )   | —                            | 1,626     | 2,649   | (100 )  | —                            | 2,549    |
| Balance, June 30               | \$2,923   | \$ 135  | \$ (2,972 )                  | \$86      | \$10,982  | \$ (100 )   | \$ (3,315 )                  | \$7,567  |
|                                | Six Months Ended June 30                            |   |                              |           | 2016  |   |                              |          |
|                                | 2017  |   | 2016                         |           | 2016  |   | 2016                         |          |
|                                | Unrealized Holding Gains (Losses) on AFS Securities | Unrealized Holding Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total     | Unrealized Holding Gains (Losses) on AFS Securities | Unrealized Holding Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total    |
| Balance, January 1             | \$30  | \$ 164  | \$ (2,972 )                  | \$(2,778) | \$3,536   | \$ —  | \$ (3,315 )                  | \$221    |
| OCI before reclassifications   | 4,247   | (44 )   | —                            | 4,203     | 11,341  | (152 )  | —                            | 11,189   |
| Amounts reclassified from AOCI | (142 )  | —   | —                            | (142 )    | (245 )  | —   | —                            | (245 )   |
| Subtotal                       | 4,105   | (44 )   | —                            | 4,061     | 11,096  | (152 )  | —                            | 10,944   |
| Tax effect                     | (1,212 )  | 15  | —                            | (1,197 )  | (3,650 )  | 52  | —                            | (3,598 ) |
| OCI, net of tax                | 2,893   | (29 )   | —                            | 2,864     | 7,446   | (100 )  | —                            | 7,346    |
| Balance, June 30               | \$2,923   | \$ 135  | \$ (2,972 )                  | \$86      | \$10,982  | \$ (100 )   | \$ (3,315 )                  | \$7,567  |

Included in OCI for the three and six month periods ended June 30, 2017 and 2016 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

Table of Contents

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

|  | Three Months Ended June 30 |            |          | 2016      |            |          |
|--|----------------------------|------------|----------|-----------|------------|----------|
|  | 2017                       |            |          | Auction   |            |          |
|  | Rate                       |            |          | Rate      |            |          |
|  | Money                      | All Other  | Total    | Money     | All Other  | Total    |
|  | Market                     | AFS        |          | Market    | AFS        |          |
|  | Preferred                  | Securities |          | Preferred | Securities |          |
|  | and                        |            |          | and       |            |          |
|  | Preferred                  |            |          | Preferred |            |          |
|  | Stocks                     |            |          | Stocks    |            |          |
| Unrealized gains (losses) arising during the period                                | \$186                      | \$ 2,384   | \$2,570  | \$372     | \$ 3,695   | \$4,067  |
| Reclassification adjustment for net realized (gains) losses included in net income | —                          | (142 )     | (142 )   | —         | (245 )     | (245 )   |
| Net unrealized gains (losses)  | 186                        | 2,242      | 2,428    | 372       | 3,450      | 3,822    |
| Tax effect   | —                          | (762 )     | (762 )   | —         | (1,173 )   | (1,173 ) |
| Unrealized gains (losses), net of tax  | \$186                      | \$ 1,480   | \$1,666  | \$372     | \$ 2,277   | \$2,649  |
|  | Six Months Ended June 30   |            |          | 2016      |            |          |
|  | 2017                       |            |          | Auction   |            |          |
|  | Rate                       |            |          | Rate      |            |          |
|  | Money                      | All Other  | Total    | Money     | All Other  | Total    |
|  | Market                     | AFS        |          | Market    | AFS        |          |
|  | Preferred                  | Securities |          | Preferred | Securities |          |
|  | and                        |            |          | and       |            |          |
|  | Preferred                  |            |          | Preferred |            |          |
|  | Stocks                     |            |          | Stocks    |            |          |
| Unrealized gains (losses) arising during the period                                | \$541                      | \$ 3,706   | \$4,247  | \$360     | \$ 10,981  | \$11,341 |
| Reclassification adjustment for net realized (gains) losses included in net income | —                          | (142 )     | (142 )   | —         | (245 )     | (245 )   |
| Net unrealized gains (losses)  | 541                        | 3,564      | 4,105    | 360       | 10,736     | 11,096   |
| Tax effect   | —                          | (1,212 )   | (1,212 ) | —         | (3,650 )   | (3,650 ) |
| Unrealized gains (losses), net of tax  | \$541                      | \$ 2,352   | \$2,893  | \$360     | \$ 7,086   | \$7,446  |

Table of ContentsNote 13 – Parent Company Only Financial Information  
Interim Condensed Balance Sheets

|   | June 30<br>2017  | December 31<br>2016 |
|---|------------------|---------------------|
| <b>ASSETS</b>                                     |                  |                     |
| Cash on deposit at the Bank                       | \$1,144          | \$ 1,297            |
| AFS securities                                    | —                | 251                 |
| Investments in subsidiaries                       | 145,128          | 138,549             |
| Premises and equipment                            | 1,940            | 1,991               |
| Other assets                                      | 52,673           | 52,846              |
| <b>TOTAL ASSETS</b>                               | <b>\$200,885</b> | <b>\$ 194,934</b>   |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                  |                     |
| Other liabilities                                 | \$5,815          | \$ 7,035            |
| Shareholders' equity                              | 195,070          | 187,899             |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$200,885</b> | <b>\$ 194,934</b>   |

## Interim Condensed Statements of Income

|   | Three Months<br>Ended<br>June 30 |                | Six Months<br>Ended<br>June 30 |                |
|---|----------------------------------|----------------|--------------------------------|----------------|
|   | 2017                             | 2016           | 2017                           | 2016           |
| <b>Income</b>   |                                  |                |                                |                |
| Dividends from subsidiaries   | \$2,600                          | \$2,000        | \$4,300                        | \$3,600        |
| Interest income   | —                                | 4              | 2                              | 8              |
| Management fee and other  | 1,691                            | 1,758          | 3,241                          | 3,282          |
| <b>Total income</b>   | <b>4,291</b>                     | <b>3,762</b>   | <b>7,543</b>                   | <b>6,890</b>   |
| <b>Expenses</b>   |                                  |                |                                |                |
| Compensation and benefits   | 1,118                            | 1,184          | 2,490                          | 2,384          |
| Occupancy and equipment   | 432                              | 413            | 876                            | 843            |
| Audit and related fees  | 140                              | 100            | 264                            | 196            |
| Other   | 634                              | 588            | 1,175                          | 1,134          |
| <b>Total expenses</b>   | <b>2,324</b>                     | <b>2,285</b>   | <b>4,805</b>                   | <b>4,557</b>   |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 1,967                            | 1,477          | 2,738                          | 2,333          |
| Federal income tax benefit  | 212                              | 171            | 528                            | 417            |
| Income before equity in undistributed earnings of subsidiaries                        | 2,179                            | 1,648          | 3,266                          | 2,750          |
| Undistributed earnings of subsidiaries  | 1,665                            | 1,759          | 3,714                          | 3,674          |
| <b>Net income</b>   | <b>\$3,844</b>                   | <b>\$3,407</b> | <b>\$6,980</b>                 | <b>\$6,424</b> |

Table of Contents

## Interim Condensed Statements of Cash Flows

|  | Six Months<br>Ended<br>June 30 |          |
|--|--------------------------------|----------|
|  | 2017                           | 2016     |
| Operating activities   |                                |          |
| Net income   | \$6,980                        | \$6,424  |
| Adjustments to reconcile net income to cash provided by operations                   |                                |          |
| Undistributed earnings of subsidiaries   | (3,714 )                       | (3,674 ) |
| Undistributed earnings of equity securities without readily determinable fair values | 93                             | (141 )   |
| Share-based payment awards under equity compensation plan                            | 302                            | 273      |
| Depreciation   | 77                             | 81       |
| Changes in operating assets and liabilities which provided (used) cash               |                                |          |
| Other assets   | 80                             | 108      |
| Accrued interest and other liabilities   | (1,219 )                       | (1,692 ) |
| Net cash provided by (used in) operating activities                                  | 2,599                          | 1,379    |
| Investing activities   |                                |          |
| Maturities, calls, principal payments, and sales of AFS securities                   | 249                            | —        |
| Purchases of premises and equipment  | (26 )                          | (69 )    |
| Net cash provided by (used in) investing activities                                  | 223                            | (69 )    |
| Financing activities   |                                |          |
| Cash dividends paid on common stock  | (3,920 )                       | (3,744 ) |
| Proceeds from the issuance of common stock   | 3,764                          | 2,489    |
| Common stock repurchased   | (2,622 )                       | (1,462 ) |
| Common stock purchased for deferred compensation obligations                         | (197 )                         | (164 )   |
| Net cash provided by (used in) financing activities                                  | (2,975 )                       | (2,881 ) |
| Increase (decrease) in cash and cash equivalents                                     | (153 )                         | (1,571 ) |
| Cash and cash equivalents at beginning of period                                     | 1,297                          | 4,125    |
| Cash and cash equivalents at end of period   | \$1,144                        | \$2,554  |

## 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, 2017 and 2016 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.

Table of Contents

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, 2017 and 2016. This analysis should be read in conjunction with our 2016 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, 2017, we reported net income of \$3,844 and \$6,980 and earnings per common share of \$0.49 and \$0.89, respectively. Net income and earnings per common share for the same periods of 2016 were \$3,407 and \$6,424 and \$0.44 and \$0.82, respectively. The increase in earnings was primarily driven by interest income which increased \$2,060 for the first six months of 2017 in comparison to the same period in 2016. Increased interest income is the result of strong loan growth during the past year.

During the six month period ended June 30, 2017, total assets grew by 2.61% to \$1,777,298, and assets under management increased to \$2,501,187 which includes loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$723,889. Total loans increased by \$37,882 from December 31, 2016 which was largely driven by growth of \$24,920 in the commercial loan portfolio. The growth in the loan portfolio was funded by an increase of \$15,112 in deposits since December 31, 2016, with the remainder being funded through additional borrowed funds.

Our net yield on interest earning assets remains historically low at 3.01% for the six month period ended June 30, 2017. The growth in net interest income will increase only through continued growth in a strategic mix of loans, investments, and other income earning assets. We do not anticipate that the Federal Reserve Bank will increase short term interest rates significantly in the remainder of 2017; therefore, we anticipate marginal improvements in our net yield on interest earning assets in the short term. We are committed to increasing earnings and shareholder value through growth in our loan portfolio, investment and trust services, and in deposits while managing operating costs. Reclassifications: Certain amounts reported in the 2016 consolidated financial statements have been reclassified to conform with the 2017 presentation.

Table of Contents

## Results of Operations

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

|  | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |   |
|--|-----------------|------------------|---------------------|----------------------|-----------------|---|
| <b>INCOME STATEMENT DATA</b>                                   |                 |                  |                     |                      |                 |   |
| Interest income  | \$ 14,498       | \$ 13,861        | \$ 13,760           | \$ 13,607            | \$ 13,218       |   |
| Interest expense   | 3,028           | 2,831            | 2,826               | 2,747                | 2,678           |   |
| Net interest income  | 11,470          | 11,030           | 10,934              | 10,860               | 10,540          |   |
| Provision for loan losses                                      | 9               | 27               | (320 )              | 17                   | 12              |   |
| Noninterest income   | 2,788           | 2,616            | 3,187               | 2,946                | 2,752           |   |
| Noninterest expenses   | 9,507           | 9,951            | 10,166              | 9,433                | 9,218           |   |
| Federal income tax expense                                     | 898             | 532              | 493                 | 763                  | 655             |   |
| Net Income   | \$ 3,844        | \$ 3,136         | \$ 3,782            | \$ 3,593             | \$ 3,407        |   |
| <b>PER SHARE</b>   |                 |                  |                     |                      |                 |   |
| Basic earnings   | \$ 0.49         | \$ 0.40          | \$ 0.48             | \$ 0.46              | \$ 0.44         |   |
| Diluted earnings   | \$ 0.48         | \$ 0.39          | \$ 0.47             | \$ 0.45              | \$ 0.43         |   |
| Dividends  | \$ 0.25         | \$ 0.25          | \$ 0.25             | \$ 0.25              | \$ 0.24         |   |
| Tangible book value*   | \$ 18.62        | \$ 18.34         | \$ 18.16            | \$ 17.93             | \$ 17.72        |   |
| Quoted market value  |                 |                  |                     |                      |                 |   |
| High   | \$ 28.45        | \$ 29.00         | \$ 28.35            | \$ 28.08             | \$ 28.25        |   |
| Low  | \$ 27.60        | \$ 27.60         | \$ 27.60            | \$ 27.60             | \$ 27.63        |   |
| Close*   | \$ 28.00        | \$ 27.60         | \$ 27.85            | \$ 27.70             | \$ 27.90        |   |
| Common shares outstanding*                                     | 7,862,553       | 7,843,120        | 7,821,069           | 7,833,481            | 7,836,442       |   |
| <b>PERFORMANCE RATIOS</b>                                      |                 |                  |                     |                      |                 |   |
| Return on average total assets                                 | 0.87            | % 0.72           | % 0.88              | % 0.85               | % 0.81          | % |
| Return on average shareholders' equity                         | 7.85            | % 6.56           | % 7.77              | % 7.27               | % 7.05          | % |
| Return on average tangible shareholders' equity                | 10.59           | % 8.77           | % 10.70             | % 10.28              | % 9.89          | % |
| Net interest margin yield (FTE)                                | 3.03            | % 2.99           | % 3.01              | % 3.05               | % 2.97          | % |
| <b>BALANCE SHEET DATA*</b>                                     |                 |                  |                     |                      |                 |   |
| Gross loans  | \$ 1,048,497    | \$ 1,012,920     | \$ 1,010,615        | \$ 989,366           | \$ 919,594      |   |
| AFS securities   | \$ 567,862      | \$ 590,114       | \$ 558,096          | \$ 564,229           | \$ 602,463      |   |
| Total assets   | \$ 1,777,298    | \$ 1,760,860     | \$ 1,732,151        | \$ 1,706,498         | \$ 1,680,359    |   |
| Deposits   | \$ 1,210,152    | \$ 1,231,061     | \$ 1,195,040        | \$ 1,175,833         | \$ 1,156,870    |   |
| Borrowed funds   | \$ 360,940      | \$ 327,375       | \$ 337,694          | \$ 325,409           | \$ 318,596      |   |
| Shareholders' equity   | \$ 195,070      | \$ 190,976       | \$ 187,899          | \$ 195,184           | \$ 195,133      |   |
| Gross loans to deposits  | 86.64           | % 82.28          | % 84.57             | % 84.14              | % 79.49         | % |
| <b>ASSETS UNDER MANAGEMENT*</b>                                |                 |                  |                     |                      |                 |   |
| Loans sold with servicing retained                             | \$ 269,595      | \$ 270,217       | \$ 272,882          | \$ 275,037           | \$ 275,958      |   |
| Assets managed by our Investment and Trust Services Department | \$ 454,294      | \$ 444,749       | \$ 427,693          | \$ 424,573           | \$ 415,762      |   |
| Total assets under management                                  | \$ 2,501,187    | \$ 2,475,826     | \$ 2,432,726        | \$ 2,406,108         | \$ 2,372,079    |   |
| <b>ASSET QUALITY*</b>  |                 |                  |                     |                      |                 |   |
| Nonperforming loans to gross loans                             | 0.26            | % 0.24           | % 0.17              | % 0.16               | % 0.13          | % |
| Nonperforming assets to total assets                           | 0.17            | % 0.15           | % 0.11              | % 0.11               | % 0.09          | % |
| ALLL to gross loans  | 0.72            | % 0.74           | % 0.73              | % 0.79               | % 0.83          | % |
| <b>CAPITAL RATIOS*</b>   |                 |                  |                     |                      |                 |   |

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|                                |       |         |         |         |         |   |
|--------------------------------|-------|---------|---------|---------|---------|---|
| Shareholders' equity to assets | 10.98 | % 10.85 | % 10.85 | % 11.44 | % 11.61 | % |
| Tier 1 leverage                | 8.50  | % 8.54  | % 8.56  | % 8.59  | % 8.50  | % |
| Common equity tier 1 capital   | 12.43 | % 12.49 | % 12.39 | % 12.41 | % 13.08 | % |
| Tier 1 risk-based capital      | 12.43 | % 12.49 | % 12.39 | % 12.41 | % 13.08 | % |
| Total risk-based capital       | 13.07 | % 13.14 | % 13.04 | % 13.10 | % 13.80 | % |

\* At end of period

40

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Table of Contents

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

|  | June 30<br>2017 | June 30<br>2016 | June 30<br>2015 | June 30<br>2014 | June 30<br>2013 |   |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|---|
| <b>INCOME STATEMENT DATA</b>                                   |                 |                 |                 |                 |                 |   |
| Interest income  | \$28,359        | \$26,299        | \$25,512        | \$25,318        | \$25,054        |   |
| Interest expense   | 5,859           | 5,292           | 5,006           | 4,968           | 5,602           |   |
| Net interest income  | 22,500          | 21,007          | 20,506          | 20,350          | 19,452          |   |
| Provision for loan losses                                      | 36              | 168             | (1,261)         | (442)           | 515             |   |
| Noninterest income   | 5,404           | 4,975           | 4,757           | 4,683           | 5,183           |   |
| Noninterest expenses   | 19,458          | 18,298          | 17,005          | 17,349          | 16,601          |   |
| Federal income tax expense                                     | 1,430           | 1,092           | 1,748           | 1,252           | 1,219           |   |
| Net Income   | \$6,980         | \$6,424         | \$7,771         | \$6,874         | \$6,300         |   |
| <b>PER SHARE</b>   |                 |                 |                 |                 |                 |   |
| Basic earnings   | \$0.89          | \$0.82          | \$1.00          | \$0.89          | \$0.82          |   |
| Diluted earnings   | \$0.87          | \$0.80          | \$0.98          | \$0.87          | \$0.80          |   |
| Dividends  | \$0.50          | \$0.48          | \$0.46          | \$0.44          | \$0.42          |   |
| Tangible book value*   | \$18.62         | \$17.72         | \$17.17         | \$16.08         | \$15.19         |   |
| Quoted market value  |                 |                 |                 |                 |                 |   |
| High   | \$29.00         | \$29.90         | \$23.80         | \$23.94         | \$26.00         |   |
| Low  | \$27.60         | \$27.25         | \$22.00         | \$22.52         | \$21.60         |   |
| Close*   | \$28.00         | \$27.90         | \$23.75         | \$22.95         | \$24.75         |   |
| Common shares outstanding*                                     | 7,862,553       | 7,836,442       | 7,797,188       | 7,735,156       | 7,703,589       |   |
| <b>PERFORMANCE RATIOS</b>                                      |                 |                 |                 |                 |                 |   |
| Return on average total assets                                 | 0.80            | % 0.77          | % 1.00          | % 0.91          | % 0.88          | % |
| Return on average shareholders' equity                         | 7.21            | % 6.71          | % 8.69          | % 8.24          | % 7.63          | % |
| Return on average tangible shareholders' equity                | 9.67            | % 9.37          | % 11.71         | % 11.17         | % 10.98         | % |
| Net interest margin yield (FTE)                                | 3.01            | % 2.97          | % 3.15          | % 3.21          | % 3.22          | % |
| <b>BALANCE SHEET DATA*</b>                                     |                 |                 |                 |                 |                 |   |
| Gross loans  | \$1,048,497     | \$919,594       | \$831,831       | \$819,253       | \$805,733       |   |
| AFS securities   | \$567,862       | \$602,463       | \$595,318       | \$550,518       | \$499,424       |   |
| Total assets   | \$1,777,298     | \$1,680,359     | \$1,586,975     | \$1,522,135     | \$1,451,415     |   |
| Deposits   | \$1,210,152     | \$1,156,870     | \$1,090,469     | \$1,060,928     | \$1,021,424     |   |
| Borrowed funds   | \$360,940       | \$318,596       | \$307,599       | \$279,457       | \$262,460       |   |
| Shareholders' equity   | \$195,070       | \$195,133       | \$178,025       | \$171,099       | \$159,288       |   |
| Gross loans to deposits  | 86.64           | % 79.49         | % 76.28         | % 77.22         | % 78.88         | % |
| <b>ASSETS UNDER MANAGEMENT*</b>                                |                 |                 |                 |                 |                 |   |
| Loans sold with servicing retained                             | \$269,595       | \$275,958       | \$289,089       | \$290,590       | \$295,047       |   |
| Assets managed by our Investment and Trust Services Department | \$454,294       | \$415,762       | \$400,827       | \$374,092       | \$336,132       |   |
| Total assets under management                                  | \$2,501,187     | \$2,372,079     | \$2,276,891     | \$2,186,817     | \$2,082,594     |   |
| <b>ASSET QUALITY*</b>  |                 |                 |                 |                 |                 |   |
| Nonperforming loans to gross loans                             | 0.26            | % 0.13          | % 0.19          | % 0.57          | % 0.52          | % |
| Nonperforming assets to total assets                           | 0.17            | % 0.09          | % 0.15          | % 0.38          | % 0.36          | % |
| ALLL to gross loans  | 0.72            | % 0.83          | % 1.08          | % 1.31          | % 1.45          | % |
| <b>CAPITAL RATIOS*</b>   |                 |                 |                 |                 |                 |   |
| Shareholders' equity to assets                                 | 10.98           | % 11.61         | % 11.22         | % 11.24         | % 10.97         | % |
| Tier 1 leverage  | 8.50            | % 8.50          | % 8.77          | % 8.50          | % 8.38          | % |

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|                              |       |         |         |         |         |   |
|------------------------------|-------|---------|---------|---------|---------|---|
| Common equity tier 1 capital | 12.43 | % 13.08 | % 13.94 | % N/A   | N/A     |   |
| Tier 1 risk-based capital    | 12.43 | % 13.08 | % 13.94 | % 13.86 | % 13.60 | % |
| Total risk-based capital     | 13.07 | % 13.80 | % 14.88 | % 15.11 | % 14.85 | % |

\* At end of period

41

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Table of Contents

## 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 34% federal income tax rate. 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, 2017      |                         |                      | March 31, 2017  |                         |                      | June 30, 2016   |                         |                      |
|   | 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                                   | \$1,028,875        | \$ 10,685               | 4.15 %               | \$997,443       | \$ 10,120               | 4.06 %               | \$893,282       | \$ 9,316                | 4.17 %               |
| Taxable investment securities           | 374,156            | 2,226                   | 2.38 %               | 364,251         | 2,151                   | 2.36 %               | 419,252         | 2,303                   | 2.20 %               |
| Nontaxable investment securities        | 206,668            | 2,314                   | 4.48 %               | 205,372         | 2,316                   | 4.51 %               | 208,425         | 2,356                   | 4.52 %               |
| Fed Funds Sold                          | 95                 | —                       | — %                  | 2,397           | 4                       | 0.67 %               | —               | —                       | — %                  |
| Other                                   | 23,299             | 174                     | 2.99 %               | 26,929          | 171                     | 2.54 %               | 23,564          | 157                     | 2.67 %               |
| Total earning assets                    | 1,633,093          | 15,399                  | 3.77 %               | 1,596,392       | 14,762                  | 3.70 %               | 1,544,523       | 14,132                  | 3.66 %               |
| <b>NONEARNING ASSETS</b>                |                    |                         |                      |                 |                         |                      |                 |                         |                      |
| Allowance for loan losses               | (7,554 )           |                         |                      | (7,480 )        |                         |                      | (7,557 )        |                         |                      |
| Cash and demand deposits due from banks | 18,425             |                         |                      | 18,736          |                         |                      | 17,942          |                         |                      |
| Premises and equipment                  | 28,895             |                         |                      | 29,238          |                         |                      | 28,363          |                         |                      |
| Accrued income and other assets         | 99,468             |                         |                      | 97,692          |                         |                      | 101,341         |                         |                      |
| Total assets                            | \$1,772,327        |                         |                      | \$1,734,578     |                         |                      | \$1,684,612     |                         |                      |
| <b>INTEREST BEARING LIABILITIES</b>     |                    |                         |                      |                 |                         |                      |                 |                         |                      |
| Interest bearing demand deposits        | \$209,638          | \$ 55                   | 0.10 %               | \$213,617       | \$ 53                   | 0.10 %               | \$204,044       | \$ 40                   | 0.08 %               |
| Savings deposits                        | 360,870            | 259                     | 0.29 %               | 354,006         | 222                     | 0.25 %               | 340,251         | 144                     | 0.17 %               |
| Time deposits                           | 436,716            | 1,301                   | 1.19 %               | 436,003         | 1,265                   | 1.16 %               | 427,753         | 1,234                   | 1.15 %               |
| Borrowed funds                          | 356,096            | 1,413                   | 1.59 %               | 328,368         | 1,291                   | 1.57 %               | 320,337         | 1,260                   | 1.57 %               |
| Total interest bearing liabilities      | 1,363,320          | 3,028                   | 0.89 %               | 1,331,994       | 2,831                   | 0.85 %               | 1,292,385       | 2,678                   | 0.83 %               |
| <b>NONINTEREST BEARING LIABILITIES</b>  |                    |                         |                      |                 |                         |                      |                 |                         |                      |
| Demand deposits                         | 202,597            |                         |                      | 200,598         |                         |                      | 189,520         |                         |                      |
| Other                                   | 10,579             |                         |                      | 10,841          |                         |                      | 9,360           |                         |                      |

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|  |             |             |             |
|--|-------------|-------------|-------------|
| Shareholders' equity                       | 195,831     | 191,145     | 193,347     |
| Total liabilities and shareholders' equity | \$1,772,327 | \$1,734,578 | \$1,684,612 |
| Net interest income (FTE)                  | \$ 12,371   | \$ 11,931   | \$ 11,454   |
| Net yield on interest earning assets (FTE) | 3.03 %      | 2.99 %      | 2.97 %      |

42

---

Table of Contents

|  | Six Months Ended   |                               |                            |                    |                               |                            |
|--|--------------------|-------------------------------|----------------------------|--------------------|-------------------------------|----------------------------|
|  | June 30, 2017      |                               |                            | June 30, 2016      |                               |                            |
|  | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate | Average<br>Balance | Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |
| <b>INTEREST EARNING ASSETS</b>             |                    |                               |                            |                    |                               |                            |
| Loans                                      | \$ 1,013,248       | \$ 20,805                     | 4.11 %                     | \$ 875,533         | \$ 18,355                     | 4.19 %                     |
| Taxable investment securities              | 369,231            | 4,377                         | 2.37 %                     | 425,999            | 4,703                         | 2.21 %                     |
| Nontaxable investment securities           | 206,023            | 4,627                         | 4.49 %                     | 210,060            | 4,779                         | 4.55 %                     |
| Fed Funds Sold                             | 1,240              | 4                             | 0.65 %                     | —                  | —                             | — %                        |
| Other                                      | 25,128             | 345                           | 2.75 %                     | 25,246             | 315                           | 2.50 %                     |
| Total earning assets                       | 1,614,870          | 30,158                        | 3.74 %                     | 1,536,838          | 28,152                        | 3.66 %                     |
| <b>NONEARNING ASSETS</b>                   |                    |                               |                            |                    |                               |                            |
| Allowance for loan losses                  | (7,517 )           |                               |                            | (7,498 )           |                               |                            |
| Cash and demand deposits due from banks    | 18,551             |                               |                            | 17,857             |                               |                            |
| Premises and equipment                     | 29,068             |                               |                            | 28,308             |                               |                            |
| Accrued income and other assets            | 98,588             |                               |                            | 101,039            |                               |                            |
| Total assets                               | \$ 1,753,560       |                               |                            | \$ 1,676,544       |                               |                            |
| <b>INTEREST BEARING LIABILITIES</b>        |                    |                               |                            |                    |                               |                            |
| Interest bearing demand deposits           | \$ 211,616         | \$ 108                        | 0.10 %                     | \$ 206,177         | \$ 82                         | 0.08 %                     |
| Savings deposits                           | 357,456            | 481                           | 0.27 %                     | 341,396            | 288                           | 0.17 %                     |
| Time deposits                              | 436,362            | 2,566                         | 1.18 %                     | 424,333            | 2,447                         | 1.15 %                     |
| Borrowed funds                             | 342,307            | 2,704                         | 1.58 %                     | 315,488            | 2,475                         | 1.57 %                     |
| Total interest bearing liabilities         | 1,347,741          | 5,859                         | 0.87 %                     | 1,287,394          | 5,292                         | 0.82 %                     |
| <b>NONINTEREST BEARING LIABILITIES</b>     |                    |                               |                            |                    |                               |                            |
| Demand deposits                            | 201,613            |                               |                            | 188,242            |                               |                            |
| Other                                      | 10,707             |                               |                            | 9,501              |                               |                            |
| Shareholders' equity                       | 193,499            |                               |                            | 191,407            |                               |                            |
| Total liabilities and shareholders' equity | \$ 1,753,560       |                               |                            | \$ 1,676,544       |                               |                            |
| Net interest income (FTE)                  |                    | \$ 24,299                     |                            |                    | \$ 22,860                     |                            |
| Net yield on interest earning assets (FTE) |                    |                               | 3.01 %                     |                    |                               | 2.97 %                     |

**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.

**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.

Table of Contents

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, 2017 Compared to March 31, 2017 Increase (Decrease) Due to |       |       | Three Months Ended June 30, 2017 Compared to June 30, 2016 Increase (Decrease) Due to |        |         | Six Months Ended June 30, 2017 Compared to June 30, 2016 Increase (Decrease) Due to |         |         |
|-------------------------------------|--|-------|-------|---|--------|---------|---|---------|---------|
|                                     | Volume   | Rate  | Net   | Volume  | Rate   | Net     | Volume  | Rate    | Net     |
| Changes in interest income          |  |       |       |   |        |         |   |         |         |
| Loans                               | \$323  | \$242 | \$565 | \$1,408   | \$(39) | \$1,369 | \$2,835   | \$(385) | \$2,450 |
| Taxable investment securities       | 59   | 16    | 75    | (259)   | 182    | (77)    | (656)   | 330     | (326)   |
| Nontaxable investment securities    | 15   | (17)  | (2)   | (20)  | (22)   | (42)    | (91)  | (61)    | (152)   |
| Fed Funds Sold                      | —  | (4)   | (4)   | —   | —      | —       | 4   | —       | 4       |
| Other                               | (25)   | 28    | 3     | (2)   | 19     | 17      | (1)   | 31      | 30      |
| Total changes in interest income    | 372  | 265   | 637   | 1,127   | 140    | 1,267   | 2,091   | (85)    | 2,006   |
| Changes in interest expense         |  |       |       |   |        |         |   |         |         |
| Interest bearing demand deposits    | (1)  | 3     | 2     | 1   | 14     | 15      | 2   | 24      | 26      |
| Savings deposits                    | 4  | 33    | 37    | 9   | 106    | 115     | 14  | 179     | 193     |
| Time deposits                       | 2  | 34    | 36    | 26  | 41     | 67      | 70  | 49      | 119     |
| Borrowed funds                      | 110  | 12    | 122   | 142   | 11     | 153     | 212   | 17      | 229     |
| Total changes in interest expense   | 115  | 82    | 197   | 178   | 172    | 350     | 298   | 269     | 567     |
| Net change in interest margin (FTE) | \$257  | \$183 | \$440 | \$949   | \$(32) | \$917   | \$1,793   | \$(354) | \$1,439 |

Our net yield on interest earning assets remains at historically 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 downward 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 2017.

Average Yield / Rate for the Three Month Periods Ended:

|  | June 30 2017 | March 31 2017 | December 31 2016 | September 30 2016 | June 30 2016 |
|--|--------------|---------------|------------------|-------------------|--------------|
| Total earning assets                       | 3.77%        | 3.70%         | 3.73%            | 3.76%             | 3.66%        |
| Total interest bearing liabilities         | 0.89%        | 0.85%         | 0.87%            | 0.86%             | 0.83%        |
| Net yield on interest earning assets (FTE) | 3.03%        | 2.99%         | 3.01%            | 3.05%             | 2.97%        |

Quarter to Date Net Interest Income (FTE)

|                             | June 30 2017 | March 31 2017 | December 31 2016 | September 30 2016 | June 30 2016 |
|-----------------------------|--------------|---------------|------------------|-------------------|--------------|
| Total interest income (FTE) | \$15,399     | \$14,762      | \$14,642         | \$14,508          | \$14,132     |
| Total interest expense      | 3,028        | 2,831         | 2,826            | 2,747             | 2,678        |
| Net interest income (FTE)   | \$12,371     | \$11,931      | \$11,816         | \$11,761          | \$11,454     |

Table of Contents

## 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 reflection of other qualitative risks that reflects 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 |          | Six Months Ended |         |
|--|--------------------|----------|------------------|---------|
|  | June 30            |          | June 30          |         |
|  | 2017               | 2016     | 2017             | 2016    |
| ALLL at beginning of period                                    | \$7,500            | \$7,500  | \$7,400          | \$7,400 |
| Charge-offs  |                    |          |                  |         |
| Commercial and agricultural                                    | 25                 | 32       | 52               | 48      |
| Residential real estate  | —                  | 128      | 43               | 369     |
| Consumer   | 44                 | 48       | 118              | 132     |
| Total charge-offs  | 69                 | 208      | 213              | 549     |
| Recoveries   |                    |          |                  |         |
| Commercial and agricultural                                    | 55                 | 189      | 188              | 370     |
| Residential real estate  | 63                 | 45       | 99               | 95      |
| Consumer   | 42                 | 62       | 90               | 116     |
| Total recoveries   | 160                | 296      | 377              | 581     |
| Net loan charge-offs (recoveries)                              | (91 )              | (88 )    | (164 )           | (32 )   |
| Provision for loan losses                                      | 9                  | 12       | 36               | 168     |
| ALLL at end of period  | \$7,600            | \$7,600  | \$7,600          | \$7,600 |
| Net loan charge-offs (recoveries) to average loans outstanding | (0.01 )%           | (0.01 )% | (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  | March 31 | December 31 | September 30 | June 30  |
|--|----------|----------|-------------|--------------|----------|
|  | 2017     | 2017     | 2016        | 2016         | 2016     |
| Total charge-offs  | \$69     | \$144    | \$ 236      | \$ 131       | \$208    |
| Total recoveries   | 160      | 217      | 156         | 314          | 296      |
| Net loan charge-offs (recoveries)                              | (91 )    | (73 )    | 80          | (183 )       | (88 )    |
| Net loan charge-offs (recoveries) to average loans outstanding | (0.01 )% | (0.01 )% | 0.01 %      | (0.02 )%     | (0.01 )% |
| Provision for loan losses                                      | \$9      | \$27     | \$ (320 )   | \$ 17        | \$12     |
| Provision for loan losses to average loans outstanding         | — %      | — %      | (0.03 )%    | — %          | — %      |
| ALLL   | \$7,600  | \$7,500  | \$ 7,400    | \$ 7,800     | \$7,600  |
| ALLL as a % of loans at end of period                          | 0.72 %   | 0.74 %   | 0.73 %      | 0.79 %       | 0.83 %   |

Net loan recoveries and improvement in credit quality indicators have resulted in a reduction of the required ALLL as a percentage of loans over the past year. During this time, credit quality indicators, specifically historical loss factors, remain strong and have led to lower levels of required reserves. While they can be more volatile, loans individually evaluated for impairment have been steadily declining. The addition of advances to mortgage brokers contributed to the overall decline in the level of ALLL to gross loans as there are no historical losses requiring reserves. While these advances contribute to other qualitative factors, the impact is not significant on the required level of the ALLL.





Table of Contents

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

|                                       | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|---------------------------------------|-----------------|------------------|---------------------|----------------------|-----------------|
| <b>ALLL</b>                           |                 |                  |                     |                      |                 |
| Individually evaluated for impairment | \$2,455         | \$2,381          | \$ 2,371            | \$ 2,523             | \$2,602         |
| Collectively evaluated for impairment | 5,145           | 5,119            | 5,029               | 5,277                | 4,998           |
| <b>Total</b>                          | <b>\$7,600</b>  | <b>\$7,500</b>   | <b>\$ 7,400</b>     | <b>\$ 7,800</b>      | <b>\$7,600</b>  |
| <b>ALLL to gross loans</b>            |                 |                  |                     |                      |                 |
| Individually evaluated for impairment | 0.23 %          | 0.24 %           | 0.23 %              | 0.26 %               | 0.28 %          |
| Collectively evaluated for impairment | 0.49 %          | 0.50 %           | 0.50 %              | 0.53 %               | 0.55 %          |
| <b>Total</b>                          | <b>0.72 %</b>   | <b>0.74 %</b>    | <b>0.73 %</b>       | <b>0.79 %</b>        | <b>0.83 %</b>   |

For further discussion of the allocation of the ALLL, see “Note 5 – 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.

|   | <b>Total Past Due and Nonaccrual Loans</b> |                  |                     |                      |                 |
|---|--|------------------|---------------------|----------------------|-----------------|
|   | June 30<br>2017                            | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
| Commercial and agricultural                               | \$4,920                                    | \$5,758          | \$ 4,598            | \$ 3,148             | \$2,247         |
| Residential real estate                                   | 2,358                                      | 3,168            | 2,716               | 2,436                | 2,755           |
| Consumer  | 64   | 35               | 115                 | 51                   | 23              |
| <b>Total</b>  | <b>\$7,342</b>                             | <b>\$8,961</b>   | <b>\$ 7,429</b>     | <b>\$ 5,635</b>      | <b>\$5,025</b>  |
| <b>Total past due and nonaccrual loans to gross loans</b> | <b>0.70 %</b>                              | <b>0.88 %</b>    | <b>0.74 %</b>       | <b>0.57 %</b>        | <b>0.55 %</b>   |

While past due and nonaccrual status loans have increased over the last year, they continue to be below historical norms and are the result of strong loan performance. 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 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

Table of Contents

## 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.

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, 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, 2017 or December 31, 2016.

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 to ensure its continued appropriateness.

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

|                                | Three Months Ended June 30, 2017 |          |            |          |          |          |
|--------------------------------|----------------------------------|----------|------------|----------|----------|----------|
|                                | Accruing Interest                |          | Nonaccrual |          | Total    |          |
|                                | Number                           | Balance  | Number     | Balance  | Number   | Balance  |
|                                | of Loans                         | of Loans | of Loans   | of Loans | of Loans | of 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 |

|                                | Six Months Ended June 30, 2017 |          |            |          |          |          |
|--------------------------------|--------------------------------|----------|------------|----------|----------|----------|
|                                | Accruing Interest              |          | Nonaccrual |          | Total    |          |
|                                | Number                         | Balance  | Number     | Balance  | Number   | Balance  |
|                                | of Loans                       | of Loans | of Loans   | of Loans | of Loans | of Loans |
| 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 |



Table of Contents

|                                | Three Months Ended June 30, 2016 |           |            |         |        |           |
|--------------------------------|----------------------------------|-----------|------------|---------|--------|-----------|
|                                | Accruing Interest                |           | Nonaccrual |         | Total  |           |
|                                | Number                           | Balance   | Number     | Balance | Number | Balance   |
|                                | of                               |           | of         |         | of     |           |
|                                | Loans                            |           | Loans      |         | Loans  |           |
| April 1, 2016                  | 151                              | \$ 19,411 | 6          | \$ 577  | 157    | \$ 19,988 |
| New modifications              | 3                                | 201       | —          | —       | 3      | 201       |
| Principal advances (payments)  | —                                | (350 )    | —          | (9 )    | —      | (359 )    |
| Loans paid-off                 | (2 )                             | (98 )     | (1)        | (221 )  | (3 )   | (319 )    |
| Partial charge-offs            | —                                | —         | —          | (81 )   | —      | (81 )     |
| Balances charged-off           | —                                | —         | —          | —       | —      | —         |
| Transfers to OREO              | —                                | —         | —          | —       | —      | —         |
| Transfers to accrual status    | —                                | —         | —          | —       | —      | —         |
| Transfers to nonaccrual status | (1 )                             | (321 )    | 1          | 321     | —      | —         |
| June 30, 2016                  | 151                              | \$ 18,843 | 6          | \$ 587  | 157    | \$ 19,430 |
|                                | Six Months Ended June 30, 2016   |           |            |         |        |           |
|                                | Accruing Interest                |           | Nonaccrual |         | Total  |           |
|                                | Number                           | Balance   | Number     | Balance | Number | Balance   |
|                                | of                               |           | of         |         | of     |           |
|                                | Loans                            |           | Loans      |         | Loans  |           |
| January 1, 2016                | 155                              | \$ 20,931 | 5          | \$ 394  | 160    | \$ 21,325 |
| New modifications              | 6                                | 229       | —          | —       | 6      | 229       |
| Principal advances (payments)  | —                                | (627 )    | —          | (17 )   | —      | (644 )    |
| Loans paid-off                 | (6 )                             | (1,076 )  | (1)        | (221 )  | (7 )   | (1,297 )  |
| Partial charge-offs            | —                                | —         | —          | (133 )  | —      | (133 )    |
| Balances charged-off           | (1 )                             | (15 )     | —          | —       | (1 )   | (15 )     |
| Transfers to OREO              | —                                | —         | (1)        | (35 )   | (1 )   | (35 )     |
| Transfers to accrual status    | —                                | —         | —          | —       | —      | —         |
| Transfers to nonaccrual status | (3 )                             | (599 )    | 3          | 599     | —      | —         |
| June 30, 2016                  | 151                              | \$ 18,843 | 6          | \$ 587  | 157    | \$ 19,430 |

The following table summarizes our TDRs as of:

|                          | June 30, 2017     |            |           | December 31, 2016 |            |           |              |
|--------------------------|-------------------|------------|-----------|-------------------|------------|-----------|--------------|
|                          | Accruing Interest | Nonaccrual | Total     | Accruing Interest | Nonaccrual | Total     | Total Change |
| Current                  | \$ 23,328         | \$ 295     | \$ 23,623 | \$ 17,557         | \$ 559     | \$ 18,116 | \$ 5,507     |
| Past due 30-59 days      | 1,631             | 466        | 2,097     | 2,898             | 230        | 3,128     | (1,031 )     |
| Past due 60-89 days      | —                 | —          | —         | 138               | —          | 138       | (138 )       |
| Past due 90 days or more | 223               | 398        | 621       | —                 | —          | —         | 621          |
| Total                    | \$ 25,182         | \$ 1,159   | \$ 26,341 | \$ 20,593         | \$ 789     | \$ 21,382 | \$ 4,959     |

Additional disclosures about TDRs are included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

Table of Contents

## Impaired Loans

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

|                                      | June 30, 2017       |                                |                        | December 31, 2016   |                                |                        |
|--------------------------------------|---------------------|--------------------------------|------------------------|---------------------|--------------------------------|------------------------|
|                                      | Recorded<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Recorded<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| <b>TDRs</b>                          |                     |                                |                        |                     |                                |                        |
| Commercial real estate               | \$6,008             | \$6,129                        | \$ 733                 | \$6,264             | \$6,383                        | \$ 713                 |
| Commercial other                     | 1,195               | 1,195                          | 50                     | 1,444               | 1,455                          | 25                     |
| Agricultural real estate             | 7,826               | 7,826                          | —                      | 4,037               | 4,037                          | —                      |
| Agricultural other                   | 3,171               | 3,171                          | —                      | 1,380               | 1,380                          | 1                      |
| Residential real estate senior liens | 7,956               | 8,333                          | 1,563                  | 8,058               | 8,437                          | 1,539                  |
| Residential real estate junior liens | 76                  | 76                             | 15                     | 71                  | 71                             | 13                     |
| Home equity lines of credit          | 89                  | 389                            | —                      | 102                 | 402                            | —                      |
| Consumer secured                     | 20                  | 20                             | —                      | 26                  | 26                             | —                      |
| <b>Total TDRs</b>                    | <b>26,341</b>       | <b>27,139</b>                  | <b>2,361</b>           | <b>21,382</b>       | <b>22,191</b>                  | <b>2,291</b>           |
| <b>Other impaired loans</b>          |                     |                                |                        |                     |                                |                        |
| Commercial real estate               | 159                 | 245                            | —                      | 151                 | 226                            | 3                      |
| Commercial other                     | —                   | —                              | —                      | —                   | —                              | —                      |
| Agricultural real estate             | —                   | —                              | —                      | —                   | —                              | —                      |
| Agricultural other                   | 128                 | 128                            | —                      | 128                 | 128                            | —                      |
| Residential real estate senior liens | 437                 | 644                            | 86                     | 406                 | 612                            | 76                     |
| Residential real estate junior liens | —                   | —                              | —                      | 1                   | 11                             | 1                      |
| Home equity lines of credit          | 70                  | 70                             | 8                      | —                   | —                              | —                      |
| Consumer secured                     | —                   | —                              | —                      | —                   | —                              | —                      |
| <b>Total other impaired loans</b>    | <b>794</b>          | <b>1,087</b>                   | <b>94</b>              | <b>686</b>          | <b>977</b>                     | <b>80</b>              |
| <b>Total impaired loans</b>          | <b>\$27,135</b>     | <b>\$28,226</b>                | <b>\$ 2,455</b>        | <b>\$22,068</b>     | <b>\$23,168</b>                | <b>\$ 2,371</b>        |

Additional disclosure related to impaired loans is included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

Table of Contents

## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

|   | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|---|-----------------|------------------|---------------------|----------------------|-----------------|
| Nonaccrual status loans                     | \$1,563         | \$1,138          | \$ 1,060            | \$ 690               | \$974           |
| Accruing loans past due 90 days or more     | 1,203           | 1,339            | 633                 | 847                  | 208             |
| Total nonperforming loans                   | 2,766           | 2,477            | 1,693               | 1,537                | 1,182           |
| Foreclosed assets                           | 229             | 158              | 231                 | 284                  | 249             |
| Total nonperforming assets                  | \$2,995         | \$2,635          | \$ 1,924            | \$ 1,821             | \$1,431         |
| Nonperforming loans as a % of total loans   | 0.26 %          | 0.24 %           | 0.17 %              | 0.16 %               | 0.13 %          |
| Nonperforming assets as a % of total assets | 0.17 %          | 0.15 %           | 0.11 %              | 0.11 %               | 0.09 %          |

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. While nonperforming loans have increased in recent periods, current levels of nonperforming loans continue to reflect historically low levels.

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

|                             | June 30<br>2017 | December 31<br>2016 |
|-----------------------------|-----------------|---------------------|
| Commercial and agricultural | \$864           | \$ 405              |
| Residential real estate     | 295             | 384                 |
| Total                       | \$1,159         | \$ 789              |

Additional disclosures about nonaccrual status loans are included in “Note 5 – 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, 2017.

We believe that the level of the ALLL is appropriate as of June 30, 2017. 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.

Table of Contents

## Noninterest Income and Noninterest Expenses

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

|   | Three Months Ended June 30 |         |        |          |
|---|----------------------------|---------|--------|----------|
|   | 2017                       | 2016    | Change |          |
|   |                            |         | \$     | %        |
| Service charges and fees                            |                            |         |        |          |
| ATM and debit card fees                             | \$675                      | \$637   | \$38   | 5.97 %   |
| NSF and overdraft fees                              | 461                        | 462     | (1 )   | (0.22 )% |
| Freddie Mac servicing fee                           | 170                        | 174     | (4 )   | (2.30 )% |
| Net OMSR income (loss)                              | (17 )                      | (227 )  | 210    | N/M      |
| Service charges on deposit accounts                 | 86                         | 86      | —      | — %      |
| All other   | 30                         | 31      | (1 )   | (3.23 )% |
| Total service charges and fees                      | 1,405                      | 1,163   | 242    | 20.81 %  |
| Net gain on sale of mortgage loans                  | 199                        | 127     | 72     | 56.69 %  |
| Earnings on corporate owned life insurance policies | 183                        | 195     | (12 )  | (6.15 )% |
| Net gains (losses) on sale of AFS securities        | 142                        | 245     | (103)  | (42.04)% |
| Other   |                            |         |        |          |
| Trust and brokerage advisory fees                   | 666                        | 609     | 57     | 9.36 %   |
| Corporate Settlement Solutions joint venture        | 105                        | 224     | (119)  | (53.13)% |
| Other   | 88                         | 189     | (101)  | (53.44)% |
| Total other   | 859                        | 1,022   | (163)  | (15.95)% |
| Total noninterest income                            | \$2,788                    | \$2,752 | \$36   | 1.31 %   |
|   | Six Months Ended June 30   |         |        |          |
|   | 2017                       | 2016    | Change |          |
|   |                            |         | \$     | %        |
| Service charges and fees                            |                            |         |        |          |
| ATM and debit card fees                             | \$1,278                    | \$1,234 | \$44   | 3.57 %   |
| NSF and overdraft fees                              | 902                        | 880     | 22     | 2.50 %   |
| Freddie Mac servicing fee                           | 339                        | 357     | (18 )  | (5.04 )% |
| Net OMSR income (loss)                              | 184                        | (329 )  | 513    | N/M      |
| Service charges on deposit accounts                 | 171                        | 171     | —      | — %      |
| All other   | 61                         | 63      | (2 )   | (3.17 )% |
| Total service charges and fees                      | 2,935                      | 2,376   | 559    | 23.53 %  |
| Net gain on sale of mortgage loans                  | 354                        | 209     | 145    | 69.38 %  |
| Earnings on corporate owned life insurance policies | 363                        | 383     | (20 )  | (5.22 )% |
| Net gains (losses) on sale of AFS securities        | 142                        | 245     | (103 ) | (42.04)% |
| Other   |                            |         |        |          |
| Trust and brokerage advisory fees                   | 1,237                      | 1,135   | 102    | 8.99 %   |
| Corporate Settlement Solutions joint venture        | 87                         | 217     | (130 ) | (59.91)% |
| Other   | 286                        | 410     | (124 ) | (30.24)% |
| Total other   | 1,610                      | 1,762   | (152 ) | (8.63 )% |
| Total noninterest income                            | \$5,404                    | \$4,975 | \$429  | 8.62 %   |

Table of Contents

Significant changes in noninterest income are detailed below:

Offering rates on residential mortgage loans and prepayment speeds have been the most significant drivers behind fluctuations in net OMSR income (loss). We anticipate increases in mortgage rates and decreased prepayment speeds; therefore, we anticipate net OMSR income to remain positive during the remainder of 2017.

We anticipate increases in our originations in purchase money mortgage activity as a result of our various initiatives to drive growth. As a result, we expect net gains on the sale of mortgage loans to increase during the remainder of 2017.

We continue to invest considerable efforts to increase our market share in trust and brokerage advisory services. These efforts have translated into increases in such fees. We anticipate that these fees will continue to increase during the remainder of 2017.

Corporate Settlement Solutions income is down in the second quarter of 2017 due to the sales cycle on a couple of substantial new customers taking longer than anticipated. It is anticipated that income will increase during the remainder of 2017.

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



Table of Contents

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

|                                   | Three Months Ended June 30 |         |        |         |   |
|-----------------------------------|----------------------------|---------|--------|---------|---|
|                                   | 2017                       | 2016    | Change |         |   |
|                                   |                            |         | \$     | %       |   |
| Compensation and benefits         |                            |         |        |         |   |
| Employee salaries                 | \$3,961                    | \$3,381 | \$580  | 17.15   | % |
| Employee benefits                 | 872                        | 1,303   | (431 ) | (33.08) | % |
| Total compensation and benefits   | 4,833                      | 4,684   | 149    | 3.18    | % |
| Furniture and equipment           |                            |         |        |         |   |
| Service contracts                 | 784                        | 774     | 10     | 1.29    | % |
| Depreciation                      | 508                        | 517     | (9 )   | (1.74 ) | % |
| All other                         | 60                         | 49      | 11     | 22.45   | % |
| Total furniture and equipment     | 1,352                      | 1,340   | 12     | 0.90    | % |
| Occupancy                         |                            |         |        |         |   |
| Depreciation                      | 210                        | 194     | 16     | 8.25    | % |
| Outside services                  | 200                        | 191     | 9      | 4.71    | % |
| Property taxes                    | 146                        | 143     | 3      | 2.10    | % |
| Utilities                         | 115                        | 120     | (5 )   | (4.17 ) | % |
| All other                         | 144                        | 140     | 4      | 2.86    | % |
| Total occupancy                   | 815                        | 788     | 27     | 3.43    | % |
| Other                             |                            |         |        |         |   |
| ATM and debit card fees           | 404                        | 228     | 176    | 77.19   | % |
| Audit and related fees            | 237                        | 186     | 51     | 27.42   | % |
| Director fees                     | 213                        | 214     | (1 )   | (0.47 ) | % |
| Consulting fees                   | 208                        | 196     | 12     | 6.12    | % |
| Loan underwriting fees            | 192                        | 127     | 65     | 51.18   | % |
| FDIC insurance premiums           | 155                        | 217     | (62 )  | (28.57) | % |
| Donations and community relations | 168                        | 146     | 22     | 15.07   | % |
| Postage and freight               | 110                        | 91      | 19     | 20.88   | % |
| Printing and supplies             | 103                        | 129     | (26 )  | (20.16) | % |
| Marketing costs                   | 100                        | 103     | (3 )   | (2.91 ) | % |
| Education and travel              | 93                         | 125     | (32 )  | (25.60) | % |
| All other                         | 524                        | 644     | (120 ) | (18.63) | % |
| Total other                       | 2,507                      | 2,406   | 101    | 4.20    | % |
| Total noninterest expenses        | \$9,507                    | \$9,218 | \$289  | 3.14    | % |

Table of Contents

|                                   | Six Months Ended June 30 |          |         |          |
|-----------------------------------|--------------------------|----------|---------|----------|
|                                   | 2017                     | 2016     | Change  |          |
|                                   |                          |          | \$      | %        |
| Compensation and benefits         |                          |          |         |          |
| Employee salaries                 | \$8,122                  | \$6,777  | \$1,345 | 19.85 %  |
| Employee benefits                 | 2,387                    | 2,695    | (308 )  | (11.43)% |
| Total compensation and benefits   | 10,509                   | 9,472    | 1,037   | 10.95 %  |
| Furniture and equipment           |                          |          |         |          |
| Service contracts                 | 1,572                    | 1,498    | 74      | 4.94 %   |
| Depreciation                      | 1,020                    | 1,050    | (30 )   | (2.86 )% |
| All other                         | 104                      | 87       | 17      | 19.54 %  |
| Total furniture and equipment     | 2,696                    | 2,635    | 61      | 2.31 %   |
| Occupancy                         |                          |          |         |          |
| Depreciation                      | 420                      | 388      | 32      | 8.25 %   |
| Outside services                  | 399                      | 384      | 15      | 3.91 %   |
| Property taxes                    | 292                      | 288      | 4       | 1.39 %   |
| Utilities                         | 258                      | 261      | (3 )    | (1.15 )% |
| All other                         | 283                      | 277      | 6       | 2.17 %   |
| Total occupancy                   | 1,652                    | 1,598    | 54      | 3.38 %   |
| Other                             |                          |          |         |          |
| ATM and debit card fees           | 620                      | 417      | 203     | 48.68 %  |
| Audit and related fees            | 435                      | 345      | 90      | 26.09 %  |
| Director fees                     | 422                      | 423      | (1 )    | (0.24 )% |
| Consulting fees                   | 413                      | 369      | 44      | 11.92 %  |
| Loan underwriting fees            | 309                      | 235      | 74      | 31.49 %  |
| FDIC insurance premiums           | 308                      | 422      | (114 )  | (27.01)% |
| Donations and community relations | 298                      | 265      | 33      | 12.45 %  |
| Postage and freight               | 219                      | 197      | 22      | 11.17 %  |
| Printing and supplies             | 210                      | 220      | (10 )   | (4.55 )% |
| Marketing costs                   | 189                      | 258      | (69 )   | (26.74)% |
| Education and travel              | 189                      | 236      | (47 )   | (19.92)% |
| All other                         | 989                      | 1,206    | (217 )  | (17.99)% |
| Total other                       | 4,601                    | 4,593    | 8       | 0.17 %   |
| Total noninterest expenses        | \$19,458                 | \$18,298 | \$1,160 | 6.34 %   |

Significant changes in noninterest expenses are detailed below:

Employee salaries have increased in 2017 as a result of new positions required for future growth within our new markets, normal merit increases and increased incentive compensation. As such, we anticipate employee salaries expense to continue to trend higher for the remainder of 2017 compared to the expense levels of 2016.

Employee benefits have declined in 2017 due to a settlement with an insurance claim administrator in favor of Isabella Bank.

ATM and debit card fees increased in the second quarter of 2017 due to an early contract termination fee.

FDIC insurance premiums have declined in 2017 as a result of changes to the premium calculation; therefore, 2017 expenses are expected to be lower than 2016.

Marketing costs fluctuate from period-to-period based on the timing of campaigns. For the remainder of 2017, expenses are expected to slightly exceed 2016 levels as a result of marketing initiatives planned for 2017.

Table of Contents

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

## Analysis of Changes in Financial Condition

|  | June 30<br>2017    | December 31<br>2016 | \$ Change       | % Change<br>(unannualized) |          |
|--|--------------------|---------------------|-----------------|----------------------------|----------|
| <b>ASSETS</b>  |                    |                     |                 |                            |          |
| Cash and cash equivalents                                  | \$21,834           | \$ 22,894           | \$(1,060 )      | (4.63 )                    | %        |
| AFS securities   |                    |                     |                 |                            |          |
| Amortized cost of AFS securities                           | 563,309            | 557,648             | 5,661           | 1.02                       | %        |
| Unrealized gains (losses) on AFS securities                | 4,553              | 448                 | 4,105           | N/M                        |          |
| AFS securities   | 567,862            | 558,096             | 9,766           | 1.75                       | %        |
| Mortgage loans AFS   | 1,482              | 1,816               | (334 )          | (18.39 )                   | %        |
| Loans  |                    |                     |                 |                            |          |
| Gross loans  | 1,048,497          | 1,010,615           | 37,882          | 3.75                       | %        |
| Less allowance for loan and lease losses                   | 7,600              | 7,400               | 200             | 2.70                       | %        |
| Net loans  | 1,040,897          | 1,003,215           | 37,682          | 3.76                       | %        |
| Premises and equipment                                     | 28,679             | 29,314              | (635 )          | (2.17 )                    | %        |
| Corporate owned life insurance policies                    | 26,663             | 26,300              | 363             | 1.38                       | %        |
| Accrued interest receivable                                | 5,686              | 6,580               | (894 )          | (13.59 )                   | %        |
| Equity securities without readily determinable fair values | 23,401             | 21,694              | 1,707           | 7.87                       | %        |
| Goodwill and other intangible assets                       | 48,604             | 48,666              | (62 )           | (0.13 )                    | %        |
| Other assets   | 12,190             | 13,576              | (1,386 )        | (10.21 )                   | %        |
| <b>TOTAL ASSETS</b>  | <b>\$1,777,298</b> | <b>\$ 1,732,151</b> | <b>\$45,147</b> | <b>2.61</b>                | <b>%</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                |                    |                     |                 |                            |          |
| <b>Liabilities</b>   |                    |                     |                 |                            |          |
| Deposits   | \$1,210,152        | \$ 1,195,040        | \$15,112        | 1.26                       | %        |
| Borrowed funds   | 360,940            | 337,694             | 23,246          | 6.88                       | %        |
| Accrued interest payable and other liabilities             | 11,136             | 11,518              | (382 )          | (3.32 )                    | %        |
| Total liabilities  | 1,582,228          | 1,544,252           | 37,976          | 2.46                       | %        |
| Shareholders' equity                                       | 195,070            | 187,899             | 7,171           | 3.82                       | %        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>          | <b>\$1,777,298</b> | <b>\$ 1,732,151</b> | <b>\$45,147</b> | <b>2.61</b>                | <b>%</b> |

As shown above, total assets have increased \$45,147 since December 31, 2016 which was primarily driven by loan growth of \$37,882. This growth was funded by an increase in deposits and in borrowed funds of \$15,112 and \$23,246 respectively since December 31, 2016. While generating quality loans will continue to be competitive, we expect that loans will continue to grow in 2017.

The following table outlines the changes in loans:

|                         | June 30<br>2017 | December 31<br>2016 | \$ Change | % Change<br>(unannualized) |   |
|-------------------------|-----------------|---------------------|-----------|----------------------------|---|
| Commercial              | \$600,584       | \$ 575,664          | \$24,920  | 4.33                       | % |
| Agricultural            | 130,954         | 126,492             | 4,462     | 3.53                       | % |
| Residential real estate | 270,207         | 266,050             | 4,157     | 1.56                       | % |
| Consumer                | 46,752          | 42,409              | 4,343     | 10.24                      | % |
| Total                   | \$1,048,497     | \$ 1,010,615        | \$37,882  | 3.75                       | % |

Table of Contents

The following table displays loan balances as of:

|                         | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|-------------------------|-----------------|------------------|---------------------|----------------------|-----------------|
| Commercial              | \$600,584       | \$576,822        | \$575,664           | \$554,847            | \$500,374       |
| Agricultural            | 130,954         | 126,049          | 126,492             | 133,637              | 126,517         |
| Residential real estate | 270,207         | 267,141          | 266,050             | 260,122              | 255,116         |
| Consumer                | 46,752          | 42,908           | 42,409              | 40,760               | 37,587          |
| Total                   | \$1,048,497     | \$1,012,920      | \$1,010,615         | \$989,366            | \$919,594       |

While competition for commercial and agricultural loans continues to be strong, we experienced growth in these segments of the portfolio during 2016 and anticipate continued growth in 2017. Residential real estate and consumer loans have experienced growth over the last year and are both expected to increase for the remainder of 2017.

The following table outlines the changes in deposits:

|                                     | June 30<br>2017 | December 31<br>2016 | \$ Change | % Change<br>(unannualized) |
|-------------------------------------|-----------------|---------------------|-----------|----------------------------|
| Noninterest bearing demand deposits | \$210,122       | \$205,071           | \$5,051   | 2.46 %                     |
| Interest bearing demand deposits    | 212,365         | 209,325             | 3,040     | 1.45 %                     |
| Savings deposits                    | 357,756         | 347,230             | 10,526    | 3.03 %                     |
| Certificates of deposit             | 314,482         | 321,914             | (7,432)   | (2.31) %                   |
| Brokered certificates of deposit    | 94,948          | 88,632              | 6,316     | 7.13 %                     |
| Internet certificates of deposit    | 20,479          | 22,868              | (2,389)   | (10.45) %                  |
| Total                               | \$1,210,152     | \$1,195,040         | \$15,112  | 1.26 %                     |

The following table displays deposit balances as of:

|                                     | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|-------------------------------------|-----------------|------------------|---------------------|----------------------|-----------------|
| Noninterest bearing demand deposits | \$210,122       | \$207,448        | \$205,071           | \$201,804            | \$192,194       |
| Interest bearing demand deposits    | 212,365         | 216,975          | 209,325             | 205,817              | 197,590         |
| Savings deposits                    | 357,756         | 365,287          | 347,230             | 331,414              | 331,144         |
| Certificates of deposit             | 314,482         | 320,345          | 321,914             | 324,910              | 328,771         |
| Brokered certificates of deposit    | 94,948          | 98,442           | 88,632              | 87,583               | 83,677          |
| Internet certificates of deposit    | 20,479          | 22,564           | 22,868              | 24,305               | 23,494          |
| Total                               | \$1,210,152     | \$1,231,061      | \$1,195,040         | \$1,175,833          | \$1,156,870     |

Deposit demand continues to be driven by non-contractual deposits, such as demand and savings deposits, while certificates of deposit and Internet certificates of deposit have gradually declined. Brokered certificates of deposit offer another source of funding and fluctuate from period-to-period based on our funding needs, including changes in assets such as loans and investments.

Table of Contents

The balance of AFS securities fluctuate from period-to-period based on changes in loans and deposits. While loan growth has been strong over the last year, we purchased AFS securities in periods when deposit growth outpaced loan demand. Conversely, we have sold AFS securities in periods when loan demand has outpaced deposit growth. We remain active in investments with our local schools and municipalities. Potential future growth is anticipated in state and political subdivisions AFS securities and purchases of mortgage-backed securities and collateralized mortgage obligations. The following table displays fair values of AFS securities as of:

|                                     | June 30<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|-------------------------------------|-----------------|------------------|---------------------|----------------------|-----------------|
| Government sponsored enterprises    | \$281           | \$10,264         | \$ 10,259           | \$ 344               | \$10,371        |
| States and political subdivisions   | 222,093         | 222,777          | 212,919             | 219,689              | 226,047         |
| Auction rate money market preferred | 3,095           | 2,977            | 2,794               | 3,145                | 3,119           |
| Preferred stocks                    | 3,665           | 3,597            | 3,425               | 3,588                | 3,406           |
| Mortgage-backed securities          | 221,957         | 229,774          | 227,256             | 226,649              | 240,195         |
| Collateralized mortgage obligations | 116,771         | 120,725          | 101,443             | 110,814              | 119,325         |
| Total                               | \$567,862       | \$590,114        | \$ 558,096          | \$ 564,229           | \$602,463       |

Borrowed funds include FHLB advances and securities sold under agreements to repurchase. 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<br>2017 | March 31<br>2017 | December 31<br>2016 | September 30<br>2016 | June 30<br>2016 |
|--|-----------------|------------------|---------------------|----------------------|-----------------|
| FHLB advances  | \$310,000       | \$270,000        | \$ 270,000          | \$ 250,000           | \$265,000       |
| Securities sold under agreements to repurchase without stated maturity dates | 49,950          | 57,375           | 60,894              | 54,809               | 53,596          |
| Federal funds purchased  | 990             | —                | 6,800               | 20,600               | —               |
| Total  | \$360,940       | \$327,375        | \$ 337,694          | \$ 325,409           | \$318,596       |

**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 135,516 shares or \$3,764 of common stock during the first six months of 2017, as compared to 88,486 shares or \$2,489 of common stock during the same period in 2016. 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 \$302 and \$273 during the six month periods ended June 30, 2017 and 2016, respectively.

We have a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 94,032 shares or \$2,622 of common stock during the first six months of 2017 and 51,911 shares or \$1,462 during the first six months of 2016. As of June 30, 2017, we were authorized to repurchase up to an additional 105,875 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 8.50% as of June 30, 2017.



Table of Contents

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<br>2017 |                     | December 31<br>2016 |                     |
|------------------------------|-----------------|---------------------|---------------------|---------------------|
|                              | Actual          | Minimum<br>Required | Actual              | Minimum<br>Required |
| Common equity tier 1 capital | 12.430%         | 5.750 %             | 12.390%             | 5.125 %             |
| Tier 1 capital               | 12.430%         | 7.250 %             | 12.390%             | 6.625 %             |
| Tier 2 capital               | 0.640 %         | 2.000 %             | 0.650 %             | 2.000 %             |
| Total Capital                | 13.070%         | 9.250 %             | 13.040%             | 8.625 %             |

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, 2017, the Bank exceeded these minimum capital requirements.

**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<br>2017 | December 31<br>2016 |
|--|-----------------|---------------------|
| Unfunded commitments under lines of credit | \$ 160,407      | \$ 168,840          |
| Commitments to grant loans                 | 36,746          | 29,339              |
| Commercial and standby letters of credit   | 1,493           | 1,223               |
| Total                                      | \$ 198,646      | \$ 199,402          |

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 with the majority being loans 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 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.

58

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Table of Contents

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.

**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 11 – 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 \$276,489 or 15.56% of assets as of June 30, 2017, compared to \$307,112 or 17.73% as of December 31, 2016. The decrease in primary liquidity is a direct result of our unencumbered AFS securities activity during 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 varies 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, 2017, we had available lines of credit of \$119,462.

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

|   | 2017      | 2016     | \$<br>Variance |
|---|-----------|----------|----------------|
| Net cash provided by (used in) operating activities | \$8,687   | \$8,833  | \$(146 )       |
| Net cash provided by (used in) investing activities | (45,130 ) | (1,658 ) | (43,472 )      |
| Net cash provided by (used in) financing activities | 35,383    | (1,710 ) | 37,093         |
| Increase (decrease) in cash and cash equivalents    | (1,060 )  | 5,465    | (6,525 )       |
| Cash and cash equivalents January 1                 | 22,894    | 21,569   | 1,325          |
| Cash and cash equivalents June 30                   | \$21,834  | \$27,034 | \$(5,200 )     |

**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

59

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Table of Contents

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 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, 2017, 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 project scenarios showing decreases in interest rates beyond 100 basis points 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, 2017, 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, 2017     |       |       |       |       |           |       |       |       |       |
|--|-------------------|-------|-------|-------|-------|-----------|-------|-------|-------|-------|
|  | 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 | (2.23)%           | 2.36% | 4.67% | 6.60% | 8.68% | (2.27)%   | 2.79% | 5.31% | 7.14% | 8.68% |
|  | December 31, 2016 |       |       |       |       |           |       |       |       |       |
|  | 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 | (4.49)%           | 2.19% | 4.31% | 5.68% | 6.67% | (5.32)%   | 2.64% | 5.01% | 6.33% | 6.75% |

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Table of Contents

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of June 30, 2017 and December 31, 2016. 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, 2017 |           |           |           |           |            | Total     | Fair Value |
|--|---------------|-----------|-----------|-----------|-----------|------------|-----------|------------|
|  | 2018          | 2019      | 2020      | 2021      | 2022      | Thereafter |           |            |
| Rate sensitive assets                          |               |           |           |           |           |            |           |            |
| Other interest bearing assets                  | \$249         | \$—       | \$100     | \$—       | \$—       | \$—        | \$349     | \$344      |
| Average interest rates                         | 0.98          | % —       | % 0.35    | % —       | % —       | % —        | % 0.80    | %          |
| AFS securities                                 | \$109,667     | \$79,419  | \$76,855  | \$62,941  | \$51,836  | \$187,144  | \$567,862 | \$567,862  |
| Average interest rates                         | 2.24          | % 2.41    | % 2.56    | % 2.54    | % 2.40    | % 2.48     | % 2.43    | %          |
| Fixed interest rate loans (1)                  | \$168,142     | \$109,706 | \$112,363 | \$110,146 | \$116,292 | \$205,396  | \$822,045 | \$802,838  |
| Average interest rates                         | 4.04          | % 4.31    | % 4.26    | % 4.22    | % 4.22    | % 4.02     | % 4.15    | %          |
| Variable interest rate loans (1)               | \$76,147      | \$33,166  | \$29,606  | \$15,998  | \$28,272  | \$43,263   | \$226,452 | \$226,452  |
| Average interest rates                         | 5.09          | % 4.57    | % 4.59    | % 4.14    | % 4.22    | % 3.94     | % 4.55    | %          |
| Rate sensitive liabilities                     |               |           |           |           |           |            |           |            |
| Fixed rate borrowed funds                      | \$145,940     | \$70,000  | \$40,000  | \$25,000  | \$50,000  | \$20,000   | \$350,940 | \$351,076  |
| Average interest rates                         | 1.13          | % 1.95    | % 1.72    | % 1.54    | % 2.07    | % 2.54     | % 1.60    | %          |
| Variable rate borrowed funds                   | \$—           | \$—       | \$—       | \$10,000  | \$—       | \$—        | \$10,000  | \$10,000   |
| Average interest rates                         | —             | % —       | % —       | % 1.34    | % —       | % —        | % 1.34    | %          |
| Savings and NOW accounts                       | \$135,834     | \$42,252  | \$37,787  | \$33,822  | \$30,293  | \$290,133  | \$570,121 | \$570,121  |
| Average interest rates                         | 0.48          | % 0.15    | % 0.15    | % 0.15    | % 0.15    | % 0.13     | % 0.22    | %          |
| Fixed interest rate certificates of deposit    | \$205,035     | \$71,509  | \$40,849  | \$46,190  | \$42,356  | \$19,126   | \$425,065 | \$423,033  |
| Average interest rates                         | 0.90          | % 1.27    | % 1.48    | % 1.69    | % 1.77    | % 1.98     | % 1.24    | %          |
| Variable interest rate certificates of deposit | \$2,490       | \$2,354   | \$—       | \$—       | \$—       | \$—        | \$4,844   | \$4,844    |
| Average interest rates                         | 1.00          | % 1.21    | % —       | % —       | % —       | % —        | % 1.10    | %          |



Table of Contents

|  | December 31, 2016 |           |           |           |           |            |           | Fair Value |
|--|-------------------|-----------|-----------|-----------|-----------|------------|-----------|------------|
|  | 2017              | 2018      | 2019      | 2020      | 2021      | Thereafter | Total     |            |
| Rate sensitive assets                          |                   |           |           |           |           |            |           |            |
| Other interest bearing assets                  | \$2,727           | \$—       | \$—       | \$—       | \$—       | \$—        | \$2,727   | \$2,727    |
| Average interest rates                         | 0.34              | % —       | % —       | % —       | % —       | % —        | % 0.34    | %          |
| AFS securities                                 | \$114,247         | \$71,220  | \$64,931  | \$63,150  | \$66,976  | \$177,572  | \$558,096 | \$558,096  |
| Average interest rates                         | 2.35              | % 2.38    | % 2.45    | % 2.64    | % 2.57    | % 2.50     | % 2.47    | %          |
| Fixed interest rate loans (1)                  | \$159,964         | \$115,741 | \$103,514 | \$107,185 | \$112,811 | \$199,160  | \$798,375 | \$778,769  |
| Average interest rates                         | 4.15              | % 4.25    | % 4.34    | % 4.16    | % 4.15    | % 4.10     | % 4.18    | %          |
| Variable interest rate loans (1)               | \$69,024          | \$29,179  | \$38,248  | \$16,179  | \$23,632  | \$35,978   | \$212,240 | \$212,240  |
| Average interest rates                         | 4.83              | % 4.32    | % 4.16    | % 3.62    | % 3.74    | % 3.86     | % 4.26    | %          |
| Rate sensitive liabilities                     |                   |           |           |           |           |            |           |            |
| Fixed rate borrowed funds                      | \$137,694         | \$50,000  | \$60,000  | \$10,000  | \$50,000  | \$20,000   | \$327,694 | \$326,975  |
| Average interest rates                         | 0.83              | % 2.16    | % 1.99    | % 1.98    | % 1.91    | % 2.54     | % 1.55    | %          |
| Variable rate borrowed funds                   | \$—               | \$—       | \$—       | \$—       | \$10,000  | \$—        | \$10,000  | \$10,000   |
| Average interest rates                         | —                 | % —       | % —       | % —       | % 1.21    | % —        | % 1.21    | %          |
| Savings and NOW accounts                       | \$84,972          | \$42,596  | \$38,220  | \$34,326  | \$30,858  | \$325,583  | \$556,555 | \$556,555  |
| Average interest rates                         | 0.57              | % 0.12    | % 0.11    | % 0.11    | % 0.11    | % 0.11     | % 0.18    | %          |
| Fixed interest rate certificates of deposit    | \$195,389         | \$80,139  | \$45,110  | \$33,929  | \$50,978  | \$24,881   | \$430,426 | \$427,100  |
| Average interest rates                         | 0.86              | % 1.18    | % 1.35    | % 1.58    | % 1.68    | % 1.84     | % 1.18    | %          |
| Variable interest rate certificates of deposit | \$1,078           | \$1,910   | \$—       | \$—       | \$—       | \$—        | \$2,988   | \$2,988    |
| Average interest rates                         | 0.62              | % 0.99    | % —       | % —       | % —       | % —        | % 0.85    | %          |

(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 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, 2017, 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, 2017, 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 effect, our internal control over financial reporting.

Table of Contents

## 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, 2016.

## 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 21, 2016, 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, 2017, with respect to this plan:

|                   | Common Shares<br>Repurchased | Average Price<br>Number Per Common<br>Share | Total Number of<br>Common Shares<br>Purchased<br>as Part of Publicly<br>Announced Plan<br>or Program | Maximum Number of<br>Common<br>Shares That May Yet Be<br>Purchased Under the<br>Plans or Programs |
|-------------------|------------------------------|---|--|---|
| Balance, March 31 |                              |   |  | 158,142   |
| April 1 - 30      | 19,935                       | \$ 27.89                                    | 19,935   | 138,207   |
| May 1 - 31        | 16,147                       | 27.68                                       | 16,147   | 122,060   |
| June 1 - 30       | 16,185                       | 27.87                                       | 16,185   | 105,875   |
| Balance, June 30  | 52,267                       | \$ 27.82                                    | 52,267   | 105,875   |

## Item 3. Defaults Upon Senior Securities.

Not applicable.

## Item 4. Mine Safety Disclosures.

Not applicable.

## Item 5. Other Information.

Not applicable.



Table of Contents

Item 6. Exhibits.

(a) Exhibits

| Exhibit<br>Number | Exhibits   |
|-------------------|--|
| 31(a)             | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer |
| 31(b)             | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer |
| 32                | Section 1350 Certification of Principal Executive Officer and Principal Financial Officer                  |
| 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.

Table of Contents

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 4, 2017 /s/ Jae A. Evans  
Jae A. Evans  
President, Chief Executive Officer  
(Principal Executive Officer)

Date: August 4, 2017 /s/ Rhonda S. Tudor  
Rhonda S. Tudor  
Interim Chief Financial Officer  
(Principal Accounting Officer)