

INDEPENDENT BANK CORP /MI/  
Form 10-Q  
August 08, 2013

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2013

Commission file number 0-7818

INDEPENDENT BANK CORPORATION  
(Exact name of registrant as specified in its charter)

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

230 West Main Street, P.O. Box 491, Ionia, Michigan 48846  
(Address of principal executive offices)

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

NONE  
Former name, address and fiscal year, if changed since last report.

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, non-accelerated filer or smaller reporting company.  
Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

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

Common stock, no par value 9,493,399

Class

Outstanding at August 7, 2013



## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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Discussions and statements in this report that are not statements of historical fact, including, without limitation, statements that include terms such as “will,” “may,” “should,” “believe,” “expect,” “forecast,” “anticipate,” “estimate,” “project,” “likely,” “optimistic” and “plan,” and statements about future or projected financial and operating results, plans, projections, objectives, expectations, and intentions and other statements that are not historical facts, are forward-looking statements. Forward-looking statements include, but are not limited to, descriptions of plans and objectives for future operations, products or services; projections of our future revenue, earnings or other measures of economic performance; forecasts of credit losses and other asset quality trends; predictions as to our Bank’s ability to maintain certain regulatory capital standards; our expectation that we will have sufficient cash on hand to meet expected obligations during 2013; and descriptions of steps we may take to improve our capital position. These forward-looking statements express our current expectations, forecasts of future events, or long-term goals and, by their nature, are subject to assumptions, risks, and uncertainties. Although we believe that the expectations, forecasts, and goals reflected in these forward-looking statements are reasonable, actual results could differ materially for a variety of reasons, including, among others:

- our ability to successfully raise new equity capital, effect a redemption of our outstanding convertible preferred stock held by the U.S. Treasury, exit the Troubled Asset Relief Program (“TARP”), bring quarterly payments on our trust preferred securities current, and otherwise implement our capital plan;
- our receipt of regulatory approvals necessary for us to take certain actions pursuant to our capital plan, including a reclassification of the equity of our subsidiary bank, the return of capital by our subsidiary bank to our holding company, our payment of accrued but unpaid dividends on our trust preferred securities, and our redemption of the preferred stock and warrant held by the U.S. Treasury;
- the failure of assumptions underlying the establishment of and provisions made to our allowance for loan losses;

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- the timing and pace of an economic recovery in Michigan and the United States in general, including regional and local real estate markets;
- the ability of our Bank to remain well-capitalized;
- the failure of assumptions underlying our estimate of probable incurred losses from vehicle service contract payment plan counterparty contingencies, including our assumptions regarding future cancellations of vehicle service contracts, the value to us of collateral that may be available to recover funds due from our counterparties, and our ability to enforce the contractual obligations of our counterparties to pay amounts owing to us;
- further adverse developments in the vehicle service contract industry;
- the risk that sales of our common stock could trigger a reduction in the amount of net operating loss carryforwards that we may be able to utilize for income tax purposes;
- the continued services of our management team; and
- implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act or other new legislation, which may have significant effects on us and the financial services industry, the exact nature and extent of which cannot be determined at this time.

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all inclusive. The risk factors disclosed in Part I – Item A of our Annual Report on Form 10-K for the year ended December 31, 2012, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks that our management believes could materially affect the results described by forward-looking statements in this report.

However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us, that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

IndexPart I - Item 1. INDEPENDENT BANK CORPORATION AND SUBSIDIARIES  
Condensed Consolidated Statements of Financial Condition

|  | June 30,<br>2013<br>(unaudited)      | December<br>31,<br>2012 |
|--|--------------------------------------|-------------------------|
|  | (In thousands, except share amounts) |                         |
| Assets   |                                      |                         |
| Cash and due from banks  | \$47,512                             | \$55,487                |
| Interest bearing deposits                                      | 92,863                               | 124,295                 |
| Cash and Cash Equivalents                                      | 140,375                              | 179,782                 |
| Interest bearing deposits - time                               | 8,698                                | -                       |
| Trading securities   | 293                                  | 110                     |
| Securities available for sale                                  | 353,775                              | 208,413                 |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 21,496                               | 20,838                  |
| Loans held for sale, carried at fair value                     | 35,529                               | 47,487                  |
| Loans held for sale, carried at lower of cost or fair value    | -                                    | 3,292                   |
| Loans  |                                      |                         |
| Commercial   | 617,050                              | 617,258                 |
| Mortgage   | 503,042                              | 527,340                 |
| Installment  | 190,041                              | 189,849                 |
| Payment plan receivables                                       | 75,949                               | 84,692                  |
| Total Loans  | 1,386,082                            | 1,419,139               |
| Allowance for loan losses                                      | (36,786 )                            | (44,275 )               |
| Net Loans  | 1,349,296                            | 1,374,864               |
| Other real estate and repossessed assets                       | 17,790                               | 26,133                  |
| Property and equipment, net                                    | 47,450                               | 47,016                  |
| Bank-owned life insurance                                      | 51,564                               | 50,890                  |
| Deferred tax assets, net                                       | 58,066                               | -                       |
| Capitalized mortgage loan servicing rights                     | 13,037                               | 11,013                  |
| Vehicle service contract counterparty receivables, net         | 15,091                               | 18,449                  |
| Other intangibles  | 3,569                                | 3,975                   |
| Prepaid FDIC deposit insurance assessment                      | -                                    | 9,448                   |
| Accrued income and other assets                                | 18,645                               | 22,157                  |
| Total Assets   | \$2,134,674                          | \$2,023,867             |
| Liabilities and Shareholders' Equity                           |                                      |                         |
| Deposits   |                                      |                         |
| Non-interest bearing   | \$498,511                            | \$488,126               |
| Savings and interest-bearing checking                          | 898,782                              | 871,238                 |
| Reciprocal   | 46,722                               | 33,242                  |
| Retail time  | 358,849                              | 372,340                 |
| Brokered time  | 13,225                               | 14,591                  |
| Total Deposits   | 1,816,089                            | 1,779,537               |
| Other borrowings   | 17,503                               | 17,625                  |
| Subordinated debentures  | 50,175                               | 50,175                  |
| Vehicle service contract counterparty payables                 | 6,292                                | 7,725                   |
| Accrued expenses and other liabilities                         | 35,780                               | 33,830                  |
| Total Liabilities  | 1,925,839                            | 1,888,892               |
| Shareholders' Equity   |                                      |                         |

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|  |             |             |
|--|-------------|-------------|
| Convertible preferred stock, no par value, 200,000 shares authorized; 74,426 shares issued and outstanding at June 30, 2013 and December 31, 2012; liquidation preference: \$87,292 at June 30, 2013 and \$85,150 at December 31, 2012 | 86,455      | 84,204      |
| Common stock, no par value, 500,000,000 shares authorized; issued and outstanding: 9,481,505 shares at June 30, 2013 and 9,093,732 shares at December 31, 2012   | 255,114     | 251,237     |
| Accumulated deficit  | (125,464 )  | (192,408 )  |
| Accumulated other comprehensive loss   | (7,270 )    | (8,058 )    |
| Total Shareholders' Equity   | 208,835     | 134,975     |
| Total Liabilities and Shareholders' Equity   | \$2,134,674 | \$2,023,867 |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

|  | Three Months   |          | Six Months Ended |          |
|--|----------------|----------|------------------|----------|
|  | Ended          |          | June 30,         |          |
|  | June 30,       |          | June 30,         |          |
|  | 2013           | 2012     | 2013             | 2012     |
|  | (unaudited)    |          |                  |          |
|  | (In thousands) |          |                  |          |
| Interest Income  |                |          |                  |          |
| Interest and fees on loans                                 | \$20,303       | \$23,696 | \$41,013         | \$48,042 |
| Interest on securities                                     |                |          |                  |          |
| Taxable  | 993            | 933      | 1,663            | 1,591    |
| Tax-exempt   | 242            | 244      | 480              | 540      |
| Other investments  | 324            | 382      | 656              | 778      |
| Total Interest Income                                      | 21,862         | 25,255   | 43,812           | 50,951   |
| Interest Expense   |                |          |                  |          |
| Deposits   | 1,463          | 2,305    | 2,992            | 4,729    |
| Other borrowings   | 876            | 1,120    | 1,741            | 2,292    |
| Total Interest Expense                                     | 2,339          | 3,425    | 4,733            | 7,021    |
| Net Interest Income  | 19,523         | 21,830   | 39,079           | 43,930   |
| Provision for loan losses                                  | (2,107 )       | 1,056    | (2,798 )         | 6,187    |
| Net Interest Income After Provision for Loan Losses        | 21,630         | 20,774   | 41,877           | 37,743   |
| Non-interest Income  |                |          |                  |          |
| Service charges on deposit accounts                        | 3,583          | 4,552    | 6,989            | 8,753    |
| Interchange income   | 1,933          | 2,407    | 3,690            | 4,729    |
| Net gains (losses) on assets                               |                |          |                  |          |
| Mortgage loans   | 3,208          | 3,579    | 6,845            | 7,439    |
| Securities   | 107            | 169      | 191              | 853      |
| Other than temporary impairment loss on securities         |                |          |                  |          |
| Total impairment loss                                      | (26 )          | (85 )    | (26 )            | (262 )   |
| Loss recognized in other comprehensive loss                | -              | -        | -                | -        |
| Net impairment loss recognized in earnings                 | (26 )          | (85 )    | (26 )            | (262 )   |
| Mortgage loan servicing                                    | 1,654          | (1,088 ) | 2,276            | (352 )   |
| Title insurance fees                                       | 368            | 489      | 852              | 997      |
| (Increase) decrease in fair value of U.S. Treasury warrant | 20             | (25 )    | (1,025 )         | (179 )   |
| Other  | 2,164          | 3,044    | 4,287            | 5,648    |
| Total Non-interest Income                                  | 13,011         | 13,042   | 24,079           | 27,626   |
| Non-interest Expense                                       |                |          |                  |          |
| Compensation and employee benefits                         | 11,715         | 13,506   | 23,022           | 25,988   |
| Occupancy, net   | 2,147          | 2,490    | 4,571            | 5,206    |
| Data processing  | 2,042          | 2,003    | 3,958            | 3,936    |
| Loan and collection  | 1,702          | 2,407    | 3,928            | 5,297    |
| Vehicle service contract counterparty contingencies        | 3,127          | 326      | 3,254            | 797      |
| Furniture, fixtures and equipment                          | 1,088          | 1,211    | 2,120            | 2,407    |
| Communications   | 730            | 922      | 1,510            | 1,895    |
| Legal and professional                                     | 664            | 1,268    | 1,356            | 2,165    |
| FDIC deposit insurance                                     | 711            | 816      | 1,341            | 1,673    |
| Advertising  | 659            | 639      | 1,229            | 1,195    |
| Provision for loss reimbursement on sold loans             | 356            | 126      | 1,019            | 558      |

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|   |          |         |          |         |
|---|----------|---------|----------|---------|
| Net losses on other real estate and repossessed assets    | 320      | 633     | 972      | 1,620   |
| Interchange expense                                       | 418      | 447     | 828      | 853     |
| Credit card and bank service fees                         | 331      | 624     | 665      | 1,275   |
| Cost (recoveries) related to unfunded lending commitments | 48       | (12 )   | 29       | (59 )   |
| Other   | 1,684    | 2,077   | 3,413    | 2,726   |
| Total Non-interest Expense                                | 27,742   | 29,483  | 53,215   | 57,532  |
| Income Before Income Tax                                  | 6,899    | 4,333   | 12,741   | 7,837   |
| Income tax benefit  | (56,489) | -       | (56,454) | -       |
| Net Income  | \$63,388 | \$4,333 | \$69,195 | \$7,837 |
| Preferred stock dividends and discount accretion          | 1,157    | 1,092   | 2,252    | 2,148   |
| Net Income Applicable to Common Stock                     | \$62,231 | \$3,241 | \$66,943 | \$5,689 |
| Net Income Per Common Share                               |          |         |          |         |
| Basic   | \$6.56   | \$0.38  | \$7.14   | \$0.66  |
| Diluted   | 2.64     | 0.11    | 2.90     | 0.19    |
| Dividends Per Common Share                                |          |         |          |         |
| Declared  | \$.00    | \$.00   | \$.00    | \$.00   |
| Paid  | .00      | .00     | .00      | .00     |

See notes to interim condensed consolidated financial statements (unaudited)



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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

|  | Three months<br>ended<br>June 30,<br>2013 |         | Six months<br>ended<br>June 30,<br>2013 |         |
|--|---|---------|---|---------|
|  | 2012                                      | 2012    | 2012                                    | 2012    |
|  | (unaudited)                               |         | (unaudited)                             |         |
|  | (In thousands)                            |         | (In thousands)                          |         |
| Net income   | \$63,388                                  | \$4,333 | \$69,195                                | \$7,837 |
| Other comprehensive income (loss), before tax  |   |         |   |         |
| Available for sale securities  |   |         |   |         |
| Unrealized gain (loss) arising during period   | (2,463 )                                  | 2,671   | (1,489 )                                | 1,634   |
| Change in unrealized losses for which a portion of other than temporary impairment has been recognized in earnings | 258                                       | 204     | 291                                     | 333     |
| Reclassification adjustment for other than temporary impairment included in earnings                               | 26  | 85      | 26                                      | 262     |
| Reclassification adjustments for (gains) losses included in earnings   | (15 )                                     | (151 )  | (8 )                                    | (843 )  |
| Unrealized gains (losses) recognized in other comprehensive income on available for sale securities                | (2,194 )                                  | 2,809   | (1,180 )                                | 1,386   |
| Income tax benefit   | (413 )                                    | -       | (413 )                                  | -       |
| Unrealized gains (losses) recognized in other comprehensive income on available for sale securities, net of tax    | (1,781 )                                  | 2,809   | (767 )                                  | 1,386   |
| Derivative instruments   |   |         |   |         |
| Unrealized loss arising during period  | (35 )                                     | (24 )   | (38 )                                   | (75 )   |
| Reclassification adjustment for expense recognized in earnings   | 114                                       | 120     | 208                                     | 305     |
| Reclassification adjustment for accretion on settled derivatives   | -   | 146     | -                                       | 291     |
| Unrealized gains recognized in other comprehensive income on derivative instruments                                | 79  | 242     | 170                                     | 521     |
| Income tax benefit   | (1,385 )                                  | -       | (1,385 )                                | -       |
| Unrealized gains recognized in other comprehensive income on derivative instruments, net of tax                    | 1,464                                     | 242     | 1,555                                   | 521     |
| Other comprehensive income (loss)  | (317 )                                    | 3,051   | 788                                     | 1,907   |
| Comprehensive income   | \$63,071                                  | \$7,384 | \$69,983                                | \$9,744 |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

|   | Six months ended June<br>30,  |           |
|---|-------------------------------|-----------|
|   | 2013                          | 2012      |
|   | (unaudited - In<br>thousands) |           |
| Net Income  | \$69,195                      | \$7,837   |
| Adjustments to Reconcile Net Income to Net Cash from Operating Activities                                       |                               |           |
| Proceeds from sales of loans held for sale  | 249,123                       | 246,587   |
| Disbursements for loans held for sale   | (230,320)                     | (237,733) |
| Provision for loan losses   | (2,798 )                      | 6,187     |
| Deferred federal income tax benefit   | (58,066 )                     | -         |
| Deferred loan fees  | (86 )                         | (404 )    |
| Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities and loans | (1,735 )                      | (2,351 )  |
| Net gains on mortgage loans   | (6,845 )                      | (7,439 )  |
| Net gains on securities   | (191 )                        | (853 )    |
| Securities impairment recognized in earnings  | 26                            | 262       |
| Net losses on other real estate and repossessed assets  | 972                           | 1,620     |
| Vehicle service contract counterparty contingencies   | 3,254                         | 797       |
| Share based compensation  | 427                           | 304       |
| Increase in accrued income and other assets   | 12,210                        | 3,288     |
| Increase in accrued expenses and other liabilities  | 1,228                         | 4,262     |
| Total Adjustments   | (32,801 )                     | 14,527    |
| Net Cash from Operating Activities  | 36,394                        | 22,364    |
| Cash Flow used in Investing Activities  |                               |           |
| Proceeds from the sale of securities available for sale   | 2,940                         | 18,999    |
| Proceeds from the maturity of securities available for sale   | 23,750                        | 60,728    |
| Principal payments received on securities available for sale  | 14,697                        | 11,220    |
| Purchases of securities available for sale  | (185,450)                     | (179,262) |
| Purchases of interest bearing deposits  | (8,488 )                      | -         |
| Purchase of Federal Reserve Bank stock  | (658 )                        | -         |
| Redemption of Federal Reserve Bank stock  | -                             | 334       |
| Net cash from branch sale   | 3,292                         | -         |
| Net decrease in portfolio loans (loans originated, net of principal payments)                                   | 24,938                        | 53,220    |
| Net proceeds from the sale of watch, substandard and non-performing loans                                       | 6,721                         | -         |
| Proceeds from the collection of vehicle service contract counterparty receivables                               | 560                           | 396       |
| Proceeds from the sale of other real estate and repossessed assets  | 9,821                         | 8,912     |
| Proceeds from the sale of property and equipment, net   | 3                             | 352       |
| Capital expenditures  | (3,881 )                      | (3,609 )  |
| Net Cash used in Investing Activities   | (111,755)                     | (28,710 ) |
| Cash Flow from Financing Activities   |                               |           |
| Net increase in total deposits  | 36,552                        | 99,472    |
| Net increase in other borrowings  | -                             | 9         |
| Proceeds from Federal Home Loan Bank advances   | 100                           | 12,000    |
| Payments of Federal Home Loan Bank advances   | (222 )                        | (27,467 ) |
| Net increase (decrease) in vehicle service contract counterparty payables                                       | (1,433 )                      | 485       |
| Proceeds from issuance of common stock  | 957                           | 497       |

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|  |           |           |
|--|-----------|-----------|
| Net Cash from Financing Activities   | 35,954    | 84,996    |
| Net Increase (Decrease) in Cash and Cash Equivalents   | (39,407 ) | 78,650    |
| Cash and Cash Equivalents at Beginning of Period   | 179,782   | 341,108   |
| Cash and Cash Equivalents at End of Period   | \$140,375 | \$419,758 |
| Cash paid during the period for  |           |           |
| Interest   | \$3,617   | \$5,914   |
| Income taxes   | 76        | 186       |
| Transfers to other real estate and repossessed assets  | 2,450     | 5,994     |
| Transfer of payment plan receivables to vehicle service contract counterparty receivables      | 418       | 849       |
| Purchase of securities available for sale and interest bearing deposits - time not yet settled | 3,211     | -         |
| Transfers to loans held for sale   | -         | 54,127    |
| Transfers to fixed assets held for sale  | -         | 11,065    |
| Transfers to deposits held for sale  | -         | 420,261   |

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

|   | Six months ended<br>June 30, |            |
|---|------------------------------|------------|
|   | 2013                         | 2012       |
|   | (unaudited)                  |            |
|   | (In thousands)               |            |
| Balance at beginning of period  | \$ 134,975                   | \$ 102,627 |
| Net income  | 69,195                       | 7,837      |
| Issuance of common stock  | 1,966                        | 497        |
| Common stock warrant  | 1,484                        | -          |
| Share based compensation  | 427                          | 304        |
| Net change in accumulated other comprehensive loss, net of related tax effect | 788                          | 1,907      |
| Balance at end of period  | \$ 208,835                   | \$ 113,172 |

See notes to interim condensed consolidated financial statements (unaudited)

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Preparation of Financial Statements

The condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2012 included in our Annual Report on Form 10-K.

In our opinion, the accompanying unaudited condensed consolidated financial statements contain all the adjustments necessary to present fairly our consolidated financial condition as of June 30, 2013 and December 31, 2012, and the results of operations for the three and six-month periods ended June 30, 2013 and 2012. The results of operations for the three and six-month periods ended June 30, 2013, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the assessment for other than temporary impairment (“OTTI”) on investment securities, the determination of the allowance for loan losses, the determination of vehicle service contract counterparty contingencies, the valuation of originated mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2012 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In February, 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-02, “Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income”. This ASU amended guidance on the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this guidance require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. This amended guidance became effective for us at January 1, 2013 and was applied prospectively. The effect of adopting this standard did not have a material impact on our consolidated operating results or financial condition, but the additional disclosures are included in note #16.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

3. Securities

Securities available for sale consist of the following:

|  | Amortized Unrealized |         |         | Fair Value |
|--|----------------------|---------|---------|------------|
|  | Cost                 | Gains   | Losses  |            |
|  | (In thousands)       |         |         |            |
| June 30, 2013                                    |                      |         |         |            |
| U.S. agency                                      | \$13,565             | \$-     | \$151   | \$13,414   |
| U.S. agency residential mortgage-backed          | 184,074              | 1,492   | 306     | 185,260    |
| Private label residential mortgage-backed        | 8,105                | 94      | 717     | 7,482      |
| Other asset backed                               | 10,979               | -       | -       | 10,979     |
| Obligations of states and political subdivisions | 125,963              | 481     | 2,011   | 124,433    |
| Corporate  | 9,886                | 1       | 75      | 9,812      |
| Trust preferred                                  | 2,899                | -       | 504     | 2,395      |
| Total  | \$355,471            | \$2,068 | \$3,764 | \$353,775  |
| December 31, 2012                                |                      |         |         |            |
| U.S. agency                                      | \$30,620             | \$70    | \$23    | \$30,667   |
| U.S. agency residential mortgage-backed          | 126,151              | 1,264   | 3       | 127,412    |
| Private label residential mortgage-backed        | 9,070                | -       | 876     | 8,194      |
| Obligations of states and political subdivisions | 38,384               | 736     | 69      | 39,051     |
| Trust preferred                                  | 4,704                | -       | 1,615   | 3,089      |
| Total  | \$208,929            | \$2,070 | \$2,586 | \$208,413  |

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

|  | Less Than Twelve Months |                   | Twelve Months or More |                   | Total      |                   |
|--|-------------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|  | Fair Value              | Unrealized Losses | Fair Value            | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (In thousands)          |                   |                       |                   |            |                   |
| June 30, 2013                                    |                         |                   |                       |                   |            |                   |
| U.S. agency                                      | \$13,414                | \$ 151            | \$-                   | \$ -              | \$13,414   | \$ 151            |
| U.S. agency residential mortgage-backed          | 60,581                  | 306               | -                     | -                 | 60,581     | 306               |
| Private label residential mortgage-backed        | 483                     | 7                 | 5,103                 | 710               | 5,586      | 717               |
| Obligations of states and political subdivisions | 89,833                  | 1,964             | 1,209                 | 47                | 91,042     | 2,011             |
| Corporate  | 7,812                   | 75                | -                     | -                 | 7,812      | 75                |
| Trust preferred                                  | -                       | -                 | 2,395                 | 504               | 2,395      | 504               |
| Total  | \$172,123               | \$ 2,503          | \$8,707               | \$ 1,261          | \$180,830  | \$ 3,764          |
| December 31, 2012                                |                         |                   |                       |                   |            |                   |
| U.S. agency                                      | \$8,097                 | \$ 23             | \$-                   | \$ -              | \$8,097    | \$ 23             |

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|  |          |       |          |          |          |          |
|--|----------|-------|----------|----------|----------|----------|
| U.S. agency residential mortgage-backed          | -        | -     | 457      | 3        | 457      | 3        |
| Private label residential mortgage-backed        | -        | -     | 8,192    | 876      | 8,192    | 876      |
| Obligations of states and political subdivisions | 7,384    | 69    | -        | -        | 7,384    | 69       |
| Trust preferred                                  | -        | -     | 3,089    | 1,615    | 3,089    | 1,615    |
| Total  | \$15,481 | \$ 92 | \$11,738 | \$ 2,494 | \$27,219 | \$ 2,586 |

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

U.S. agency and U.S. agency residential mortgage-backed securities — at June 30, 2013 we had four U.S. Agency and nine U.S. Agency residential mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to rises in term interest rates and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label residential mortgage backed securities — at June 30, 2013 we had six of these type of securities whose fair value is less than amortized cost. Two of the issues are rated by a major rating agency as investment grade while two are below investment grade and two are split rated. Three of these bonds have impairment in excess of 10% and four of these holdings have been impaired for more than 12 months.

The unrealized losses are largely attributable to credit spread widening on these securities since their acquisition. The underlying loans within these securities include Jumbo (71%) and Alt A (29%) at June 30, 2013.

| June 30, 2013 |                            | December 31, 2012 |                            |
|---------------|----------------------------|-------------------|----------------------------|
| Fair Value    | Net Unrealized Gain (Loss) | Fair Value        | Net Unrealized Gain (Loss) |

Private label residential mortgage-backed

|       |         |           |         |           |
|-------|---------|-----------|---------|-----------|
| Jumbo | \$5,299 | \$ (483 ) | \$6,041 | \$ (594 ) |
| Alt-A | 2,183   | (140 )    | 2,153   | (282 )    |

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



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

All private label residential mortgage-backed securities are reviewed for OTTI utilizing a cash flow projection. The cash flow analysis forecasts cash flow from the underlying loans in each transaction and then applies these cash flows to the bonds in the securitization. The cash flows from the underlying loans consider contractual payment terms (scheduled amortization), prepayments, defaults and severity of loss given default. The analysis uses dynamic assumptions for prepayments, defaults and loss severity. Near term prepayment assumptions are based on recently observed prepayment rates. More weight is given to longer term historic performance (12 months). In some cases, recently observed prepayment rates are lower than historic norms due to a minimal amount of new jumbo loan issuances. This loan market is heavily dependent upon securitization for funding, and new securitization transactions have been minimal. Our model projections anticipate that prepayment rates gradually revert to historical levels. For seasoned ARM transactions, normalized prepayment rates range from 12% to 24% CPR. For fixed rate collateral (one transaction), the prepayment speeds are projected to remain stable.

Default assumptions are largely based on the volume of existing real estate owned, pending foreclosures and severe delinquencies. Other considerations include the quality of loan underwriting, recent default experience, realized loss performance and the volume of less severe delinquencies. Default levels generally are projected to remain elevated or increase for a period of time sufficient to address the level of distressed loans in the transaction. Our projections expect defaults to then decline, generally beginning in year three. Current loss severity assumptions are based on recent observations when meaningful data is available. Loss severity is expected to remain elevated for the next 18 months. Severity is expected to decline beginning in year two due to improving overall economic conditions, improving real estate prices and a reduced inventory of foreclosed properties on the market. Except for three securities discussed in further detail below (all three are currently below investment grade), our cash flow analysis forecasts complete recovery of our cost basis for each reviewed security.

At June 30, 2013 three below investment grade private label residential mortgage-backed securities had credit related OTTI and are summarized as follows:

|                                | Senior Security | Super Senior Security | Senior Support Security | Total   |
|--------------------------------|-----------------|-----------------------|-------------------------|---------|
| (In thousands)                 |                 |                       |                         |         |
| As of June 30, 2013            |                 |                       |                         |         |
| Fair value                     | \$2,903         | \$ 1,838              | \$ 57                   | \$4,798 |
| Amortized cost                 | 3,231           | 1,801                 | -                       | 5,032   |
| Non-credit unrealized loss     | 328             | -                     | -                       | 328     |
| Unrealized gain                | -               | 37                    | 57                      | 94      |
| Cumulative credit related OTTI | 748             | 457                   | 380                     | 1,585   |

Credit related OTTI recognized in our Condensed Consolidated Statements of Operations

For the three months ended June 30,

|      |      |      |      |      |
|------|------|------|------|------|
| 2013 | \$26 | \$ - | \$ - | \$26 |
| 2012 | 85   | -    | -    | 85   |

For the six months ended June 30,

|      |     |    |    |     |
|------|-----|----|----|-----|
| 2013 | 26  | -  | -  | 26  |
| 2012 | 170 | 32 | 60 | 262 |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

Obligations of states and political subdivisions — at June 30, 2013 we had 97 municipal securities whose fair value is less than amortized cost. The increase in unrealized losses during the first half of 2013 is primarily due to increases in interest rates. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at June 30, 2013 we had six corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at June 30, 2013 we had three trust preferred securities whose fair value is less than amortized cost. All of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities over the past several years has suffered from credit spread widening fueled by uncertainty regarding potential losses of financial companies and repricing of risk related to these hybrid capital securities.

One of the three securities is rated by two major rating agencies as investment grade, while one is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.8 million as of June 30, 2013, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of June 30, 2013 and December 31, 2012:

| June 30, 2013  |                     | December 31, 2012 |                     |
|----------------|---------------------|-------------------|---------------------|
| Fair Value     | Net Unrealized Loss | Fair Value        | Net Unrealized Loss |
|                |                     |                   |                     |
| (In thousands) |                     |                   |                     |

## Trust preferred securities

|                |         |           |         |           |
|----------------|---------|-----------|---------|-----------|
| Rated issues   | \$1,615 | \$ (284 ) | \$1,581 | \$ (316 ) |
| Unrated issues | 780     | (220 )    | 1,508   | (1,299 )  |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

We recorded credit related OTTI charges in earnings on securities available for sale of \$0.026 million and \$0.085 million during the three month periods ended June 30, 2013 and 2012, respectively and \$0.026 million and \$0.262 million during the six month periods ended June 30, 2013 and 2012, respectively (see discussion above).

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

|  | Three months<br>ended<br>June 30,<br>2013 |         | Six months<br>ended<br>June 30,<br>2012 |         |
|--|---|---------|---|---------|
|  | 2013                                      | 2012    | 2013                                    | 2012    |
|  | (In thousands)                            |         |   |         |
| Balance at beginning of period   | \$1,809                                   | \$1,647 | \$1,809                                 | \$1,470 |
| Additions to credit losses on securities for which no previous OTTI was recognized | -   | -       | -                                       | -       |
| Increases to credit losses on securities for which OTTI was previously recognized  | 26  | 85      | 26                                      | 262     |
| Balance at end of period   | \$1,835                                   | \$1,732 | \$1,835                                 | \$1,732 |

The amortized cost and fair value of securities available for sale at June 30, 2013, by contractual maturity, follow. The actual maturity may differ from the contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Amortized Fair<br>Cost Value |           |
|--|------------------------------|-----------|
|  | (In thousands)               |           |
| Maturing within one year                       | \$5,428                      | \$5,435   |
| Maturing after one year but within five years  | 42,273                       | 42,308    |
| Maturing after five years but within ten years | 26,061                       | 26,062    |
| Maturing after ten years                       | 78,551                       | 76,249    |
|  | 152,313                      | 150,054   |
| U.S. agency residential mortgage-backed        | 184,074                      | 185,260   |
| Private label residential mortgage-backed      | 8,105                        | 7,482     |
| Other asset backed                             | 10,979                       | 10,979    |
| Total  | \$355,471                    | \$353,775 |

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

|      | Realized       |       |           |
|------|----------------|-------|-----------|
|      | Proceeds       | Gains | Losses(1) |
|      | (In thousands) |       |           |
| 2013 | \$2,940        | \$ 15 | \$ 7      |
| 2012 | 18,999         | 843   | -         |

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(1) Losses in 2013 and 2012 exclude \$0.026 million and \$0.262 million, respectively of credit related OTTI recognized in earnings.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During 2013 and 2012 our trading securities consisted of various preferred stocks. During the first six months of 2013 and 2012 we recognized gains on trading securities of \$0.183 million and \$0.010 million, respectively, that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. Both of these amounts, relate to gains recognized on trading securities still held at each respective period end.

4. Loans

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

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

|   | Commercial     | Mortgage | Installment | Payment<br>Plan<br>Receivables | Unallocated | Total    |
|---|----------------|----------|-------------|--------------------------------|-------------|----------|
|   | (In thousands) |          |             |                                |             |          |
| 2013                                    |                |          |             |                                |             |          |
| Balance at beginning of period          | \$10,058       | \$20,163 | \$3,162     | \$129                          | \$7,253     | \$40,765 |
| Additions (deductions)                  |                |          |             |                                |             |          |
| Provision for loan losses               | (1,404)        | (349)    | 141         | (12)                           | (483)       | (2,107)  |
| Recoveries credited to allowance        | 3,181          | 450      | 306         | 21                             | -           | 3,958    |
| Loans charged against the allowance     | (3,599)        | (1,605)  | (613)       | (13)                           | -           | (5,830)  |
| Balance at end of period                | \$8,236        | \$18,659 | \$2,996     | \$125                          | \$6,770     | \$36,786 |
| 2012                                    |                |          |             |                                |             |          |
| Balance at beginning of period          | \$16,441       | \$23,271 | \$5,534     | \$206                          | \$10,554    | \$56,006 |
| Additions (deductions)                  |                |          |             |                                |             |          |
| Provision for loan losses               | 1,194          | 570      | 229         | (7)                            | (930)       | 1,056    |
| Recoveries credited to allowance        | 390            | 572      | 389         | -                              | -           | 1,351    |
| Loans charged against the allowance     | (2,379)        | (2,950)  | (953)       | (4)                            | -           | (6,286)  |
| Reclassification to loans held for sale | (170)          | (192)    | (218)       | -                              | (201)       | (781)    |
| Balance at end of period                | \$15,476       | \$21,271 | \$4,981     | \$195                          | \$9,423     | \$51,346 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Commercial     | Mortgage | Installment | Payment<br>Plan<br>Receivables | Unallocated | Total    |
|---|----------------|----------|-------------|--------------------------------|-------------|----------|
|   | (In thousands) |          |             |                                |             |          |
| 2013                                    |                |          |             |                                |             |          |
| Balance at beginning of period          | \$11,402       | \$21,447 | \$3,378     | \$144                          | \$7,904     | \$44,275 |
| Additions (deductions)                  |                |          |             |                                |             |          |
| Provision for loan losses               | (1,676)        | (488)    | 516         | (16)                           | (1,134)     | (2,798)  |
| Recoveries credited to allowance        | 3,717          | 1,072    | 592         | 28                             | -           | 5,409    |
| Loans charged against the allowance     | (5,207)        | (3,372)  | (1,490)     | (31)                           | -           | (10,100) |
| Balance at end of period                | \$8,236        | \$18,659 | \$2,996     | \$125                          | \$6,770     | \$36,786 |
| 2012                                    |                |          |             |                                |             |          |
| Balance at beginning of period          | \$18,183       | \$22,885 | \$6,146     | \$197                          | \$11,473    | \$58,884 |
| Additions (deductions)                  |                |          |             |                                |             |          |
| Provision for loan losses               | 2,690          | 4,805    | 518         | 23                             | (1,849)     | 6,187    |
| Recoveries credited to allowance        | 1,396          | 1,120    | 715         | -                              | -           | 3,231    |
| Loans charged against the allowance     | (6,623)        | (7,347)  | (2,180)     | (25)                           | -           | (16,175) |
| Reclassification to loans held for sale | (170)          | (192)    | (218)       | -                              | (201)       | (781)    |
| Balance at end of period                | \$15,476       | \$21,271 | \$4,981     | \$195                          | \$9,423     | \$51,346 |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Commercial     | Mortgage  | Installment | Payment<br>Plan<br>Receivables | Unallocated | Total       |
|--|----------------|-----------|-------------|--------------------------------|-------------|-------------|
|  | (In thousands) |           |             |                                |             |             |
| June 30, 2013                                    |                |           |             |                                |             |             |
| Allowance for loan losses:                       |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$4,446        | \$11,637  | \$1,398     | \$ -                           | \$ -        | \$17,481    |
| Collectively evaluated for impairment            | 3,790          | 7,022     | 1,598       | 125                            | 6,770       | 19,305      |
| Total ending allowance balance                   | \$8,236        | \$18,659  | \$2,996     | \$125                          | \$6,770     | \$36,786    |
| Loans  |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$47,559       | \$82,838  | \$7,184     | \$ -                           |             | \$137,581   |
| Collectively evaluated for impairment            | 571,150        | 422,710   | 183,612     | 75,949                         |             | 1,253,421   |
| Total loans recorded investment                  | 618,709        | 505,548   | 190,796     | 75,949                         |             | 1,391,002   |
| Accrued interest included in recorded investment | 1,659          | 2,506     | 755         | -                              |             | 4,920       |
| Total loans                                      | \$617,050      | \$503,042 | \$190,041   | \$75,949                       |             | \$1,386,082 |
| December 31, 2012                                |                |           |             |                                |             |             |
| Allowance for loan losses:                       |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$6,558        | \$12,869  | \$1,582     | \$ -                           | \$ -        | \$21,009    |
| Collectively evaluated for impairment            | 4,844          | 8,578     | 1,796       | 144                            | 7,904       | 23,266      |
| Total ending allowance balance                   | \$11,402       | \$21,447  | \$3,378     | \$144                          | \$7,904     | \$44,275    |
| Loans  |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$55,634       | \$88,028  | \$7,505     | \$ -                           |             | \$151,167   |
| Collectively evaluated for impairment            | 563,316        | 441,703   | 183,090     | 84,692                         |             | 1,272,801   |
| Total loans recorded investment                  | 618,950        | 529,731   | 190,595     | 84,692                         |             | 1,423,968   |
| Accrued interest included in recorded investment | 1,692          | 2,391     | 746         | -                              |             | 4,829       |
| Total loans                                      | \$617,258      | \$527,340 | \$189,849   | \$84,692                       |             | \$1,419,139 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 90+<br>and<br>Still<br>Accruing<br>(In thousands) | Non-<br>Accrual | Total Non-<br>Performing<br>Loans |
|---|---|-----------------|-----------------------------------|
| June 30, 2013   |   |                 |                                   |
| Commercial  |   |                 |                                   |
| Income producing - real estate                        | \$ 120  | \$ 1,580        | \$ 1,700                          |
| Land, land development and construction - real estate | -   | 1,775           | 1,775                             |
| Commercial and industrial                             | 9   | 1,503           | 1,512                             |
| Mortgage  |   |                 |                                   |
| 1-4 family  | 3   | 7,901           | 7,904                             |
| Resort lending  | -   | 3,780           | 3,780                             |
| Home equity line of credit - 1st lien                 | -   | 429             | 429                               |
| Home equity line of credit - 2nd lien                 | -   | 729             | 729                               |
| Installment   |   |                 |                                   |
| Home equity installment - 1st lien                    | -   | 1,284           | 1,284                             |
| Home equity installment - 2nd lien                    | -   | 494             | 494                               |
| Loans not secured by real estate                      | -   | 431             | 431                               |
| Other   | -   | -               | -                                 |
| Payment plan receivables                              |   |                 |                                   |
| Full refund   | -   | 57              | 57                                |
| Partial refund  | -   | 10              | 10                                |
| Other   | -   | -               | -                                 |
| Total recorded investment                             | \$ 132  | \$ 19,973       | \$ 20,105                         |
| Accrued interest included in recorded investment      | \$ 1  | \$-             | \$ 1                              |
| December 31, 2012                                     |   |                 |                                   |
| Commercial  |   |                 |                                   |
| Income producing - real estate                        | \$-   | \$ 5,611        | \$ 5,611                          |
| Land, land development and construction - real estate | -   | 4,062           | 4,062                             |
| Commercial and industrial                             | -   | 5,080           | 5,080                             |
| Mortgage  |   |                 |                                   |
| 1-4 family  | 7   | 9,654           | 9,661                             |
| Resort lending  | -   | 4,861           | 4,861                             |
| Home equity line of credit - 1st lien                 | -   | 529             | 529                               |
| Home equity line of credit - 2nd lien                 | -   | 685             | 685                               |
| Installment   |   |                 |                                   |
| Home equity installment - 1st lien                    | -   | 1,278           | 1,278                             |
| Home equity installment - 2nd lien                    | -   | 675             | 675                               |
| Loans not secured by real estate                      | -   | 390             | 390                               |
| Other   | -   | -               | -                                 |
| Payment plan receivables                              |   |                 |                                   |
| Full refund   | -   | 57              | 57                                |
| Partial refund  | -   | 38              | 38                                |
| Other   | -   | 9               | 9                                 |

|  |     |          |           |
|--|-----|----------|-----------|
| Total recorded investment                        | \$7 | \$32,929 | \$ 32,936 |
| Accrued interest included in recorded investment | \$- | \$-      | \$ -      |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An aging analysis of loans by class follows:

|   | Loans Past Due |               |             | Total    | Loans not<br>Past Due | Total<br>Loans |
|---|----------------|---------------|-------------|----------|-----------------------|----------------|
|   | 30-59<br>days  | 60-89<br>days | 90+<br>days |          |                       |                |
| (In thousands)  |                |               |             |          |                       |                |
| June 30, 2013   |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$185          | \$315         | \$1,229     | \$1,729  | \$233,654             | \$235,383      |
| Land, land development and construction - real estate |                |               |             |          |                       |                |
| Commercial and industrial                             | -              | -             | 427         | 427      | 39,071                | 39,498         |
| Mortgage  | 1,190          | 995           | 495         | 2,680    | 341,148               | 343,828        |
| 1-4 family  | 4,292          | 805           | 7,904       | 13,001   | 271,706               | 284,707        |
| Resort lending  | 124            | -             | 3,780       | 3,904    | 154,302               | 158,206        |
| Home equity line of credit - 1st lien                 | 369            | -             | 429         | 798      | 17,779                | 18,577         |
| Home equity line of credit - 2nd lien                 | 470            | 194           | 729         | 1,393    | 42,665                | 44,058         |
| Installment   |                |               |             |          |                       |                |
| Home equity installment - 1st lien                    | 624            | 170           | 1,284       | 2,078    | 27,441                | 29,519         |
| Home equity installment - 2nd lien                    | 429            | 110           | 494         | 1,033    | 37,150                | 38,183         |
| Loans not secured by real estate                      | 797            | 213           | 431         | 1,441    | 119,039               | 120,480        |
| Other   | 38             | 10            | -           | 48       | 2,566                 | 2,614          |
| Payment plan receivables                              |                |               |             |          |                       |                |
| Full refund   | 1,817          | 753           | 57          | 2,627    | 68,853                | 71,480         |
| Partial refund  | 98             | 29            | 10          | 137      | 4,297                 | 4,434          |
| Other   | 2              | -             | -           | 2        | 33                    | 35             |
| Total recorded investment                             | \$10,435       | \$3,594       | \$17,269    | \$31,298 | \$1,359,704           | \$1,391,002    |
| Accrued interest included in recorded investment      | \$97           | \$34          | \$1         | \$132    | \$4,788               | \$4,920        |
| December 31, 2012                                     |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$3,734        | \$609         | \$2,826     | \$7,169  | \$215,623             | \$222,792      |
| Land, land development and construction - real estate |                |               |             |          |                       |                |
| Commercial and industrial                             | 336            | -             | 1,176       | 1,512    | 41,750                | 43,262         |
| Mortgage  | 2,522          | 654           | 1,913       | 5,089    | 347,807               | 352,896        |
| 1-4 family  | 4,429          | 1,115         | 9,661       | 15,205   | 279,132               | 294,337        |
| Resort lending  | 748            | 370           | 4,861       | 5,979    | 164,414               | 170,393        |
| Home equity line of credit - 1st lien                 | 453            | 51            | 529         | 1,033    | 18,003                | 19,036         |
| Home equity line of credit - 2nd lien                 | 442            | 32            | 685         | 1,159    | 44,806                | 45,965         |
| Installment   |                |               |             |          |                       |                |
| Home equity installment - 1st lien                    | 599            | 140           | 1,278       | 2,017    | 30,368                | 32,385         |
| Home equity installment - 2nd lien                    | 430            | 125           | 675         | 1,230    | 38,956                | 40,186         |
| Loans not secured by real estate                      | 899            | 259           | 390         | 1,548    | 113,751               | 115,299        |

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|  |          |         |          |          |             |             |
|--|----------|---------|----------|----------|-------------|-------------|
| Other  | 24       | 12      | -        | 36       | 2,689       | 2,725       |
| Payment plan receivables                         |          |         |          |          |             |             |
| Full refund                                      | 2,249    | 552     | 57       | 2,858    | 77,335      | 80,193      |
| Partial refund                                   | 112      | 46      | 38       | 196      | 4,119       | 4,315       |
| Other  | 3        | 6       | 9        | 18       | 166         | 184         |
| Total recorded investment                        | \$16,980 | \$3,971 | \$24,098 | \$45,049 | \$1,378,919 | \$1,423,968 |
| Accrued interest included in recorded investment | \$146    | \$43    | \$-      | \$189    | \$4,640     | \$4,829     |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During the three month period ending June 30, 2013 we sold certain commercial watch, substandard and non-performing loans as follows:

|   | (In<br>thousands) |
|---|-------------------|
| Income producing - real estate                        | \$ 4,570          |
| Land, land development and construction - real estate | 401               |
| Commercial and industrial                             | 3,630             |
| Total   | \$ 8,601          |

Impaired loans are as follows :

|  | June 30,<br>2013 | December<br>31,<br>2012 |
|--|------------------|-------------------------|
| Impaired loans with no allocated allowance             | (In thousands)   |                         |
| TDR  | \$16,741         | \$14,435                |
| Non - TDR  | 538              | 418                     |
| Impaired loans with an allocated allowance             |                  |                         |
| TDR - allowance based on collateral                    | 8,868            | 16,231                  |
| TDR - allowance based on present value cash flow       | 109,889          | 112,997                 |
| Non - TDR - allowance based on collateral              | 1,023            | 6,580                   |
| Non - TDR - allowance based on present value cash flow | -                | -                       |
| Total impaired loans                                   | \$137,059        | \$150,661               |
| Amount of allowance for loan losses allocated          |                  |                         |
| TDR - allowance based on collateral                    | \$2,952          | \$5,060                 |
| TDR - allowance based on present value cash flow       | 14,276           | 14,462                  |
| Non - TDR - allowance based on collateral              | 253              | 1,487                   |
| Non - TDR - allowance based on present value cash flow | -                | -                       |
| Total amount of allowance for loan losses allocated    | \$17,481         | \$21,009                |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows (1):

|   | June 30, 2013       |                          |                   | December 31, 2012   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| (In thousands)                                    |                     |                          |                   |                     |                          |                   |
| With no related allowance recorded:               |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | \$4,813             | \$4,808                  | \$ -              | \$4,050             | \$4,672                  | \$ -              |
| Land, land development & construction-real estate | 3,475               | 4,459                    | -                 | 3,304               | 3,294                    | -                 |
| Commercial and industrial                         | 4,129               | 4,417                    | -                 | 2,611               | 2,592                    | -                 |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 8                   | 8                        | -                 | -                   | -                        | -                 |
| Resort lending                                    | 35                  | 163                      | -                 | -                   | -                        | -                 |
| Home equity line of credit - 1st lien             | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity line of credit - 2nd lien             | -                   | -                        | -                 | -                   | -                        | -                 |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity installment - 1st lien                | 1,950               | 2,070                    | -                 | 2,027               | 2,219                    | -                 |
| Home equity installment - 2nd lien                | 2,311               | 2,302                    | -                 | 2,278               | 2,278                    | -                 |
| Loans not secured by real estate                  | 591                 | 697                      | -                 | 610                 | 681                      | -                 |
| Other   | 18                  | 18                       | -                 | 20                  | 20                       | -                 |
|   | 17,330              | 18,942                   | -                 | 14,900              | 15,756                   | -                 |
| With an allowance recorded:                       |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 19,410              | 22,139                   | 1,910             | 20,628              | 24,250                   | 1,822             |
| Land, land development & construction-real estate | 5,800               | 6,535                    | 943               | 8,808               | 11,971                   | 1,986             |
| Commercial and industrial                         | 9,932               | 10,194                   | 1,593             | 16,233              | 18,564                   | 2,750             |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 60,948              | 64,384                   | 7,957             | 64,160              | 68,418                   | 8,518             |
| Resort lending                                    | 21,650              | 22,547                   | 3,593             | 23,763              | 24,160                   | 4,321             |
| Home equity line of credit - 1st lien             | 155                 | 166                      | 83                | 62                  | 77                       | 30                |
| Home equity line of credit - 2nd lien             | 42                  | 118                      | 4                 | 43                  | 118                      | -                 |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity installment - 1st lien                | 1,076               | 1,185                    | 520               | 1,215               | 1,240                    | 610               |
| Home equity installment - 2nd lien                | 1,010               | 1,019                    | 816               | 1,161               | 1,174                    | 930               |
| Loans not secured by real estate                  | 228                 | 228                      | 62                | 194                 | 194                      | 42                |
| Other   | -                   | -                        | -                 | -                   | -                        | -                 |
|   | 120,251             | 128,515                  | 17,481            | 136,267             | 150,166                  | 21,009            |
| Total   |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 24,223              | 26,947                   | 1,910             | 24,678              | 28,922                   | 1,822             |
| Land, land development & construction-real estate | 9,275               | 10,994                   | 943               | 12,112              | 15,265                   | 1,986             |
| Commercial and industrial                         | 14,061              | 14,611                   | 1,593             | 18,844              | 21,156                   | 2,750             |
| Mortgage  |                     |                          |                   |                     |                          |                   |

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|                                       |           |           |          |           |           |          |
|---------------------------------------|-----------|-----------|----------|-----------|-----------|----------|
| 1-4 family                            | 60,956    | 64,392    | 7,957    | 64,160    | 68,418    | 8,518    |
| Resort lending                        | 21,685    | 22,710    | 3,593    | 23,763    | 24,160    | 4,321    |
| Home equity line of credit - 1st lien | 155       | 166       | 83       | 62        | 77        | 30       |
| Home equity line of credit - 2nd lien | 42        | 118       | 4        | 43        | 118       | -        |
| Installment                           |           |           |          |           |           |          |
| Home equity installment - 1st lien    | 3,026     | 3,255     | 520      | 3,242     | 3,459     | 610      |
| Home equity installment - 2nd lien    | 3,321     | 3,321     | 816      | 3,439     | 3,452     | 930      |
| Loans not secured by real estate      | 819       | 925       | 62       | 804       | 875       | 42       |
| Other                                 | 18        | 18        | -        | 20        | 20        | -        |
| Total                                 | \$137,581 | \$147,457 | \$17,481 | \$151,167 | \$165,922 | \$21,009 |

|  |       |       |
|--|-------|-------|
| Accrued interest included in recorded investment | \$522 | \$506 |
|--|-------|-------|

(1) There were no impaired payment plan receivables at June 30, 2013 or December 31, 2012.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2013                              |                                  | 2012                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|   | (In thousands)                    |                                  |                                   |                                  |
| With no related allowance recorded:               |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | \$4,856                           | \$ 42                            | \$2,211                           | \$ 13                            |
| Land, land development & construction-real estate | 3,212                             | 42                               | 2,877                             | 36                               |
| Commercial and industrial                         | 4,400                             | 76                               | 3,896                             | 44                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 4                                 | -                                | -                                 | -                                |
| Resort lending                                    | 35                                | -                                | 936                               | -                                |
| Home equity line of credit - 1st lien             | -                                 | -                                | -                                 | -                                |
| Home equity line of credit - 2nd lien             | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | 2,020                             | 28                               | 1,827                             | 32                               |
| Home equity installment - 2nd lien                | 2,313                             | 33                               | 1,987                             | 30                               |
| Loans not secured by real estate                  | 599                               | 7                                | 473                               | 7                                |
| Other   | 19                                | -                                | 23                                | -                                |
|   | 17,458                            | 228                              | 14,230                            | 162                              |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 20,745                            | 176                              | 24,300                            | 120                              |
| Land, land development & construction-real estate | 6,837                             | 55                               | 10,495                            | 52                               |
| Commercial and industrial                         | 11,886                            | 88                               | 18,954                            | 156                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 62,011                            | 682                              | 66,900                            | 725                              |
| Resort lending                                    | 21,916                            | 222                              | 23,697                            | 252                              |
| Home equity line of credit - 1st lien             | 156                               | -                                | 70                                | -                                |
| Home equity line of credit - 2nd lien             | 42                                | -                                | 93                                | 1                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | 1,023                             | 8                                | 1,709                             | 9                                |
| Home equity installment - 2nd lien                | 1,074                             | 12                               | 1,469                             | 6                                |
| Loans not secured by real estate                  | 221                               | 4                                | 241                               | 3                                |
| Other   | -                                 | -                                | -                                 | -                                |
|   | 125,911                           | 1,247                            | 147,928                           | 1,324                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 25,601                            | 218                              | 26,511                            | 133                              |
| Land, land development & construction-real estate | 10,049                            | 97                               | 13,372                            | 88                               |
| Commercial and industrial                         | 16,286                            | 164                              | 22,850                            | 200                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 62,015                            | 682                              | 66,900                            | 725                              |
| Resort lending                                    | 21,951                            | 222                              | 24,633                            | 252                              |

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|                                       |           |          |           |          |
|---------------------------------------|-----------|----------|-----------|----------|
| Home equity line of credit - 1st lien | 156       | -        | 70        | -        |
| Home equity line of credit - 2nd lien | 42        | -        | 93        | 1        |
| Installment                           |           |          |           |          |
| Home equity installment - 1st lien    | 3,043     | 36       | 3,536     | 41       |
| Home equity installment - 2nd lien    | 3,387     | 45       | 3,456     | 36       |
| Loans not secured by real estate      | 820       | 11       | 714       | 10       |
| Other                                 | 19        | -        | 23        | -        |
| Total                                 | \$143,369 | \$ 1,475 | \$162,158 | \$ 1,486 |

(1) There were no impaired payment plan receivables during the three month periods ended June 30, 2013 and 2012, respectively.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2013                              |                                  | 2012                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|   | (In thousands)                    |                                  |                                   |                                  |
| With no related allowance recorded:               |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | \$4,587                           | \$ 105                           | \$3,016                           | \$ 30                            |
| Land, land development & construction-real estate | 3,243                             | 84                               | 1,991                             | 36                               |
| Commercial and industrial                         | 3,803                             | 114                              | 3,795                             | 46                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 3                                 | -                                | -                                 | -                                |
| Resort lending                                    | 23                                | -                                | 805                               | -                                |
| Home equity line of credit - 1st lien             | -                                 | -                                | -                                 | -                                |
| Home equity line of credit - 2nd lien             | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | 2,022                             | 52                               | 1,918                             | 52                               |
| Home equity installment - 2nd lien                | 2,301                             | 62                               | 1,987                             | 51                               |
| Loans not secured by real estate                  | 602                               | 15                               | 528                               | 13                               |
| Other   | 19                                | 1                                | 23                                | 1                                |
|   | 16,603                            | 433                              | 14,063                            | 229                              |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 20,706                            | 313                              | 23,793                            | 267                              |
| Land, land development & construction-real estate | 7,494                             | 111                              | 11,117                            | 105                              |
| Commercial and industrial                         | 13,335                            | 228                              | 17,667                            | 270                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 62,727                            | 1,388                            | 67,329                            | 1,449                            |
| Resort lending                                    | 22,532                            | 441                              | 24,055                            | 496                              |
| Home equity line of credit - 1st lien             | 125                               | 1                                | 67                                | 1                                |
| Home equity line of credit - 2nd lien             | 42                                | 1                                | 106                               | 2                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity installment - 1st lien                | 1,087                             | 20                               | 1,550                             | 30                               |
| Home equity installment - 2nd lien                | 1,103                             | 25                               | 1,453                             | 25                               |
| Loans not secured by real estate                  | 212                               | 6                                | 211                               | 5                                |
| Other   | -                                 | -                                | -                                 | -                                |
|   | 129,363                           | 2,534                            | 147,348                           | 2,650                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 25,293                            | 418                              | 26,809                            | 297                              |
| Land, land development & construction-real estate | 10,737                            | 195                              | 13,108                            | 141                              |
| Commercial and industrial                         | 17,138                            | 342                              | 21,462                            | 316                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 62,730                            | 1,388                            | 67,329                            | 1,449                            |
| Resort lending                                    | 22,555                            | 441                              | 24,860                            | 496                              |

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|                                       |           |          |           |          |
|---------------------------------------|-----------|----------|-----------|----------|
| Home equity line of credit - 1st lien | 125       | 1        | 67        | 1        |
| Home equity line of credit - 2nd lien | 42        | 1        | 106       | 2        |
| Installment                           |           |          |           |          |
| Home equity installment - 1st lien    | 3,109     | 72       | 3,468     | 82       |
| Home equity installment - 2nd lien    | 3,404     | 87       | 3,440     | 76       |
| Loans not secured by real estate      | 814       | 21       | 739       | 18       |
| Other                                 | 19        | 1        | 23        | 1        |
| Total                                 | \$145,966 | \$ 2,967 | \$161,411 | \$ 2,879 |

(1) There were no impaired payment plan receivables during the six month periods ended June 30, 2013 and 2012, respectively.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our average investment in impaired loans was approximately \$143.4 million and \$162.2 million for the three-month periods ended June 30, 2013 and 2012, respectively and \$146.0 million and \$161.4 million for the six-month periods ended June 30, 2013 and 2012, respectively. Cash receipts on impaired loans on non-accrual status are generally applied to the principal balance. Interest income recognized on impaired loans during the three months ending June 30, 2013 and 2012 was approximately \$1.5 million and \$1.5 million, respectively and was approximately \$3.0 million and \$2.9 million during the six months ending June 30, 2013 and 2012, respectively.

Troubled debt restructurings follow:

|                         | June 30, 2013  |                      | Total     |
|-------------------------|----------------|----------------------|-----------|
|                         | Commercial     | Retail               |           |
|                         | (In thousands) |                      |           |
| Performing TDR's        | \$42,543       | \$83,187             | \$125,730 |
| Non-performing TDR's(1) | 3,298          | 6,470 <sup>(2)</sup> | 9,768     |
| Total                   | \$45,841       | \$89,657             | \$135,498 |

|                         | December 31, 2012 |                      | Total     |
|-------------------------|-------------------|----------------------|-----------|
|                         | Commercial        | Retail               |           |
|                         | (In thousands)    |                      |           |
| Performing TDR's        | \$40,753          | \$85,977             | \$126,730 |
| Non-performing TDR's(1) | 7,756             | 9,177 <sup>(2)</sup> | 16,933    |
| Total                   | \$48,509          | \$95,154             | \$143,663 |

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

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

We allocated \$17.2 million and \$19.5 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2013 and December 31, 2012, respectively.

During the three and six months ended June 30, 2013 and 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan have generally been for periods ranging from 9 months to 60 months but have extended to as much as 480 months in certain circumstances. Modifications involving an extension of the maturity date have generally been for periods ranging from 1 month to 60 months but have extended to as much as 193 months in certain circumstances.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   |    | Pre-modification<br>Number<br>of Recorded<br>Contributions<br>(Dollars in thousands) | Post-modification<br>Recorded<br>Balance |
|---|----|--|--|
| 2013  |    |  |  |
| Commercial  |    |  |  |
| Income producing - real estate                    | 2  | \$ 395   | \$ 287                                   |
| Land, land development & construction-real estate | -  | -  | -  |
| Commercial and industrial                         | 2  | 72   | 70                                       |
| Mortgage  |    |  |  |
| 1-4 family  | 6  | 482  | 451                                      |
| Resort lending                                    | 1  | 234  | 231                                      |
| Home equity line of credit - 1st lien             | -  | -  | -  |
| Home equity line of credit - 2nd lien             | -  | -  | -  |
| Installment                                       |    |  |  |
| Home equity installment - 1st lien                | 6  | 153  | 144                                      |
| Home equity installment - 2nd lien                | 4  | 64   | 66                                       |
| Loans not secured by real estate                  | 1  | 27   | 27                                       |
| Other   | -  | -  | -  |
| Total   | 22 | \$ 1,427   | \$ 1,276                                 |
| 2012  |    |  |  |
| Commercial  |    |  |  |
| Income producing - real estate                    | 12 | \$ 8,045   | \$ 7,974                                 |
| Land, land development & construction-real estate | 1  | 49   | 77                                       |
| Commercial and industrial                         | 19 | 4,286  | 4,001                                    |
| Mortgage  |    |  |  |
| 1-4 family  | 28 | 3,504  | 3,372                                    |
| Resort lending                                    | 11 | 3,031  | 2,917                                    |
| Home equity line of credit - 1st lien             | -  | -  | -  |
| Home equity line of credit - 2nd lien             | -  | -  | -  |
| Installment                                       |    |  |  |
| Home equity installment - 1st lien                | 6  | 118  | 115                                      |
| Home equity installment - 2nd lien                | 6  | 317  | 313                                      |
| Loans not secured by real estate                  | 9  | 252  | 233                                      |
| Other   | -  | -  | -  |
| Total   | 92 | \$ 19,602  | \$ 19,002                                |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   |           | Pre-modification       | Post-modification |
|---|-----------|------------------------|-------------------|
|   | Number    | Recorded               | Recorded          |
|   | of        | Balance                | Balance           |
|   | Contracts |                        |                   |
|   |           | (Dollars in thousands) |                   |
| 2013  |           |                        |                   |
| Commercial  |           |                        |                   |
| Income producing - real estate                    | 5         | \$ 4,478               | \$ 3,877          |
| Land, land development & construction-real estate | 1         | 16                     | -                 |
| Commercial and industrial                         | 15        | 912                    | 810               |
| Mortgage  |           |                        |                   |
| 1-4 family  | 13        | 1,273                  | 1,235             |
| Resort lending                                    | 4         | 1,033                  | 1,022             |
| Home equity line of credit - 1st lien             | 1         | 95                     | 96                |
| Home equity line of credit - 2nd lien             | -         | -                      | -                 |
| Installment                                       |           |                        |                   |
| Home equity installment - 1st lien                | 13        | 326                    | 317               |
| Home equity installment - 2nd lien                | 10        | 212                    | 212               |
| Loans not secured by real estate                  | 3         | 84                     | 54                |
| Other   | -         | -                      | -                 |
| Total   | 65        | \$ 8,429               | \$ 7,623          |
| 2012  |           |                        |                   |
| Commercial  |           |                        |                   |
| Income producing - real estate                    | 14        | \$ 8,268               | \$ 8,191          |
| Land, land development & construction-real estate | 3         | 2,887                  | 2,913             |
| Commercial and industrial                         | 33        | 8,196                  | 7,895             |
| Mortgage  |           |                        |                   |
| 1-4 family  | 43        | 4,802                  | 4,639             |
| Resort lending                                    | 18        | 5,206                  | 5,072             |
| Home equity line of credit - 1st lien             | 1         | 15                     | 6                 |
| Home equity line of credit - 2nd lien             | -         | -                      | -                 |
| Installment                                       |           |                        |                   |
| Home equity installment - 1st lien                | 10        | 426                    | 426               |
| Home equity installment - 2nd lien                | 13        | 511                    | 507               |
| Loans not secured by real estate                  | 10        | 277                    | 258               |
| Other   | -         | -                      | -                 |
| Total   | 145       | \$ 30,588              | \$ 29,907         |

The troubled debt restructurings described above for 2013 increased the allowance for loan losses by \$0.1 million and resulted in zero charge offs during the three months ended June 30, 2013 and increased the allowance by \$0.2 million and resulted in \$0.3 million of charge offs during the six months ended June 30, 2013.

The troubled debt restructurings described above for 2012 increased the allowance for loan losses by \$0.4 million and resulted in \$0.3 million of charge offs during the three months ending June 30, 2012 and increased the allowance by

\$0.6 million and resulted in \$0.3 million of charge offs during the six months ending June 30, 2012.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Number<br>of Recorded<br>Contracts<br>(Dollars in<br>thousands) | Balance |
|---|---|---------|
| 2013  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | -   | -       |
| Mortgage  |   |         |
| 1-4 family  | -   | -       |
| Resort lending                                    | -   | -       |
| Home equity line of credit - 1st lien             | -   | -       |
| Home equity line of credit - 2nd lien             | -   | -       |
| Installment                                       |   |         |
| Home equity installment - 1st lien                | -   | -       |
| Home equity installment - 2nd lien                | 1   | 22      |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 1   | \$ 22   |
| 2012  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | 1   | 41      |
| Mortgage  |   |         |
| 1-4 family  | 2   | 148     |
| Resort lending                                    | -   | -       |
| Home equity line of credit - 1st lien             | -   | -       |
| Home equity line of credit - 2nd lien             | -   | -       |
| Installment                                       |   |         |
| Home equity installment - 1st lien                | -   | -       |
| Home equity installment - 2nd lien                | 1   | 20      |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 4   | \$ 209  |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Number<br>of Recorded<br>Contributions<br>(Dollars in<br>thousands) | Balance  |
|---|---|----------|
| 2013  |   |          |
| Commercial  |   |          |
| Income producing - real estate                    | -   | \$ -     |
| Land, land development & construction-real estate | 1   | 334      |
| Commercial and industrial                         | 2   | 143      |
| Mortgage  |   |          |
| 1-4 family  | 1   | 106      |
| Resort lending                                    | 1   | 156      |
| Home equity line of credit - 1st lien             | -   | -        |
| Home equity line of credit - 2nd lien             | -   | -        |
| Installment                                       |   |          |
| Home equity installment - 1st lien                | -   | -        |
| Home equity installment - 2nd lien                | 1   | 22       |
| Loans not secured by real estate                  | -   | -        |
| Other   | -   | -        |
|   | 6   | \$ 761   |
| 2012  |   |          |
| Commercial  |   |          |
| Income producing - real estate                    | 2   | \$ 434   |
| Land, land development & construction-real estate | 1   | 136      |
| Commercial and industrial                         | 8   | 914      |
| Mortgage  |   |          |
| 1-4 family  | 2   | 148      |
| Resort lending                                    | 1   | 117      |
| Home equity line of credit - 1st lien             | -   | -        |
| Home equity line of credit - 2nd lien             | -   | -        |
| Installment                                       |   |          |
| Home equity installment - 1st lien                | 1   | 26       |
| Home equity installment - 2nd lien                | 1   | 20       |
| Loans not secured by real estate                  | -   | -        |
| Other   | -   | -        |
|   | 16  | \$ 1,795 |

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

The troubled debt restructurings that subsequently defaulted described above for 2013 decreased the allowance for loan losses by \$0.01 million and resulted in \$0.02 million of charge offs during the three months ended June 30, 2013

and increased the allowance for loan losses by \$0.05 million and resulted in charge offs of \$0.12 million during the six months ended June 30, 2013.

The troubled debt restructurings that subsequently defaulted described above for 2012 decreased the allowance for loan losses by \$0.1 million and resulted in \$0.2 million of charge offs during the three months ending June 30, 2012 and decreased the allowance for loan losses by \$0.3 million and resulted in \$0.6 million of charge offs during the six months ending June 30, 2012.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The terms of certain other loans were modified during the three and six months ended June 30, 2013 and 2012 that did not meet the definition of a troubled debt restructuring. The modification of these loans could have included modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

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

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

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

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

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

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

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Commercial       |              |           | Substandard<br>Accrual<br>9 | Non-<br>Accrual<br>10-11 | Total |
|---|------------------|--------------|-----------|-----------------------------|--------------------------|-------|
|   | Non-watch<br>1-6 | Watch<br>7-8 |           |                             |                          |       |
|   |                  |              |           | (In<br>thousands)           |                          |       |
| June 30, 2013   |                  |              |           |                             |                          |       |
| Income producing - real estate                        | \$198,087        | \$28,157     | \$ 7,559  | \$1,580                     | \$235,383                |       |
| Land, land development and construction - real estate | 31,938           | 5,129        | 656       | 1,775                       | 39,498                   |       |
| Commercial and industrial                             | 302,006          | 30,820       | 9,499     | 1,503                       | 343,828                  |       |
| Total   | \$532,031        | \$64,106     | \$ 17,714 | \$4,858                     | \$618,709                |       |
| Accrued interest included in total                    | \$1,383          | \$200        | \$ 76     | \$-                         | \$1,659                  |       |
| December 31, 2012                                     |                  |              |           |                             |                          |       |
| Income producing - real estate                        | \$183,530        | \$27,096     | \$ 6,555  | \$5,611                     | \$222,792                |       |
| Land, land development and construction - real estate | 32,784           | 3,457        | 2,959     | 4,062                       | 43,262                   |       |
| Commercial and industrial                             | 307,566          | 26,954       | 13,296    | 5,080                       | 352,896                  |       |
| Total   | \$523,880        | \$57,507     | \$ 22,810 | \$14,753                    | \$618,950                |       |
| Accrued interest included in total                    | \$1,417          | \$163        | \$ 112    | \$-                         | \$1,692                  |       |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table summarizes credit scores by loan class for our mortgage and installment loan segments:

|                | Mortgage (1) |           | Home     | Home     |           |
|----------------|--------------|-----------|----------|----------|-----------|
|                | Resort       |           | Equity   | Equity   |           |
| 1-4            |              |           |          | 2nd      |           |
| Family         | Lending      |           | 1st Lien | Lien     | Total     |
| (In thousands) |              |           |          |          |           |
| June 30,       |              |           |          |          |           |
| 2013           |              |           |          |          |           |
| 800 and        |              |           |          |          |           |
| above          | \$21,681     | \$15,087  | \$3,327  | \$5,751  | \$45,846  |
| 750-799        | 60,588       | 58,783    | 4,977    | 12,065   | 136,413   |
| 700-749        | 58,990       | 41,689    | 3,015    | 8,552    | 112,246   |
| 650-699        | 53,520       | 20,453    | 2,879    | 7,349    | 84,201    |
| 600-649        | 33,396       | 9,578     | 2,296    | 4,839    | 50,109    |
| 550-599        | 25,039       | 4,514     | 982      | 3,076    | 33,611    |
| 500-549        | 17,986       | 1,963     | 452      | 1,786    | 22,187    |
| Under          |              |           |          |          |           |
| 500            | 8,443        | 1,359     | 416      | 589      | 10,807    |
| Unknown        | 5,064        | 4,780     | 233      | 51       | 10,128    |
| Total          | \$284,707    | \$158,206 | \$18,577 | \$44,058 | \$505,548 |
| Accrued        |              |           |          |          |           |
| interest       |              |           |          |          |           |
| included       |              |           |          |          |           |
| in total       | \$1,410      | \$775     | \$91     | \$230    | \$2,506   |
| December       |              |           |          |          |           |
| 31, 2012       |              |           |          |          |           |
| 800 and        |              |           |          |          |           |
| above          | \$19,638     | \$15,430  | \$3,031  | \$5,515  | \$43,614  |
| 750-799        | 62,419       | 67,094    | 4,758    | 12,783   | 147,054   |
| 700-749        | 59,594       | 41,860    | 3,293    | 9,177    | 113,924   |
| 650-699        | 57,584       | 17,685    | 2,309    | 7,987    | 85,565    |
| 600-649        | 31,465       | 12,317    | 3,311    | 4,775    | 51,868    |
| 550-599        | 27,739       | 7,887     | 964      | 2,754    | 39,344    |
| 500-549        | 20,243       | 1,212     | 656      | 1,997    | 24,108    |
| Under          |              |           |          |          |           |
| 500            | 9,470        | 1,637     | 456      | 789      | 12,352    |
| Unknown        | 6,185        | 5,271     | 258      | 188      | 11,902    |
| Total          | \$294,337    | \$170,393 | \$19,036 | \$45,965 | \$529,731 |
| Accrued        |              |           |          |          |           |
| interest       |              |           |          |          |           |
| included       |              |           |          |          |           |
| in total       | \$1,319      | \$750     | \$91     | \$231    | \$2,391   |

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



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|   | Installment(1)             |                               | Loans<br>not<br>Secured<br>by<br>Real<br>Estate | Other   | Total     |
|---|----------------------------|-------------------------------|---|---------|-----------|
|   | Home<br>Equity<br>1st Lien | Home<br>Equity<br>2nd<br>Lien |   |         |           |
|   | (In thousands)             |                               |   |         |           |
| June 30,<br>2013                            |                            |                               |   |         |           |
| 800 and<br>above                            | \$3,071                    | \$3,287                       | \$20,962  | \$37    | \$27,357  |
| 750-799                                     | 7,251                      | 10,799                        | 46,424  | 529     | 65,003    |
| 700-749                                     | 5,014                      | 8,625                         | 24,751  | 707     | 39,097    |
| 650-699                                     | 5,063                      | 7,734                         | 15,266  | 634     | 28,697    |
| 600-649                                     | 3,801                      | 3,337                         | 5,893   | 266     | 13,297    |
| 550-599                                     | 2,372                      | 1,914                         | 2,557   | 235     | 7,078     |
| 500-549                                     | 2,259                      | 1,600                         | 1,931   | 130     | 5,920     |
| Under<br>500                                | 525                        | 799                           | 724   | 35      | 2,083     |
| Unknown                                     | 163                        | 88                            | 1,972   | 41      | 2,264     |
| Total                                       | \$29,519                   | \$38,183                      | \$120,480                                       | \$2,614 | \$190,796 |
| Accrued<br>interest<br>included<br>in total | \$132                      | \$158                         | \$443   | \$22    | \$755     |
| December<br>31, 2012                        |                            |                               |   |         |           |
| 800 and<br>above                            | \$3,909                    | \$3,265                       | \$19,293  | \$38    | \$26,505  |
| 750-799                                     | 7,394                      | 11,300                        | 43,740  | 462     | 62,896    |
| 700-749                                     | 4,884                      | 8,826                         | 24,267  | 786     | 38,763    |
| 650-699                                     | 5,925                      | 7,164                         | 13,758  | 710     | 27,557    |
| 600-649                                     | 4,360                      | 4,214                         | 6,442   | 367     | 15,383    |
| 550-599                                     | 3,226                      | 2,716                         | 3,428   | 188     | 9,558     |
| 500-549                                     | 1,722                      | 1,403                         | 2,154   | 114     | 5,393     |
| Under<br>500                                | 760                        | 1,195                         | 895   | 42      | 2,892     |
| Unknown                                     | 205                        | 103                           | 1,322   | 18      | 1,648     |
| Total                                       | \$32,385                   | \$40,186                      | \$115,299                                       | \$2,725 | \$190,595 |
| Accrued<br>interest<br>included<br>in total | \$137                      | \$157                         | \$429   | \$23    | \$746     |

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



Mepco Finance Corporation (“Mepco”) is a wholly-owned subsidiary of our Bank that operates a vehicle service contract payment plan business throughout the United States. See Note #14 for more information about Mepco’s business. As of June 30, 2013, approximately 94.1% of Mepco’s outstanding payment plan receivables relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the full refund owing upon cancellation of the related service contract (including with respect to both the portion funded to the service contract seller and the portion funded to the administrator). These receivables are shown as “Full Refund” in the table below. Another approximately 5.8% of Mepco’s outstanding payment plan receivables as of June 30, 2013, relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the refund owing upon cancellation only with respect to the unearned portion previously funded by Mepco to the administrator (but not to the service contract seller). These receivables are shown as “Partial Refund” in the table below. The balance of Mepco’s outstanding payment plan receivables relate to programs in which there is no insurer or risk retention group that has any contractual liability to Mepco for any portion of the refund amount. These receivables are shown as “Other” in the table below. For each class of our payment plan receivables we monitor credit ratings of the counterparties as we evaluate the credit quality of this portfolio.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                   | Payment Plan Receivables |                |       |          |
|-------------------|--------------------------|----------------|-------|----------|
|                   | Full Refund              | Partial Refund | Other | Total    |
| (In thousands)    |                          |                |       |          |
| June 30, 2013     |                          |                |       |          |
| AM Best rating    |                          |                |       |          |
| A+                | \$-                      | \$-            | \$-   | \$-      |
| A                 | 28,000                   | 3,698          | -     | 31,698   |
| A-                | 9,041                    | 736            | -     | 9,777    |
| B+                | -                        | -              | -     | -        |
| B                 | -                        | -              | -     | -        |
| Not rated         | 34,439                   | -              | 35    | 34,474   |
| Total             | \$71,480                 | \$4,434        | \$35  | \$75,949 |
| December 31, 2012 |                          |                |       |          |
| AM Best rating    |                          |                |       |          |
| A+                | \$-                      | \$-            | \$110 | \$110    |
| A                 | 24,825                   | 3,916          | -     | 28,741   |
| A-                | 19,310                   | 399            | -     | 19,709   |
| B+                | 56                       | -              | -     | 56       |
| B                 | -                        | -              | -     | -        |
| Not rated         | 36,002                   | -              | 74    | 36,076   |
| Total             | \$80,193                 | \$4,315        | \$184 | \$84,692 |

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

5. Segments

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | IB(1)          | Mepco     | Other(1)(2) | Elimination(3) | Total       |
|--|----------------|-----------|-------------|----------------|-------------|
|  | (In thousands) |           |             |                |             |
| Total assets                             |                |           |             |                |             |
| June 30, 2013                            | \$2,005,794    | \$117,772 | \$266,712   | \$ (255,604 )  | \$2,134,674 |
| December 31, 2012                        | 1,885,807      | 135,447   | 192,343     | (189,730 )     | 2,023,867   |
| For the three months ended June 30, 2013 |                |           |             |                |             |
| Interest income                          | \$18,935       | \$2,927   | \$ -        | \$ -           | \$21,862    |
| Net interest income                      | 17,807         | 2,306     | (590 )      | -              | 19,523      |
| Provision for loan losses                | (2,093 )       | (14 )     | -           | -              | (2,107 )    |
| Income (loss) before income tax          | 10,637         | (2,973 )  | (742 )      | (23 )          | 6,899       |
| Net income (loss)                        | 57,442         | (1,839 )  | 7,808       | (23 )          | 63,388      |
| 2012                                     |                |           |             |                |             |
| Interest income                          | \$21,550       | \$3,705   | \$ -        | \$ -           | \$25,255    |
| Net interest income                      | 19,766         | 2,799     | (735 )      | -              | 21,830      |
| Provision for loan losses                | 1,063          | (7 )      | -           | -              | 1,056       |
| Income (loss) before income tax          | 4,944          | 337       | (925 )      | (23 )          | 4,333       |
| Net income (loss)                        | 5,059          | 222       | (925 )      | (23 )          | 4,333       |
| For the six months ended June 30, 2013   |                |           |             |                |             |
| Interest income                          | \$37,715       | \$6,097   | \$ -        | \$ -           | \$43,812    |
| Net interest income                      | 35,423         | 4,827     | (1,171 )    | -              | 39,079      |
| Provision for loan losses                | (2,780 )       | (18 )     | -           | -              | (2,798 )    |
| Income (loss) before income tax          | 17,456         | (2,150 )  | (2,518 )    | (47 )          | 12,741      |
| Net income (loss)                        | 64,506         | (1,296 )  | 6,032       | (47 )          | 69,195      |
| 2012                                     |                |           |             |                |             |
| Interest income                          | \$43,395       | \$7,556   | \$ -        | \$ -           | \$50,951    |
| Net interest income                      | 39,705         | 5,681     | (1,456 )    | -              | 43,930      |
| Provision for loan losses                | 6,166          | 21        | -           | -              | 6,187       |
| Income (loss) before income tax          | 7,957          | 1,893     | (1,966 )    | (47 )          | 7,837       |
| Net income (loss)                        | 8,601          | 1,249     | (1,966 )    | (47 )          | 7,837       |

(1) IB and Other (parent company) include \$49.1 million and \$8.5 million, respectively of income tax benefit related to the reversal of the valuation allowance on our net deferred tax assets in both the three and six month periods ending June 30, 2013 (see note #10).

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

6. Earnings Per Common Share

|   | Three Months                             |         | Six Months Ended |         |
|---|--|---------|------------------|---------|
|   | Ended<br>June 30,<br>2013                | 2012    | June 30,<br>2013 | 2012    |
|   | (in thousands, except per share amounts) |         |                  |         |
| Net income applicable to common stock   | \$62,231                                 | \$3,241 | \$66,943         | \$5,689 |
| Convertible preferred stock dividends   | 1,157                                    | 1,092   | 2,252            | 2,148   |
| Net income applicable to common stock for calculation of diluted earnings per share | \$63,388                                 | \$4,333 | \$69,195         | \$7,837 |
| Weighted average shares outstanding (1)   | 9,480                                    | 8,607   | 9,374            | 8,570   |
| Effect of convertible preferred stock   | 13,953                                   | 31,987  | 13,953           | 31,987  |
| Restricted stock units  | 391                                      | 140     | 376              | 140     |
| Stock units for deferred compensation plan for non-employee directors               | 123                                      | 58      | 119              | 41      |
| Effect of stock options   | 84                                       | 7       | 75               | -       |
| Weighted average shares outstanding for calculation of diluted earnings per share   | 24,031                                   | 40,799  | 23,897           | 40,738  |
| Net income per common share   |  |         |                  |         |
| Basic (1)   | \$6.56                                   | \$0.38  | \$7.14           | \$0.66  |
| Diluted   | \$2.64                                   | \$0.11  | \$2.90           | \$0.19  |

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

Weighted average stock options outstanding that were not considered in computing diluted net income per share because they were anti-dilutive totaled 0.06 million and 0.04 million for the three-month periods ended June 30, 2013 and 2012, respectively and totaled 0.05 million and 0.2 million for the six-month periods ended June 30, 2013 and 2012, respectively. The warrant to purchase 346,154 shares of our common stock (see note #15) was not considered in computing diluted net income per share in all periods in 2013 and 2012 as it was anti-dilutive.

7. Derivative Financial Instruments

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | June 30, 2013          |          |         |
|--|------------------------|----------|---------|
|  |                        | Average  |         |
|  | Notional               | Maturity | Fair    |
|  | Amount                 | (years)  | Value   |
|  | (Dollars in thousands) |          |         |
| No hedge designation                         |                        |          |         |
| Mandatory commitments to sell mortgage loans | \$73,369               | 0.1      | \$1,999 |
| Rate-lock mortgage loan commitments          | 36,192                 | 0.1      | 376     |
| Total  | \$109,561              | 0.1      | \$2,375 |

We have established management objectives and strategies that include interest-rate risk parameters for maximum fluctuations in net interest income and market value of portfolio equity. We monitor our interest rate risk position via simulation modeling reports. The goal of our asset/liability management efforts is to maintain profitable financial leverage within established risk parameters.

We use variable-rate and short-term fixed-rate (less than 12 months) debt obligations to fund a portion of our balance sheet, which exposes us to variability in interest rates. To meet our objectives, we may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates ("Cash Flow Hedges"). Cash Flow Hedges during 2013 and 2012 included certain pay-fixed interest-rate swaps which converted the variable-rate cash flows on debt obligations to fixed-rates. During the second quarter of 2013 we terminated our last pay-fixed interest rate swap and paid a termination fee of \$0.6 million.

We recorded the fair value of Cash Flow Hedges in accrued income and other assets and accrued expenses and other liabilities. The related gains or losses were reported in other comprehensive income or loss and were subsequently reclassified into earnings as a yield adjustment in the same period in which the related interest on the hedged items (primarily variable-rate debt obligations) affected earnings. To the extent that the Cash Flow Hedges were not effective, the ineffective portion of the Cash Flow Hedges were immediately recognized as interest expense. The remaining unrealized loss on the terminated pay-fixed interest-rate swap which was equal to the termination fee discussed above is included in accumulated other comprehensive income and is being amortized into earnings over the remaining original life of the pay-fixed interest-rate swap.

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

During 2010, we entered into an amended and restated warrant with the U.S. Department of the Treasury (“UST”) that would allow them to purchase our common stock at a fixed price (see Note #15). Because of certain anti-dilution features included in the Amended Warrant (as defined in Note #15), it was not considered to have been indexed to our common stock and was therefore accounted for as a derivative instrument and recorded as a liability. Any change in value of the Amended Warrant while it was accounted for as a derivative was recorded in other income in our Condensed Consolidated Statements of Operations. However, the anti-dilution features in the Amended Warrant which caused it to be accounted for as a derivative and included in accrued expenses and other liabilities expired on April 16, 2013. As a result, the Amended Warrant was reclassified into shareholders’ equity on that date at its then fair value which totaled \$1.5 million.

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

## Fair Values of Derivative Instruments

|   | Asset Derivatives |               |                      |               | Liability Derivatives |               |                      |               |
|---|-------------------|---------------|----------------------|---------------|-----------------------|---------------|----------------------|---------------|
|   | June 30,<br>2013  |               | December 31,<br>2012 |               | June 30,<br>2013      |               | December 31,<br>2012 |               |
|   | Balance<br>Sheet  | Fair<br>Value | Balance<br>Sheet     | Fair<br>Value | Balance<br>Sheet      | Fair<br>Value | Balance<br>Sheet     | Fair<br>Value |
|   | Location          |               | Location             |               | Location              |               | Location             |               |
|   | (In thousands)    |               |                      |               |                       |               |                      |               |
| Derivatives designated as hedging instruments     |                   |               |                      |               |                       |               |                      |               |
| Pay-fixed interest rate swap agreements           |                   |               |                      |               | Other liabilities     | \$ -          | Other liabilities    | \$739         |
| Total   |                   |               |                      |               |                       | -             |                      | 739           |
| Derivatives not designated as hedging instruments |                   |               |                      |               |                       |               |                      |               |
| Rate-lock mortgage loan commitments               | Other assets      | \$376         | Other assets         | 1,368         |                       |               |                      |               |
| Mandatory commitments to sell mortgage loans      | Other assets      | 1,999         | Other assets         | -             | Other liabilities     | -             | Other liabilities    | 122           |
| Amended Warrant                                   | Other assets      | -             | Other assets         | -             | Other liabilities     | -             | Other liabilities    | 459           |
| Total   |                   | 2,375         |                      | 1,368         |                       | -             |                      | 581           |

|                   |         |         |      |         |
|-------------------|---------|---------|------|---------|
| Total derivatives | \$2,375 | \$1,368 | \$ - | \$1,320 |
|-------------------|---------|---------|------|---------|

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Three Month Periods Ended June 30,

|  | Gain (Loss) Recognized in Other Comprehensive Income (Effective Portion) 2013 | Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) 2012 | Gain (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) 2013 | 2012      | Location of Gain (Loss) Recognized in Income (1) 2013 | Gain (Loss) Recognized in Income (1) 2012 |
|--|---|---|---|-----------|---|---|
| (In thousands)                               |   |   |   |           |   |   |
| Cash Flow Hedges                             |   |   |   |           |   |   |
| Pay-fixed interest rate swap agreements      | \$ (35)   | Interest expense  | \$ (114 )   | \$ (266 ) |   | \$ -                                      |
| Total  | \$ (35)   |   | \$ (114 )   | \$ (266 ) |   | \$ -                                      |
| No hedge designation                         |   |   |   |           |   |   |
| Rate-lock mortgage loan commitments          |   |   |   |           | Net mortgage loan gains                               | \$ (783 )                                 |
|  |   |   |   |           |   | \$ 283                                    |
| Mandatory commitments to sell mortgage loans |   |   |   |           |   |   |
|  |   |   |   |           | Net mortgage loan gains                               | 2,185                                     |
|  |   |   |   |           | Increase in fair value of U.S. Treasury warrant       | (704)                                     |
| Amended warrant                              |   |   |   |           |   | 20  |
| Total  |   |   |   |           |   | (25 )                                     |
|  |   |   |   |           |   | \$ 1,422                                  |
|  |   |   |   |           |   | \$ (446)                                  |

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Six Month Periods Ended June 30,

|  | Gain (Loss) Recognized in Other Comprehensive Income (Loss) (Effective Portion) 2013 | Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) 2012 | Gain (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) 2013 | Gain (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) 2012 | Location of Gain (Loss) Recognized in Income (1) 2013 | Gain (Loss) Recognized in Income (1) 2012 |
|--|--|---|---|---|---|---|
| (In thousands)                               |  |   |   |   |   |   |
| <b>Cash Flow Hedges</b>                      |  |   |   |   |   |   |
| Pay-fixed interest rate swap agreements      | \$(38)   | Interest expense  | \$(208)   | \$(596)   | \$-   | \$-                                       |
| Total  | \$(38)   |   | \$(208)   | \$(596)   | \$-   | \$-                                       |
| <b>No hedge designation</b>                  |  |   |   |   |   |   |
| Rate-lock mortgage loan commitments          |  |   |   |   | Net mortgage loan gains                               | \$(992)                                   |
| Mandatory commitments to sell mortgage loans |  |   |   |   | Net mortgage loan gains                               | 2,121 (90)                                |
| Amended warrant                              |  |   |   |   | Increase in fair value of U.S. Treasury warrant       | (1,025) (179)                             |
| Total  |  |   |   |   |   | \$104 \$857                               |

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

8. Intangible Assets

The following table summarizes intangible assets, net of amortization:

|   | June 30, 2013         |                          | December 31, 2012     |                          |
|---|-----------------------|--------------------------|-----------------------|--------------------------|
|   | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets - core deposits | \$ 23,703             | \$ 20,134                | \$ 23,703             | \$ 19,728                |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization of other intangibles has been estimated through 2018 and thereafter in the following table.

|                                     | (In<br>thousands) |
|-------------------------------------|-------------------|
| Six months ending December 31, 2013 | \$ 407            |
| 2014                                | 536               |
| 2015                                | 347               |
| 2016                                | 347               |
| 2017                                | 346               |
| 2018 and thereafter                 | 1,586             |
| Total                               | \$ 3,569          |

9. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.5 million shares of common stock as of June 30, 2013. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.3 million shares of common stock as of June 30, 2013. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

A portion of our president's annual salary is paid in the form of common stock. The annual amounts paid in common stock (also referred to as "salary stock") are \$0.020 million and \$0.015 million for 2013 and 2012, respectively. During the first quarter of 2011, pursuant to a management transition plan, our former chief executive officer's annual salary was increased by \$0.2 million effective January 1, 2011 through December 31, 2012. This increase was paid entirely in the form of salary stock. These shares were issued each pay period and vested immediately.

During the second quarter of 2013, we issued 0.1 million restricted stock units to six of our executive officers. These restricted stock units do not vest for a minimum of three years and until we repay in full our obligations related to the Troubled Asset Relief Program. Also, during the second quarter of 2013, pursuant to our performance-based compensation plans we granted 0.1 million stock options to certain officers, none of whom is a named executive officer. The stock options have an exercise price equal to the market value on the date of grant, vest ratably over a three year period and expire 10 years from date of grant. We use the Black Scholes option pricing model to measure compensation cost for stock options. We also estimate expected forfeitures over the vesting period.

Our directors have elected to receive at least a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis pursuant to the non-employee director stock purchase plan referenced above). Shares equal in value to that portion of each director's quarterly cash retainer are issued each quarter and vest immediately. We issued 0.03 million shares and 0.13 million shares to directors during the first six months of 2013 and 2012, respectively and expensed their value during those same periods.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Total compensation expense recognized for stock option grants, restricted stock grants, restricted stock unit grants and salary stock was \$0.1 million and \$0.3 million during the three and six month periods ended June 30, 2013, respectively, and was \$0.2 million and \$0.1 million during the same periods in 2012, respectively. The corresponding tax benefit relating to this expense was zero for the three and six month periods ended June 30, 2013 and 2012, respectively. Total expense recognized for non-employee director share based payments was \$0.1 million in both three month periods ended June 30, 2013 and 2012 and \$0.2 million in both six month periods ended June 30, 2013 and 2012.

At June 30, 2013, the total expected compensation cost related to non-vested stock options, restricted stock and restricted stock unit awards not yet recognized was \$1.8 million. The weighted-average period over which this amount will be recognized is 2.6 years.

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

|  | Number<br>of<br>Shares | Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(Years) | Aggregated<br>Intrinsic<br>Value<br>(In<br>thousands) |
|--|------------------------|------------------------------|---|---|
| Outstanding at January 1, 2013               | 275,933                | \$ 4.46                      |   |   |
| Granted                                      | 77,500                 | 6.42                         |   |   |
| Exercised                                    | (7,001 )               | 1.92                         |   |   |
| Forfeited                                    | (6,999 )               | 2.39                         |   |   |
| Expired                                      | (3,926 )               | 52.11                        |   |   |
| Outstanding at June 30, 2013                 | 335,507                | \$ 4.46                      | 8.54  | \$ 893  |
| Vested and expected to vest at June 30, 2013 | 314,062                | \$ 4.46                      | 8.48  | \$ 850  |
| Exercisable at June 30, 2013                 | 108,938                | \$ 5.69                      | 7.08  | \$ 333  |

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

|                                | Number<br>of<br>Shares | Weighted-<br>Average<br>Grant<br>Date<br>Fair Value |
|--------------------------------|------------------------|---|
| Outstanding at January 1, 2013 | 375,416                | \$ 6.21   |
| Granted                        | 82,833                 | 6.42  |
| Vested                         | (14,636 )              | 76.30   |
| Forfeited                      | -                      |   |
| Outstanding at June 30, 2013   | 443,613                | \$ 3.94   |

A summary of the weighted-average assumptions used in the Black-Scholes option pricing model for grants of stock options during 2013 follows:

|                                       |        |   |
|---------------------------------------|--------|---|
| Expected dividend yield               | 0.31   | % |
| Risk-free interest rate               | 1.12   |   |
| Expected life (in years)              | 6.00   |   |
| Expected volatility                   | 101.30 | % |
| Per share weighted-average fair value | \$4.98 |   |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Certain information regarding options exercised during the periods follows:

|                        | Three<br>Months<br>Ended<br>June 30,<br>2013 | 2012 | Six<br>Months<br>Ended<br>June 30,<br>2013 | 2012 |
|------------------------|--|------|--|------|
|                        | (In thousands)                               |      |  |      |
| Intrinsic value        | \$6  | \$ - | \$21                                       | \$ - |
| Cash proceeds received | \$2  | \$ - | \$13                                       | \$ - |
| Tax benefit realized   | \$-  | \$ - | \$-  | \$ - |

10. Income Tax

We assess whether a valuation allowance on our deferred tax assets is necessary each quarter. Reversing or reducing the valuation allowance requires us to conclude that the realization of the deferred tax assets is “more likely than not.” The ultimate realization of this asset is primarily based on generating future income. As of June 30, 2013, we have concluded that the realization of substantially all of our deferred tax assets is now more likely than not. This conclusion is primarily based upon the following factors:

- Achieving a sixth consecutive quarter of profitability;
- A forecast of future profitability that supports that the realization of the deferred tax assets is more likely than not; and
- A forecast that future asset quality continues to be stable to improving and that other factors do not exist that could cause a significant adverse impact on future profitability.

Prior to the second quarter of 2013, we had established a deferred tax asset valuation allowance against all of our net deferred tax assets. Accordingly, in these prior periods, the income tax expense related to any income before income tax was largely being offset by changes in the deferred tax valuation allowance.

Income tax expense (benefit) was \$(56.5) million in both the three and six month periods ending June 30, 2013 and zero during the same periods in the prior year. The reversal during the second quarter of 2013 of substantially all of the valuation allowance on our deferred tax assets resulted in our recording an income tax benefit of \$57.6 million. In addition, during the second quarter of 2013, we recorded \$1.4 million of income tax expense to clear from accumulated other comprehensive loss (“AOCL”) the disproportionate tax effects from cash flow hedges. These disproportionate tax effects had been charged to other comprehensive income and credited to income tax expense due to our valuation allowance on deferred tax assets (see Note #16). Because we terminated our last remaining cash flow hedge in the second quarter of 2013, it was appropriate to clear these disproportionate tax effects from AOCL.

We did not reverse approximately \$1.0 million of valuation allowance on our deferred tax assets that primarily relates to state income taxes from our Mepco segment. We determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business over the past three years.

At June 30, 2013 and December 31, 2012, we had approximately \$1.6 million and \$1.9 million, respectively of gross unrecognized tax benefits. We do not expect the total amount of unrecognized tax benefits to significantly increase or

decrease during the balance of 2013.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

11. Regulatory Matters

Capital guidelines adopted by Federal and State regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank's current year's net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of June 30, 2013 the Bank had negative undivided profits of \$59.3 million. It is not our intent to have dividends paid in amounts which would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

On October 25, 2011, the respective Boards of Directors of the Company and the Bank entered into a Memorandum of Understanding ("MOU") with the Federal Reserve Bank ("FRB") and the Michigan Department of Insurance and Financial Services ("DIFS"). The MOU largely duplicated certain provisions of board resolutions that were already in place, but also had the following specific requirements:

- Submission of a joint revised capital plan by November 30, 2011 to maintain sufficient capital at the Company on a consolidated basis and at the Bank on a stand-alone basis;
- Submission of quarterly progress reports regarding disposition plans for any assets in excess of \$1.0 million that are in ORE, are 90 days or more past due, are on our "watch list," or were adversely classified in our most recent examination;
- Enhanced reporting and monitoring at Mepco regarding risk management and the internal classification of assets;
- and
- Enhanced interest rate risk modeling practices.

Effective March 26, 2013, the FRB and DIFS terminated the MOU. Also on that date, the respective Boards of Directors of the Company and the Bank passed resolutions that require the following:

- Submission of quarterly progress reports to the FRB and DIFS regarding disposition plans for any assets in excess of \$1.0 million that are in ORE, are 90 days or more past due, are on our "watch list," or are adversely classified;
- Prior approval of the FRB and DIFS for the Bank to pay any dividend to the Company; and
- Prior approval of the FRB and DIFS for the Company to pay any dividend to its shareholders, to make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities, to increase borrowings or guarantee any debt, and/or to purchase or redeem any of its stock.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of June 30, 2013 and December 31, 2012 categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation ("FDIC") categorization.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual capital amounts and ratios follow:

|  | Actual                 |         | Minimum for<br>Adequately<br>Capitalized<br>Institutions |        | Minimum for<br>Well-Capitalized<br>Institutions |         |
|--|------------------------|---------|--|--------|---|---------|
|  | Amount                 | Ratio   | Amount   | Ratio  | Amount  | Ratio   |
|  | (Dollars in thousands) |         |  |        |   |         |
| June 30, 2013                          |                        |         |  |        |   |         |
| Total capital to risk-weighted assets  |                        |         |  |        |   |         |
| Consolidated                           | \$225,727              | 16.17 % | \$111,681  | 8.00 % | NA  | NA      |
| Independent Bank                       | 227,860                | 16.35   | 111,519  | 8.00   | 139,399   | 10.00 % |
| Tier 1 capital to risk-weighted assets |                        |         |  |        |   |         |
| Consolidated                           | \$207,938              | 14.90 % | \$55,840   | 4.00 % | NA  | NA      |
| Independent Bank                       | 210,096                | 15.07   | 55,759   | 4.00   | 83,639  | 6.00 %  |
| Tier 1 capital to average assets       |                        |         |  |        |   |         |
| Consolidated                           | \$207,938              | 10.28 % | \$80,938   | 4.00 % | NA  | NA      |
| Independent Bank                       | 210,096                | 10.35   | 81,188   | 4.00   | 101,485   | 5.00 %  |
| December 31, 2012                      |                        |         |  |        |   |         |
| Total capital to risk-weighted assets  |                        |         |  |        |   |         |
| Consolidated                           | \$204,663              | 14.71 % | \$111,268  | 8.00 % | NA  | NA      |
| Independent Bank                       | 207,553                | 14.95   | 111,063  | 8.00   | \$138,829                                       | 10.00 % |
| Tier 1 capital to risk-weighted assets |                        |         |  |        |   |         |
| Consolidated                           | \$185,948              | 13.37 % | \$55,634   | 4.00 % | NA  | NA      |
| Independent Bank                       | 189,777                | 13.67   | 55,531   | 4.00   | \$83,297  | 6.00 %  |
| Tier 1 capital to average assets       |                        |         |  |        |   |         |
| Consolidated                           | \$185,948              | 8.08 %  | \$92,026   | 4.00 % | NA  | NA      |
| Independent Bank                       | 189,777                | 8.26    | 91,919   | 4.00   | \$114,899                                       | 5.00 %  |

NA - Not applicable

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The components of our regulatory capital are as follows:

|   | Consolidated   |           | Independent Bank |           |
|---|----------------|-----------|------------------|-----------|
|   | June 30,       | December  | June 30,         | December  |
|   | 2013           | 31,       | 2013             | 31,       |
|   |                | 2012      |                  | 2012      |
|   | (In thousands) |           |                  |           |
| Total shareholders' equity  | \$208,835      | \$134,975 | \$250,480        | \$186,384 |
| Add (deduct)  |                |           |                  |           |
| Qualifying trust preferred securities   | 48,668         | 47,678    | -                | -         |
| Accumulated other comprehensive loss  | 7,270          | 8,058     | 7,270            | 8,156     |
| Intangible assets   | (3,569 )       | (3,975 )  | (3,569 )         | (3,975 )  |
| Disallowed deferred tax assets  | (52,769 )      | -         | (43,588 )        | -         |
| Disallowed capitalized mortgage loan servicing rights   | (497 )         | (788 )    | (497 )           | (788 )    |
| Tier 1 capital  | 207,938        | 185,948   | 210,096          | 189,777   |
| Qualifying trust preferred securities   | -              | 990       | -                | -         |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 17,789         | 17,725    | 17,764           | 17,776    |
| Total risk-based capital  | \$225,727      | \$204,663 | \$227,860        | \$207,553 |

In November 2011, our Board adopted a capital plan as required by the MOU and submitted it to the FRB and the DIFS. The capital plan was updated in February 2012. The FRB and DIFS have accepted such capital plan and as of June 30, 2013 and December 31, 2012 we have met the requirements of the capital plan.

The primary objective of our capital plan is to achieve and thereafter maintain the minimum capital ratios required by our Board. The minimum capital ratios established by our Board are higher than the ratios required in order to be considered "well-capitalized" under federal standards. The Board imposed these higher ratios in order to ensure that we have sufficient capital to withstand potential future losses based on our still somewhat elevated level of non-performing assets and given certain other risks and uncertainties we face. As of June 30, 2013, our Bank continued to meet the requirements to be considered "well-capitalized" under federal regulatory standards and met both of the minimum capital ratio goals established by our Board.

Set forth below are the actual capital ratios of our Bank as of June 30, 2013, the minimum capital ratios imposed by our Board, and the minimum ratios necessary to be considered "well-capitalized" under federal regulatory standards:

|  | Independent  |   | Minimum     | Minimum     |             |
|--|--------------|---|-------------|-------------|-------------|
|  | Bank         |   | Ratio       | Ratio       |             |
|  | Actual as of |   | Established | to          | be Well-    |
|  | June 30,     |   | by our      | be Well-    | Capitalized |
|  | 2013         |   | Board       | Capitalized |             |
| Total Capital to Risk-Weighted Assets  | 16.35        | % | 11.00       | %           | 10.00 %     |
| Tier 1 Capital to Average Total Assets | 10.35        |   | 8.00        |             | 5.00        |

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

On July 2, 2013, the Federal Reserve Board approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”) and will implement the Basel III regulatory capital reforms in the United States.

In general, under the New Capital Rules, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity.

We are subject to the New Capital Rules beginning on January 1, 2015. The 2.50% capital conservation buffer is being phased in over a four-year period beginning in 2016. Also, under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital.

12. Fair Value Disclosures

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

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

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

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

Loans held for sale: The fair value of mortgage loans held for sale is based on mortgage backed security pricing for comparable assets (recurring Level 2). The fair value of loans held for sale relating to branch sale was based on a discount provided for in the branch sale agreement (non-recurring Level 2).

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2013 and December 31, 2012, all of our total impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

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

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Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by us. Once received, an independent third party (for commercial properties over \$0.25 million) or a member of our special assets group (for commercial properties under \$0.25 million and retail properties) reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On an annual basis, we compare the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustment, if any, should be made to the appraisal value to arrive at fair value. For commercial properties we typically do not discount an appraisal while for retail properties we generally discount the value by 5%. In addition, we will adjust the appraised values for expected liquidation costs including sales commissions and transfer taxes.

Capitalized mortgage loan servicing rights: The fair value of capitalized mortgage loan servicing rights is based on a valuation model used by an independent third party that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Since the secondary servicing market has not been active since the later part of 2009, model assumptions are generally unobservable and are based upon the best information available including data relating to our own servicing portfolio, reviews of mortgage servicing assumption and valuation surveys and input from various mortgage servicers and, therefore, are recorded as nonrecurring Level 3. Management evaluates the third party valuation for reasonableness each quarter as part of our financial reporting control processes.

Derivatives: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets (recurring Level 2). The fair value of interest rate swap agreements, in general, were determined using a discounted cash flow model whose significant fair value inputs could generally be verified and did not typically involve judgment by management (recurring Level 2). The fair value of the Amended Warrant was determined using a simulation analysis which considers potential outcomes for a large number of independent scenarios regarding the future prices of our common stock and uses several unobservable variables (recurring Level 3).

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(unaudited)

Assets and liabilities measured at fair value, including financial assets for which we have elected the fair value option, were as follows:

|   | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Fair Value Measurements Using Significant Other Observable Inputs (Level 2) |         | Significant Unobservable Inputs (Level 3) |
|---|--|---|---------|---|
|   |  |   |         |   |
| June 30, 2013:                                    |  |   |         |   |
| Measured at Fair Value on a Recurring Basis:      |  |   |         |   |
| Assets  |  |   |         |   |
| Trading securities                                | \$293  | \$293   | \$-     | \$-                                       |
| Securities available for sale                     |  |   |         |   |
| U.S. agency                                       | 13,414   | -   | 13,414  | -   |
| U.S. agency residential mortgage-backed           | 185,260  | -   | 185,260 | -   |
| Private label residential mortgage-backed         | 7,482  | -   | 7,482   | -   |
| Other asset backed                                | 10,979   | -   | 10,979  | -   |
| Obligations of states and political subdivisions  | 124,433  | -   | 124,433 | -   |
| Trust preferred                                   | 9,812  | -   | 9,812   | -   |
| Corporate   | 2,395  | -   | 2,395   | -   |
| Loans held for sale                               | 35,529   | -   | 35,529  | -   |
| Derivatives (1)                                   | 2,375  | -   | 2,375   | -   |
| Liabilities                                       |  |   |         |   |
| Derivatives (2)                                   | -  | -   | -       | -   |
| Measured at Fair Value on a Non-recurring basis:  |  |   |         |   |
| Assets  |  |   |         |   |
| Capitalized mortgage loan servicing rights (3)    | 7,506  | -   | -       | 7,506                                     |
| Impaired loans (4)                                |  |   |         |   |
| Commercial  |  |   |         |   |
| Income producing - real estate                    | 1,771  | -   | -       | 1,771                                     |
| Land, land development & construction-real estate | 1,205  | -   | -       | 1,205                                     |
| Commercial and industrial                         | 1,894  | -   | -       | 1,894                                     |
| Mortgage  |  |   |         |   |
| 1-4 Family  | 1,243  | -   | -       | 1,243                                     |
| Resort Lending                                    | 573  | -   | -       | 573                                       |
| Other real estate (5)                             |  |   |         |   |
| Commercial  |  |   |         |   |

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|   |       |   |   |       |
|---|-------|---|---|-------|
| Land, land development & construction-real estate   | 1,507 | - | - | 1,507 |
| Mortgage  |       |   |   |       |
| 1-4 Family  | 657   | - | - | 657   |
| Resort Lending                                      | 1,735 | - | - | 1,735 |
| Installment   |       |   |   |       |
| Home equity installment - 1st lien                  | 82    | - | - | 82    |
| Payment plan receivables Full refund/partial refund | 2,668 | - | - | 2,668 |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|   | Fair Value Measurements Using |             |             |            |
|---|-------------------------------|-------------|-------------|------------|
|   | Quoted                        |             |             |            |
|   | Prices                        |             |             |            |
|   | in                            |             |             |            |
|   | Active                        |             |             |            |
|   | Markets                       | Significant | Significant |            |
|   | for                           | Other       | Un-         |            |
|   | Fair                          | Identical   | Observable  | observable |
|   | Value                         | Assets      | Inputs      | Inputs     |
|   | Measure-                      | (Level      | (Level 2)   | (Level 3)  |
|   | ments                         | 1)          | (Level 2)   | (Level 3)  |
|   | (In thousands)                |             |             |            |
| December 31, 2012:                                |                               |             |             |            |
| Measured at Fair Value on a Recurring Basis:      |                               |             |             |            |
| Assets  |                               |             |             |            |
| Trading securities                                | \$ 110                        | \$ 110      | \$ -        | \$ -       |
| Securities available for sale                     |                               |             |             |            |
| U.S. agency                                       | 30,667                        | -           | 30,667      | -          |
| U.S. agency residential mortgage-backed           | 127,412                       | -           | 127,412     | -          |
| Private label residential mortgage-backed         | 8,194                         | -           | 8,194       | -          |
| Obligations of states and political subdivisions  | 39,051                        | -           | 39,051      | -          |
| Trust preferred                                   | 3,089                         | -           | 3,089       | -          |
| Loans held for sale                               | 47,487                        | -           | 47,487      | -          |
| Derivatives (1)                                   | 1,368                         | -           | 1,368       | -          |
| Liabilities                                       |                               |             |             |            |
| Derivatives (2)                                   | 1,320                         | -           | 861         | 459        |
| Measured at Fair Value on a Non-recurring basis:  |                               |             |             |            |
| Assets  |                               |             |             |            |
| Capitalized mortgage loan servicing rights (3)    | 8,814                         | -           | -           | 8,814      |
| Impaired loans (4)                                |                               |             |             |            |
| Commercial  |                               |             |             |            |
| Income producing - real estate                    | 3,727                         | -           | -           | 3,727      |
| Land, land development & construction-real estate | 2,882                         | -           | -           | 2,882      |
| Commercial and industrial                         | 6,581                         | -           | -           | 6,581      |
| Mortgage  |                               |             |             |            |
| 1-4 Family  | 2,694                         | -           | -           | 2,694      |
| Resort Lending                                    | 380                           | -           | -           | 380        |
| Other real estate (5)                             |                               |             |             |            |
| Commercial  |                               |             |             |            |
| Income producing - real estate                    | 86                            | -           | -           | 86         |
| Land, land development & construction-real estate | 3,190                         | -           | -           | 3,190      |
| Mortgage  |                               |             |             |            |
| 1-4 Family  | 405                           | -           | -           | 405        |
| Resort Lending                                    | 3,535                         | -           | -           | 3,535      |
| Installment                                       |                               |             |             |            |



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|   |       |   |       |    |
|---|-------|---|-------|----|
| Home equity installment - 1st lien          | 59    | - | -     | 59 |
| Loans held for sale relating to branch sale | 3,292 | - | 3,292 | -  |

- (1) Included in accrued income and other assets
- (2) Included in accrued expenses and other liabilities
- (3) Only includes servicing rights that are carried at fair value due to recognition of a valuation allowance.
- (4) Only includes impaired loans with specific loss allocations based on collateral value.
- (5) Only includes other real estate with subsequent write downs to fair value.

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(unaudited)

There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2013 and 2012.

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

| Changes in Fair Values for the Six-Month<br>Periods Ended June 30 for Items Measured at<br>Fair Value Pursuant to Election of the Fair<br>Value Option |       |   |  |   |     |     |
|--|-------|---|--|---|-----|-----|
| 2013   |       | 2012  |  |   |     |     |
|  |       | Total<br>Change<br>in Fair<br>Values<br>Included<br>in<br>Current<br>Period<br>Earnings | Net Gains<br>(Losses)<br>on Assets<br>Securities | Total<br>Change<br>in Fair<br>Values<br>Included<br>in<br>Current<br>Period<br>Earnings |     |     |
| (In thousands)   |       |   |  |   |     |     |
| Trading securities   | \$183 | \$-   | \$183  | \$9   | \$- | \$9 |
| Loans held for sale  | -     | (2,241)   | (2,241)  | -   | 241 | 241 |

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

The following represent impairment charges recognized during the three and six month periods ended June 30, 2013 and 2012 relating to assets measured at fair value on a non-recurring basis:

Capitalized mortgage loan servicing rights, whose individual strata are measured at fair value, had a carrying amount of \$7.5 million which is net of a valuation allowance of \$3.6 million at June 30, 2013 and had a carrying amount of \$8.8 million which is net of a valuation allowance of \$6.1 million at December 31, 2012. A recovery (charge) of \$1.7 million and \$2.5 million was included in our results of operations for the three and six month periods ending June 30, 2013, respectively and \$(0.9) million and \$(0.2) million during the same periods in 2012.

Loans which are measured for impairment using the fair value of collateral for collateral dependent loans, had a carrying amount of \$9.9 million, with a valuation allowance of \$3.2 million at June 30, 2013 and had a carrying amount of \$22.8 million, with a valuation allowance of \$6.5 million at December 31, 2012. The provision for loan losses included in our results of operations relating to impaired loans was a credit of \$0.7 million and an expense of \$0.6 million for the three month periods ending June 30, 2013 and 2012, respectively and a credit of \$0.3 million and an expense of \$2.2 million for the six month periods ending June 30, 2013 and 2012, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$6.6 million which is net of a valuation allowance of \$4.6 million at June 30, 2013 and a carrying amount of \$7.3 million which is net of a valuation allowance of \$6.0 million at December 31, 2012. An additional charge relating to ORE measured at fair value of \$1.0 million and \$1.6 million was included in our results of operations during the three and six month periods ended June 30, 2013, respectively and \$0.5 million and \$1.2 million during the same periods in 2012.



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(unaudited)

A reconciliation for all liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30 follows:

|   | (Liability)     |         |            |         |
|---|-----------------|---------|------------|---------|
|   | Amended Warrant |         |            |         |
|   | Three Months    |         | Six Months |         |
|   | Ended           |         | Ended      |         |
|   | June 30,        |         | June 30,   |         |
|   | 2013            | 2012    | 2013       | 2012    |
|   | (In thousands)  |         |            |         |
| Beginning balance                                       | \$(1,504)       | \$(328) | \$(459 )   | \$(174) |
| Total gains (losses) realized and unrealized:           |                 |         |            |         |
| Included in results of operations                       | 20              | (25 )   | (1,025)    | (179)   |
| Included in other comprehensive income                  | -               | -       | -          | -       |
| Purchases, issuances, settlements, maturities and calls | -               | -       | -          | -       |
| Reclassification to shareholders' equity                | 1,484           | -       | 1,484      | -       |
| Transfers in and/or out of Level 3                      | -               | -       | -          | -       |
| Ending balance  | \$-             | \$(353) | \$-        | \$(353) |

|   |      |         |           |         |
|---|------|---------|-----------|---------|
| Amount of total gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at June 30 | \$20 | \$(25 ) | \$(1,025) | \$(179) |
|---|------|---------|-----------|---------|

During 2010, we entered into an amended and restated warrant with the UST that would allow it to purchase our common stock at a fixed price (see Note #15). Because of certain anti-dilution features included in the Amended Warrant, it has not been considered to be indexed to our common stock and was therefore accounted for as a derivative instrument (see Note #7). Any change in value of this warrant was recorded in other income in our Condensed Consolidated Statements of Operations. However, the anti-dilution features in the Amended Warrant which caused it to be accounted for as a derivative and included in accrued expenses and other liabilities expired on April 16, 2013. As a result, the Amended Warrant was reclassified into shareholders' equity on that date at its then fair value which totaled \$1.5 million.

The fair value of the Amended Warrant was determined using a simulation analysis which considered potential outcomes for a large number of independent scenarios regarding the future prices of our common stock. The simulation analysis relied on a binomial lattice model, a standard technique usually applied to the valuation of stock options. The binomial lattice maps out possible price paths of our common stock, the underlying asset of the Amended Warrant. The simulation was based on a 500-step lattice covering the term of the Amended Warrant. The binomial lattice required specification of 14 variables, of which several were unobservable in the market.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Quantitative information about the Amended Warrant at December 31, 2012 follows:

| (Liability)    | Valuation              | Unobservable  | Unobservable  |
|----------------|------------------------|---|---------------|
| Fair Value     | Technique              | Inputs  | Input Values  |
| (In thousands) |                        |   |               |
| \$ (459)       | Binomial Lattice Model | Probability of non-permitted equity raise           | 0.5 %         |
|                |                        | Expected discount to stock price in an equity raise | 10.0 %        |
|                |                        | Dollar amount of expected capital raise             | \$100 Million |
|                |                        | Expected time of non-permitted equity raise         | April, 2013   |

The significant unobservable inputs used in the fair value measurement of Amended Warrant were probability of a non-permitted capital raise, expected discount to stock price in an equity raise, dollar amount of expected capital raise and expected time of equity raise. Significant increases/(decreases) in any of those inputs in isolation would have resulted in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of a non-permitted capital raise and dollar amount of equity raise would have been accompanied by a directionally consistent change in fair value and a directionally opposite change in the assumption used for expected discount to stock price in an equity raise and expected time of equity raise.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Asset<br>(Liability) | Fair Value<br>(In thousands) | Valuation<br>Technique                       | Unobservable<br>Inputs   | Weighted<br>Average              |
|--|----------------------|------------------------------|--|--|----------------------------------|
| June 30, 2013                              |                      |                              |  |  |                                  |
| Capitalized mortgage loan servicing rights | \$7,506              |                              | Present value of net servicing revenue       | Discount rate<br>Cost to service<br>Ancillary income<br>Float rate         | 10.62 %<br>\$ 82<br>39<br>1.57 % |
| Impaired loans                             |                      |                              |  |  |                                  |
| Commercial                                 | 4,870                |                              | Sales comparison approach<br>Income approach | Adjustment for differences between comparable sales<br>Capitalization rate | 15.6 %<br>9.4                    |
| Mortgage                                   | 1,816                |                              | Sales comparison approach                    | Adjustment for differences between comparable sales                        | 8.7                              |
| Other real estate                          |                      |                              |  |  |                                  |
| Commercial                                 | 1,507                |                              | Sales comparison approach<br>Income approach | Adjustment for differences between comparable sales<br>Capitalization rate | (4.5 )<br>11.0                   |
| Mortgage and installment                   | 2,474                |                              | Sales comparison approach                    | Adjustment for differences between comparable sales                        | 44.2                             |
| Payment plan receivables                   | 2,668                |                              | Sales comparison approach                    | Adjustment for differences between comparable sales                        | 7.5                              |
| December 31, 2012                          |                      |                              |  |  |                                  |
| Capitalized mortgage loan servicing rights | \$8,814              |                              | Present value of net servicing revenue       | Discount rate<br>Cost to service<br>Ancillary income<br>Float rate         | 11.00 %<br>\$ 83<br>43<br>0.84 % |
| Impaired loans                             |                      |                              |  |  |                                  |
| Commercial                                 | 13,190               |                              | Sales comparison approach<br>Income approach | Adjustment for differences between comparable sales<br>Capitalization rate | 16.7 %<br>10.8                   |
| Mortgage                                   | 3,074                |                              | Sales comparison approach                    | Adjustment for differences between comparable sales                        | 9.5                              |
| Other real estate                          |                      |                              |  |  |                                  |
| Commercial                                 | 3,276                |                              | Sales comparison approach<br>Income approach | Adjustment for differences between comparable sales<br>Capitalization rate | (12.4 )<br>12.3                  |
| Mortgage and installment                   | 3,999                |                              | Sales comparison approach                    | Adjustment for differences between comparable sales                        | (6.3 )                           |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                     | Aggregate<br>Fair<br>Value | Difference | Contractual<br>Principal |
|---------------------|----------------------------|------------|--------------------------|
|                     | (In thousands)             |            |                          |
| Loans held for sale |                            |            |                          |
| June 30, 2013       | \$35,529                   | \$ (398 )  | \$ 35,927                |
| December 31, 2012   | 47,487                     | 1,843      | 45,644                   |

13. Fair Values of Financial Instruments

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

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

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

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

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

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

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Derivative financial instruments: Rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans have been valued based on mortgage backed security pricing for comparable assets. Interest rate swaps (at December 31, 2012) were valued based on the discounted value of contractual cash flows using a discount rate approximating current market rates. Each of these instruments have been classified as Level 2 as described in Note #12. The Amended Warrant (at December 31, 2012) was valued based on a simulation analysis which considers potential outcomes for a large number of independent scenarios and is classified as Level 3 as described in Note #12.

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

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

Subordinated debentures: Subordinated debentures have generally been valued based on a quoted market price of the specific or similar instruments resulting in a Level 1 or Level 2 classification.

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(unaudited)

The estimated recorded book balances and fair values follow:

|  | Recorded<br>Book<br>Balance<br>(In thousands) | Fair Value<br>Measure-<br>ments | Fair Value Measurements Using   |   |   |
|--|---|---------------------------------|---|---|---|
|  |   |                                 | Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
| June 30, 2013                              |   |                                 |   |   |   |
| Assets                                     |   |                                 |   |   |   |
| Cash and due from banks                    | \$47,512                                      | \$47,512                        | \$47,512  | \$ -  | \$ -  |
| Interest bearing deposits                  | 92,863  | 92,863                          | 92,863  | -   | -   |
| Interest bearing deposits - time           | 8,698   | 8,698                           | -   | 8,698   | -   |
| Trading securities                         | 293   | 293                             | 293   | -   | -   |
| Securities available for sale              | 353,775                                       | 353,775                         | -   | 353,775   | -   |
| Federal Home Loan Bank and Federal Reserve |   |                                 |   |   |   |
| Bank Stock                                 | 21,496  | NA                              | NA  | NA  | NA  |
| Net loans and loans held for sale          | 1,384,825                                     | 1,356,021                       | -   | 35,529  | 1,320,492   |
| Accrued interest receivable                | 6,130   | 6,130                           | 115   | 1,069   | 4,946   |
| Derivative financial instruments           | 2,375   | 2,375                           | -   | 2,375   | -   |
| Liabilities                                |   |                                 |   |   |   |
| Deposits with no stated maturity (1)       | \$1,403,163                                   | \$1,403,163                     | \$1,403,163   | \$ -  | \$ -  |
| Deposits with stated maturity (1)          | 412,926                                       | 413,769                         | -   | 413,769   | -   |
| Other borrowings                           | 17,503  | 20,424                          | -   | 20,424  | -   |
| Subordinated debentures                    | 50,175  | 47,579                          | 8,963   | 38,616  | -   |
| Accrued interest payable                   | 8,313   | 8,313                           | 3,446   | 4,867   | -   |
| Derivative financial instruments           | -   | -                               | -   | -   | -   |
| December 31, 2012                          |   |                                 |   |   |   |
| Assets                                     |   |                                 |   |   |   |
| Cash and due from banks                    | \$55,487                                      | \$55,487                        | \$55,487  | \$ -  | \$ -  |
| Interest bearing deposits                  | 124,295                                       | 124,295                         | 124,295   | -   | -   |
| Trading securities                         | 110   | 110                             | 110   | -   | -   |
| Securities available for sale              | 208,413                                       | 208,413                         | -   | 208,413   | -   |
| Federal Home Loan Bank and Federal Reserve |   |                                 |   |   |   |
| Bank Stock                                 | 20,838  | NA                              | NA  | NA  | NA  |
| Net loans and loans held for sale          | 1,425,643                                     | 1,400,385                       | -   | 50,779  | 1,349,606   |
| Accrued interest receivable                | 5,814   | 5,814                           | 102   | 934   | 4,778   |
| Derivative financial instruments           | 1,368   | 1,368                           | -   | 1,368   | -   |
| Liabilities                                |   |                                 |   |   |   |
| Deposits with no stated maturity (1)       | \$1,360,609                                   | \$1,360,609                     | \$1,360,609   | \$ -  | \$ -  |

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|                                   |         |         |       |         |     |
|-----------------------------------|---------|---------|-------|---------|-----|
| Deposits with stated maturity (1) | 418,928 | 420,374 | -     | 420,374 | -   |
| Other borrowings                  | 17,625  | 21,463  | -     | 21,463  | -   |
| Subordinated debentures           | 50,175  | 42,235  | 7,956 | 34,279  | -   |
| Accrued interest payable          | 7,197   | 7,197   | 2,942 | 4,255   | -   |
| Derivative financial instruments  | 1,320   | 1,320   | -     | 861     | 459 |

Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$5.9 million and \$1.2 million at June 30, 2013 and December 31, 2012, respectively. Deposits with a stated maturity include reciprocal (1) deposits with a recorded book balance of \$40.9 million and \$32.0 million at June 30, 2013 and December 31, 2012, respectively.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

14. Contingent Liabilities

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our Condensed Consolidated Financial Statements. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$0.4 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.

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

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

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

Upon the cancellation of a service contract and the completion of the billing process to the counterparties for amounts due to Mepco, there is a decrease in the amount of "payment plan receivables" and an increase in the amount of "vehicle service contract counterparty receivables" until such time as the amount due from the counterparty is collected. These amounts represent funds actually due to Mepco from its counterparties for cancelled service contracts. At June 30, 2013, the aggregate amount of such obligations owing to Mepco by counterparties, net of write-downs and reserves made through the recognition of vehicle service contract counterparty contingencies expense, totaled \$15.1 million. This compares to a balance of \$18.4 million at December 31, 2012. Mepco is currently in the process of working to recover these receivables, including through liquidation of collateral and litigation against counterparties.

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

When counterparties do not honor their contractual obligations to Mepco to repay advanced funds, we recognize estimated losses. Mepco pursues collection (including commencing legal action if necessary) of funds due to it under its various contracts with counterparties. Mepco has had to initiate litigation against certain counterparties, including one of the third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. Charges related to estimated losses for vehicle service contract counterparty contingencies included in non-interest expenses were \$3.1 million and \$0.3 million for the three months ended June 30, 2013 and 2012, respectively and \$3.3 million and \$0.8 million for the six months ended June 30, 2013 and 2012, respectively. The significant increase in this expense in 2013 is due to write-downs of vehicle service contract counterparty receivables in the second quarter of 2013. We reached tentative settlements in certain litigation to collect these receivables. Given the costs and uncertainty of continued litigation, we determined it was in our best interest to resolve these matters. These charges are being classified in non-interest expense because they are associated with a default or potential default of a contractual obligation under our counterparty contracts as opposed to loss on the administration of the payment plan itself.

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

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

We have established a reserve (which totaled \$2.2 million and \$1.4 million at June 30, 2013 and December 31, 2012, respectively) for loss reimbursements on sold mortgage loans. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. While we believe that the amounts we have accrued for incurred losses on sold loans are appropriate given these analyses, future losses could exceed our current estimate.

The provision for loss reimbursement on sold loans represents our estimate of incurred losses during the period related to mortgage loans that we have sold to investors (primarily Fannie Mae and Freddie Mac). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. Historically, loss reimbursements on mortgage loans sold without recourse were very rare. In 2009, we had only one actual loss reimbursement (for \$0.06 million). Prior to 2009, we had years in which we incurred no such loss reimbursements. However, our loss reimbursements increased to \$0.2 million, \$0.5 million and \$1.2 million in 2010, 2011 and 2012, respectively, as over the past two years Fannie Mae and Freddie Mac, in particular, have been doing more reviews of mortgage loans where they have incurred or expect to incur a loss and have been more aggressive in pursuing loss reimbursements from the sellers of such mortgage loans. Such loss reimbursements for the three and six month periods ended June 30, 2013 were \$0.1 million and \$0.2 million, respectively compared to \$0.2 million and \$0.7 million during the same periods in 2012, respectively. Although we are successful in the vast majority of cases where file reviews are conducted on mortgage loans that we have sold to investors and actual loss reimbursements remain relatively modest, the levels of such file reviews and loss reimbursement requests have increased.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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15. Shareholders' Equity

On April 2, 2010, we entered into an Exchange Agreement with the UST pursuant to which the UST agreed to exchange all 72,000 shares of our Series A Fixed Rate Cumulative Perpetual Preferred Stock, with an original liquidation preference of \$1,000 per share ("Series A Preferred Stock"), beneficially owned and held by the UST, plus accrued and unpaid dividends on such Series A Preferred Stock, for shares of our Series B Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, with an original liquidation preference of \$1,000 per share ("Series B Preferred Stock"). As part of the terms of the Exchange Agreement, we also agreed to amend and restate the terms of the warrant, dated December 12, 2008, issued to the UST to purchase 346,154 shares of our common stock.

On April 16, 2010, we closed the transactions described in the Exchange Agreement and we issued to the UST: (1) 74,426 shares of our Series B Preferred Stock and (2) an Amended and Restated Warrant to purchase 346,154 shares of our common stock at an exercise price of \$7.234 per share and expiring on December 12, 2018 (the "Amended Warrant"). These securities were issued in exchange for all of the 72,000 shares of Series A Preferred Stock and the original warrant that had been issued to the UST in December 2008 pursuant to the TARP Capital Purchase Program, plus approximately \$2.4 million in accrued dividends on such Series A Preferred Stock.

With the exception of being convertible into shares of our common stock, the terms of the Series B Preferred Stock are substantially similar to the terms of the Series A Preferred Stock that was exchanged. The Series B Preferred Stock qualifies as Tier 1 regulatory capital and pays cumulative dividends quarterly at a rate of 5% per annum through February 14, 2014, and at a rate of 9% per annum thereafter. The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, have the right to elect two additional directors at our next annual meeting of shareholders or at a special meeting of shareholders called for that purpose. These directors would be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid. Beginning in December of 2009, we suspended payment of quarterly dividends. The cash dividends payable to the UST amount to approximately \$4.4 million per year until December of 2013, at which time they would increase to approximately \$7.9 million per year. Because we have deferred dividends on the Series B Preferred Stock for at least six quarterly dividend periods, the UST currently has the right to elect two directors to our board. At this time, in lieu of electing such directors, the UST requested us to allow (and we have allowed) an observer to attend our Board of Directors meetings beginning in the third quarter of 2011. The UST continues to retain the right to elect two directors as described above.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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Under the terms of the Series B Preferred Stock, UST (and any subsequent holder of the Series B Preferred Stock) has the right to convert the Series B Preferred Stock into our common stock at any time. In addition, we have the right to compel a conversion of the Series B Preferred Stock into common stock, subject to the following conditions:

- (i) we shall have received all appropriate approvals from the Board of Governors of the Federal Reserve System;
- (ii) we shall have issued our common stock in exchange for at least \$40 million aggregate original liquidation amount of the trust preferred securities issued by the Company's trust subsidiaries, IBC Capital Finance II, IBC Capital Finance III, IBC Capital Finance IV, and Midwest Guaranty Trust I;
- (iii) we shall have closed one or more transactions (on terms reasonably acceptable to the UST, other than the price per share of common stock) in which investors, other than the UST, have collectively provided a minimum aggregate amount of \$100 million in cash proceeds to us in exchange for our common stock; and
- (iv) we shall have made the anti-dilution adjustments to the Series B Preferred Stock, if any, required by the terms of the Series B Preferred Stock.

If converted by the holder or by us pursuant to either of the above-described conversion rights, each share of Series B Preferred Stock (liquidation amount of \$1,000 per share) will convert into a number of shares of our common stock equal to a fraction, the numerator of which is \$750 and the denominator of which is \$7.234, which was the market price of our common stock at the time the Exchange Agreement was signed (as such market price was determined pursuant to the terms of the Series B Preferred Stock), referred to as the "conversion rate." This conversion rate is subject to certain anti-dilution adjustments that may result in a greater number of shares being issued to the holder of the Series B Preferred Stock. If converted by the holder or by us pursuant to either of the above-described conversion rights, as of June 30, 2013, the Series B Preferred Stock and accrued and unpaid dividends would have been convertible into approximately 9.8 million shares of our common stock.

Unless earlier converted by the holder or by us as described above, the Series B Preferred Stock will convert into shares of our common stock on a mandatory basis on the seventh anniversary (April 16, 2017) of the issuance of the Series B Preferred Stock. In any such mandatory conversion, each share of Series B Preferred Stock (liquidation amount of \$1,000 per share) will convert into a number of shares of our common stock equal to a fraction, the numerator of which is \$1,000 and the denominator of which is the market price of our common stock at the time of such mandatory conversion (as such market price is determined pursuant to the terms of the Series B Preferred Stock).

At the time any Series B Preferred Stock is converted into our common stock, we will be required to pay all accrued and unpaid dividends on the Series B Preferred Stock being converted in cash or, at our option, in shares of our common stock, in which case the number of shares to be issued will be equal to the amount of accrued and unpaid dividends to be paid in common stock divided by the market value of our common stock at the time of conversion (as such market price is determined pursuant to the terms of the Series B Preferred Stock). Accrued and unpaid dividends on the Series B Preferred Stock totaled \$12.9 million (approximately \$173 per share of Series B Preferred Stock) and \$10.7 million (approximately \$144 per share of Series B Preferred Stock) at June 30, 2013 and December 31, 2012, respectively. These amounts are recorded in Convertible Preferred Stock on the Condensed Consolidated Statements of Financial Condition.

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The maximum number of shares of our common stock that may be issued upon conversion of all shares of the Series B Preferred Stock and any accrued dividends on Series B Preferred Stock is 14.4 million, unless we receive shareholder approval to issue a greater number of shares.

The Series B Preferred Stock may be redeemed by us, subject to the approval of the Board of Governors of the Federal Reserve System, at any time, in an amount up to the cash proceeds (minimum of approximately \$18.6 million) from qualifying equity offerings of common stock (plus any net increase to our retained earnings after the original issue date). If we exercise this right to redeem the Series B Preferred Stock the redemption price would be the greater of (a) the \$1,000 liquidation amount per share plus any accrued and unpaid dividends and (b) the product of the applicable conversion rate (as described above) and the average of the market prices per share of our common stock (as such market price is determined pursuant to the terms of the Series B Preferred Stock) over a 20 trading day period beginning on the trading day immediately after we give notice of redemption to the holder (plus any accrued and unpaid dividends). In any redemption, we must redeem at least 25% of the number of Series B Preferred Stock shares originally issued to the UST, unless fewer of such shares are then outstanding (in which case all of the Series B Preferred Stock must be redeemed). In addition to the terms of the Series B Preferred Stock discussed above, the UST updated its Frequently Asked Questions regarding the Capital Purchase Program (“CPP”) as of March 1, 2012 to permit any CPP participant to repay its investment, in part, subject to a minimum repayment of the greater of (i) 5% of the aggregate liquidation amount of the preferred stock issued to the UST or (ii) \$100,000. Under this updated guidance, we could repay a minimum of approximately \$3.7 million, subject to the approval of the Board of Governors of the Federal Reserve System, in a partial redemption of the Series B Preferred Stock.

On July 26, 2013 we executed a Securities Purchase Agreement (“SPA”) with the UST. Under the terms of the SPA, we have agreed to purchase from the UST for \$81.0 million in cash consideration: (i) 74,426 shares of our Series B Preferred Stock, including any and all accrued and unpaid dividends; and (ii) the Amended Warrant. As a condition to the closing of the purchase of these securities, we must complete one or more common stock offerings that provide a minimum aggregate amount of \$86.0 million in gross cash proceeds. The closing of the transaction with the UST is also subject to regulatory approval, the payment of deferred and unpaid interest on our outstanding trust preferred securities, and other customary closing conditions. If the closing of the transactions described in the SPA does not occur by October 31, 2013, the UST and we each have the right to terminate the SPA.

On July 7, 2010 we executed an Investment Agreement and Registration Rights Agreement with Dutchess Opportunity Fund, II, LP (“Dutchess”) for the sale of shares of our common stock. These agreements serve to establish an equity line facility as a contingent source of liquidity at the parent company level. Pursuant to the Investment Agreement, Dutchess committed to purchase up to \$15.0 million of our common stock over a 36-month period ending November 1, 2013. We have the right, but no obligation, to draw on this equity line facility from time to time during such 36-month period by selling shares of our common stock to Dutchess. The sales price is at a 5% discount to the market price of our common stock at the time of the draw (as such market price is determined pursuant to the terms of the Investment Agreement). Through June 30, 2013, we have sold a total of 1.40 million shares (zero shares during the second quarter of 2013, 0.17 million shares during the first quarter of 2013, 0.45 million shares during 2012, 0.43 million shares during 2011 and 0.35 million shares during 2010) of our common stock to Dutchess under this equity line for total net proceeds of approximately \$4.2 million. At the present time, we have shareholder approval to sell approximately 2.6 million additional shares under this equity line. Based on our closing stock price on June 30, 2013, additional funds available under the Investment Agreement totaled approximately \$10.8 million at June 30, 2013.



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

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

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

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16. Accumulated Other Comprehensive Loss

A summary of changes in AOCL, follows (1):

|  | Unrealized<br>Losses<br>on<br>Available<br>for Sale<br>Securities<br>(In thousands) | Dispropor-<br>tionate<br>Tax<br>Effects<br>from<br>Unrealized<br>Securities<br>Available<br>for Sale | Unrealized<br>Losses on<br>Cash<br>Flow<br>Hedges | Unrealized<br>Losses on<br>Settled<br>Derivatives | Dispropor-<br>tionate<br>Tax<br>Effects<br>from<br>Cash<br>Flow<br>Hedges | Total       |
|--|---|--|---|---|---|-------------|
| For the three months ended June 30,                        |   |  |   |   |   |             |
| 2013   |   |  |   |   |   |             |
| Balances at beginning of period                            | \$679   | \$ (5,798 )  | \$ (390 )   | \$ -  | \$ (1,444 )   | \$ (6,953 ) |
| Terminated cash flow hedge                                 | -   | -  | 370   | (370 )  | -   | -           |
| Other comprehensive income (loss) before reclassifications | (1,786)   | -  | (21 )   | -   | -   | (1,807 )    |
| Amounts reclassified from AOCL                             | 5   | -  | 41  | -   | 1,444   | 1,490       |
| Net current period other comprehensive income (loss)       | (1,781)   | -  | 20  | -   | 1,444   | (317 )      |
| Balances at end of period                                  | \$ (1,102)  | \$ (5,798 )  | \$ -  | \$ (370 )   | \$ -  | \$ (7,270 ) |
| 2012   |   |  |   |   |   |             |
| Balances at beginning of period                            | \$ (5,002)  | \$ (5,617 )  | \$ (969 )   | \$ (291 )   | \$ (1,186 )   | \$ (13,065) |
| Other comprehensive income (loss) before reclassifications | 2,875   | -  | (24 )   | -   | -   | 2,851       |
| Amounts reclassified from AOCL                             | (66 )   | -  | 120   | 146   | -   | 200         |
| Net current period other comprehensive income (loss)       | 2,809   | -  | 96  | 146   | -   | 3,051       |
| Balances at end of period                                  | \$ (2,193)  | \$ (5,617 )  | \$ (873 )   | \$ (145 )   | \$ (1,186 )   | \$ (10,014) |
| For the six months ended June 30,                          |   |  |   |   |   |             |
| 2013   |   |  |   |   |   |             |
| Balances at beginning of period                            | \$ (516 )   | \$ (5,617 )  | \$ (739 )   | \$ -  | \$ (1,186 )   | \$ (8,058 ) |
| Income tax   | 181   | (181 )   | 258   | -   | (258 )  | -           |
| Balances at beginning of period, net of tax                | (335 )  | (5,798 )   | (481 )  | -   | (1,444 )  | (8,058 )    |
| Terminated cash flow hedge                                 | -   | -  | 370   | (370 )  | -   | -           |
| Other comprehensive income (loss) before reclassifications | (779 )  | -  | (24 )   | -   | -   | (803 )      |
| Amounts reclassified from AOCL                             | 12  | -  | 135   | -   | 1,444   | 1,591       |
| Net current period other comprehensive income (loss)       | (767 )  | -  | 111   | -   | 1,444   | 788         |
| Balances at end of period                                  | \$ (1,102)  | \$ (5,798 )  | \$ -  | \$ (370 )   | \$ -  | \$ (7,270 ) |

|  |            |             |             |           |             |             |
|--|------------|-------------|-------------|-----------|-------------|-------------|
| 2012   |            |             |             |           |             |             |
| Balances at beginning of period                            | \$ (3,579) | \$ (5,617 ) | \$ (1,103 ) | \$ (436 ) | \$ (1,186 ) | \$ (11,921) |
| Other comprehensive income (loss) before reclassifications | 1,967      | -           | (75 )       | -         | -           | 1,892       |
| Amounts reclassified from AOCL                             | (581 )     | -           | 305         | 291       | -           | 15          |
| Net current period other comprehensive income (loss)       | 1,386      | -           | 230         | 291       | -           | 1,907       |
| Balances at end of period                                  | \$ (2,193) | \$ (5,617 ) | \$ (873 )   | \$ (145 ) | \$ (1,186 ) | \$ (10,014) |

(1) 2013 amounts are presented net of tax as we removed substantially all of the valuation allowance on our deferred tax assets during the second quarter of 2013 (see Note #10).

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The disproportionate tax effects from securities available for sale and cash flow hedges arose due to tax effects of other comprehensive income (“OCI”) in the presence of a valuation allowance against our deferred tax assets and a pretax loss from operations. Generally, the amount of income tax expense or benefit allocated to operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided when, in the presence of a valuation allowance against deferred tax assets, there is a pretax loss from operations and pretax income from other categories in the current period. In such instances, income from other categories must offset the current loss from operations, the tax benefit of such offset being reflected in operations. During the second quarter of 2013, we terminated our last remaining cash flow hedge and cleared the disproportionate tax effects relating to cash flow hedges from accumulated other comprehensive income (see Note #10).

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

| AOCL Component                                     | Amount<br>Reclassified<br>From<br>AOCL<br>(In<br>thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|--|---|--|
| 2013   |   |  |
| Unrealized losses on available for sale securities | \$ 15   | Net gains on securities  |
|  | (26)  | ) Net impairment loss recognized in earnings                             |
|  | (11)  | ) Total reclassifications before tax                                     |
|  | (6)   | ) Tax expense (benefit)  |
|  | \$ (5)  | ) Reclassifications, net of tax  |
| Unrealized losses on cash flow hedges              | \$ (114)  | ) Interest expense   |
|  | (73)  | ) Tax expense (benefit)  |
|  | \$ (41)   | ) Reclassification, net of tax   |
| Disproportionate tax effects from cash flow hedges | \$ 1,444  | Tax expense (benefit)  |
|  | \$ (1,490)  | ) Total reclassifications for the period, net of tax                     |
| 2012   |   |  |
| Unrealized losses on available for sale securities | \$ 151  | Net gains on securities  |
|  | (85)  | ) Net impairment loss recognized in earnings                             |
|  | 66  | Total reclassifications before tax                                       |
|  | -   | Tax expense (benefit)  |
|  | \$ 66   | Reclassifications, net of tax  |
| Unrealized losses on cash flow hedges              | \$ (120)  | ) Interest expense   |
|  | -   | Tax expense (benefit)  |
|  | (120)   | ) Reclassification, net of tax   |
| Unrealized losses on settled derivatives           | \$ (146)  | ) Interest expense   |
|  | -   | Tax expense (benefit)  |
|  | (146)   | ) Reclassification, net of tax   |
|  | \$ (200)  | ) Total reclassifications for the period, net of tax                     |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A summary of reclassifications out of each component of AOCL for the six months ended June 30 follows:

| AOCL Component                                     | Amount<br>Reclassified<br>From<br>AOCL<br>(In<br>thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|--|---|--|
| 2013   |   |  |
| Unrealized losses on available for sale securities | \$ 8  | Net gains on securities  |
|  | (26)  | ) Net impairment loss recognized in earnings                             |
|  | (18)  | ) Total reclassifications before tax                                     |
|  | (6)   | ) Tax expense (benefit)  |
|  | \$ (12)   | ) Reclassifications, net of tax  |
| Unrealized losses on cash flow hedges              | \$ (208)  | ) Interest expense   |
|  | (73)  | ) Tax expense (benefit)  |
|  | \$ (135)  | ) Reclassification, net of tax   |
| Disproportionate tax effects from cash flow hedges | \$ 1,444  | Tax expense (benefit)  |
|  | \$ (1,591)  | ) Total reclassifications for the period, net of tax                     |
| 2012   |   |  |
| Unrealized losses on available for sale securities | \$ 843  | Net gains on securities  |
|  | (262)   | ) Net impairment loss recognized in earnings                             |
|  | 581   | Total reclassifications before tax                                       |
|  | -   | Tax expense (benefit)  |
|  | \$ 581  | Reclassifications, net of tax  |
| Unrealized losses on cash flow hedges              | \$ (305)  | ) Interest expense   |
|  | -   | Tax expense (benefit)  |
|  | (305)   | ) Reclassification, net of tax   |
| Unrealized losses on settled derivatives           | \$ (291)  | ) Interest expense   |
|  | -   | Tax expense (benefit)  |
|  | (291)   | ) Reclassification, net of tax   |
|  | \$ (15)   | ) Total reclassifications for the period, net of tax                     |

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ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following section presents additional information that may be necessary to assess our financial condition and results of operations. This section should be read in conjunction with our condensed consolidated financial statements contained elsewhere in this report as well as our 2012 Annual Report on Form 10-K. The Form 10-K includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

**Introduction.** Our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula. We have in general experienced a difficult economy in Michigan since 2001, although economic conditions in the state began to show signs of improvement during 2010 and generally these improvements have continued into 2013, albeit at a slower pace, as evidenced, in part, by an overall decline in the unemployment rate. However, Michigan's unemployment rate has been consistently above the national average.

We provide banking services to customers located primarily in Michigan's Lower Peninsula. Our loan portfolio, the ability of the borrowers to repay these loans and the value of the collateral securing these loans has been and will be impacted by local economic conditions. The weaker economic conditions faced in Michigan have had and may continue to have adverse consequences as described below in "Portfolio Loans and asset quality." However, since early-to mid-2009, we have generally seen an improvement in asset quality metrics. In particular, since early 2012, we have experienced a decline in non-performing assets, reduced levels of new loan defaults and reduced levels of net loan charge-offs. These factors have resulted in a more significant decline in the provision for loan losses over the past few quarters. Additionally, housing prices and other related statistics (such as home sales and new building permits) have generally been improving.

In July 2010, Congress passed and the President signed into law the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act"). The Dodd-Frank Act included the creation of the Consumer Financial Protection Bureau with power to promulgate and enforce consumer protection laws; the creation of the Financial Stability Oversight Council chaired by the Secretary of the Treasury with authority to identify institutions and practices that might pose a systemic risk; provisions affecting corporate governance and executive compensation of all companies whose securities are registered with the SEC; a provision that broadened the base for Federal Deposit Insurance Corporation ("FDIC") insurance assessments; a provision under which interchange fees for debit cards are set by the Federal Reserve under a restrictive "reasonable and proportional cost" per transaction standard; a provision that requires bank regulators to set minimum capital levels for bank holding companies that are as strong as those required for their insured depository subsidiaries, subject to a grandfather clause for financial institutions with less than \$15 billion in assets as of December 31, 2009; and new restrictions on how mortgage brokers and loan originators may be compensated. Certain provisions of the Dodd-Frank Act only apply to institutions with more than \$10 billion in assets. The Dodd-Frank Act has had (and we expect it will continue to have) a significant impact on the banking industry, including our organization.

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On May 23, 2012 we executed a definitive agreement to sell 21 branches to another financial institution (the “Branch Sale”). The branches sold included 6 branch locations in the Battle Creek, Michigan market area and 15 branch locations in Northeast Michigan. The Branch Sale closed on December 7, 2012 and resulted in the transfer of approximately \$403.1 million of deposits in exchange for our receipt of a deposit premium of approximately \$11.5 million. We also sold approximately \$48.0 million of loans at a discount of 1.75% and premises and equipment totaling approximately \$8.1 million. The Branch Sale also resulted in our transfer of \$336.1 million of cash to the purchaser. We recorded a net gain on the Branch Sale of approximately \$5.4 million in the fourth quarter of 2012.

In addition to the Branch Sale, we have closed or consolidated a total of 15 other branch locations since 2011.

On July 2, 2013, the Federal Reserve Board approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”). The rule will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act.

In general, under the New Capital Rules, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity.

We are subject to the New Capital Rules beginning on January 1, 2015. The 2.50% capital conservation buffer is being phased in over a four-year period beginning in 2016. Also, under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital.

On July 26, 2013 we executed a Securities Purchase Agreement (“SPA”) with the United States Department of the Treasury (“UST”). Under the terms of the SPA, we have agreed to purchase from the UST for \$81.0 million in cash consideration: (i) 74,426 shares of our Series B Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, with an original liquidation preference of \$1,000 per share (“Series B Preferred Stock”), including any and all accrued and unpaid dividends; and (ii) the Amended and Restated Warrant to purchase up to 346,154 shares of our common stock at an exercise price of \$7.234 per share and expiring on December 12, 2018 (the “Amended Warrant”). As a condition to the closing of the purchase of these securities, we must complete one or more common stock offerings that provide a minimum aggregate amount of \$86.0 million in gross cash proceeds. The closing of the transaction with the UST is also subject to regulatory approval, the payment of deferred and unpaid interest on our outstanding trust preferred securities, and other customary closing conditions. If the closing of the transactions described in the SPA does not occur by October 31, 2013, the UST and we each have the right to terminate the SPA.



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It is against this backdrop that we discuss our results of operations for the second quarter and first six months of 2013 as compared to 2012 and our financial condition as of June 30, 2013.

## RESULTS OF OPERATIONS

**Summary.** We recorded net income of \$63.4 million and \$4.3 million, respectively, and net income applicable to common stock of \$62.2 million and \$3.2 million, respectively, during the three months ended June 30, 2013 and 2012. The significant improvement in 2013 results as compared to 2012 primarily reflects the income tax benefit associated with the reversal of substantially all of the valuation allowance on our deferred tax assets (see “Income tax benefit.”), decreases in the provision for loan losses and decreases in non-interest expenses, which were partially offset by a decrease in net interest income.

We recorded net income of \$69.2 million and \$7.8 million, respectively, and net income applicable to common stock of \$66.9 million and \$5.7 million, respectively, during the six months ended June 30, 2013 and 2012. The reasons for the changes in the year-to-date comparative periods are generally commensurate with the quarterly comparative periods.

## Key performance ratios

|  | Three months ended<br>June 30, |        | Six months ended<br>June 30, |        |
|--|--------------------------------|--------|------------------------------|--------|
|  | 2013                           | 2012   | 2013                         | 2012   |
| Net income (annualized) to <sup>(1)(2)</sup> |                                |        |                              |        |
| Average assets                               | 12.00 %                        | 0.54 % | 6.52 %                       | 0.48 % |
| Average common shareholders' equity          | 388.31                         | 47.96  | 226.29                       | 45.34  |
| Net income per common share <sup>(1)</sup>   |                                |        |                              |        |
| Basic  | \$6.56                         | \$0.38 | \$7.14                       | \$0.66 |
| Diluted                                      | 2.64                           | 0.11   | 2.90                         | 0.19   |

(1) These amounts are calculated using net income (loss) applicable to common stock.

(2) Income before tax less preferred stock dividends and discount accretion (annualized) to average assets and average common shareholders' equity were 1.11% and 35.83% for the three months ended June 30, 2013, respectively and were 1.02% and 35.46% for the six months ended June 30, 2013, respectively.

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

Our net interest income totaled \$19.5 million during the second quarter of 2013, a decrease of \$2.3 million, or 10.6% from the year-ago period. Our tax equivalent net interest income as a percent of average interest-earning assets (the “net interest margin”) was 4.16% during the second quarter of 2013, compared to 4.06% in the year-ago period. The decrease in net interest income in 2013 compared to 2012 primarily reflects a \$281.0 million decrease in average interest-earning assets that was partially offset by a 10 basis point increase in our net interest margin. The decline in

average interest-earning assets is a result of the Branch Sale. The increase in the net interest margin is due primarily to a reduction in our cost of funds.

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Interest rates have generally been at extremely low levels over the past three years due primarily to the Federal Reserve's monetary policies and its efforts to stimulate the U.S. economy. This very low interest rate environment has had an adverse impact on our interest income and net interest income. Based on recent announcements by the Federal Reserve, short-term interest rates are expected to remain extremely low until late-2014 or early-2015 (until the U.S. unemployment rate declines to approximately 6.5%). However, during the second quarter of 2013, mid- to long-term interest rates increased substantially (for example the ten year U.S. treasury yield increased from 1.87% at the end of the first quarter of 2013 to 2.52% at the end of the second quarter of 2013). Given the repricing characteristics of our interest-earning assets and interest-bearing liabilities (and our level of non-interest bearing demand deposits), our net interest margin will generally benefit on a long-term basis from rising interest rates.

For the first six months of 2013, net interest income totaled \$39.1 million, a decrease of \$4.9 million, or 11.0% from 2012. The Company's net interest margin for the first six months of 2013 increased to 4.20% compared to 4.12% in 2012. The reasons for the decline in net interest income for the first six months of 2013 are generally consistent with those described above for the comparative quarterly periods.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the second quarter and first six months of 2013 non-accrual loans averaged \$24.9 million and \$27.9 million, respectively compared to \$47.6 million and \$51.9 million, respectively for the same periods in 2012. In addition, in the second quarter and first six months of 2013 we had net recoveries of \$0.092 million and \$0.203 million, respectively, of accrued and unpaid interest on loans placed on or taken off non-accrual during each period compared to net recoveries of \$0.085 million and \$0.054 million, respectively, during the same periods in 2012.

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## Average Balances and Tax Equivalent Rates

|  | Three Months Ended     |          |                     |                    |          |                     |
|--|------------------------|----------|---------------------|--------------------|----------|---------------------|
|  | June 30,<br>2013       |          |                     | 2012               |          |                     |
|  | Average<br>Balance     | Interest | Rate <sup>(3)</sup> | Average<br>Balance | Interest | Rate <sup>(3)</sup> |
| Assets <sup>(1)</sup>                              | (Dollars in thousands) |          |                     |                    |          |                     |
| Taxable loans                                      | \$1,413,738            | \$20,243 | 5.74 %              | \$1,556,478        | \$23,623 | 6.09 %              |
| Tax-exempt loans <sup>(2)</sup>                    | 5,684                  | 92       | 6.49                | 7,085              | 112      | 6.36                |
| Taxable securities                                 | 283,321                | 993      | 1.41                | 261,554            | 933      | 1.43                |
| Tax-exempt securities <sup>(2)</sup>               | 27,053                 | 369      | 5.47                | 26,431             | 383      | 5.83                |
| Cash – interest bearing                            | 146,132                | 84       | 0.23                | 306,329            | 196      | 0.26                |
| Other investments                                  | 21,481                 | 240      | 4.48                | 20,564             | 186      | 3.64                |
| Interest Earning Assets                            | 1,897,409              | 22,021   | 4.65                | 2,178,441          | 25,433   | 4.69                |
| Cash and due from banks                            | 42,943                 |          |                     | 51,470             |          |                     |
| Other assets, net                                  | 140,288                |          |                     | 163,096            |          |                     |
| Total Assets                                       | \$2,080,640            |          |                     | \$2,393,007        |          |                     |
| Liabilities  |                        |          |                     |                    |          |                     |
| Savings and NOW                                    | \$906,655              | 288      | 0.13                | \$1,080,130        | 486      | 0.18                |
| Time deposits                                      | 422,406                | 1,175    | 1.12                | 571,088            | 1,819    | 1.28                |
| Other borrowings                                   | 67,771                 | 876      | 5.18                | 69,826             | 1,120    | 6.45                |
| Interest Bearing Liabilities                       | 1,396,832              | 2,339    | 0.67                | 1,721,044          | 3,425    | 0.80                |
| Demand deposits                                    | 493,932                |          |                     | 523,647            |          |                     |
| Other liabilities                                  | 39,685                 |          |                     | 39,630             |          |                     |
| Shareholders' equity                               | 150,191                |          |                     | 108,686            |          |                     |
| Total liabilities and shareholders' equity         | \$2,080,640            |          |                     | \$2,393,007        |          |                     |
| Net Interest Income                                |                        | \$19,682 |                     |                    | \$22,008 |                     |
| Net Interest Income as a Percent of Earning Assets |                        |          | 4.16 %              |                    |          | 4.06 %              |

(1) All domestic.

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

(3) Annualized.

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## Average Balances and Tax Equivalent Rates

|  | Six Months Ended   |          |                     |                    |          |                     |
|--|--------------------|----------|---------------------|--------------------|----------|---------------------|
|  | June 30,<br>2013   |          |                     | 2012               |          |                     |
|  | Average<br>Balance | Interest | Rate <sup>(3)</sup> | Average<br>Balance | Interest | Rate <sup>(3)</sup> |
| (Dollars in thousands)                             |                    |          |                     |                    |          |                     |
| Assets <sup>(1)</sup>                              |                    |          |                     |                    |          |                     |
| Taxable loans                                      | \$1,425,078        | \$40,892 | 5.77 %              | \$1,569,460        | \$47,893 | 6.13 %              |
| Tax-exempt loans <sup>(2)</sup>                    | 5,783              | 186      | 6.49                | 7,162              | 229      | 6.43                |
| Taxable securities                                 | 241,829            | 1,663    | 1.39                | 223,176            | 1,591    | 1.43                |
| Tax-exempt securities <sup>(2)</sup>               | 25,635             | 731      | 5.75                | 26,788             | 822      | 6.17                |
| Cash – interest bearing                            | 165,988            | 204      | 0.25                | 312,452            | 395      | 0.25                |
| Other investments                                  | 21,161             | 452      | 4.31                | 20,696             | 383      | 3.72                |
| Interest Earning Assets                            | 1,885,474          | 44,128   | 4.71                | 2,159,734          | 51,313   | 4.77                |
| Cash and due from banks                            | 44,256             |          |                     | 53,776             |          |                     |
| Other assets, net                                  | 140,942            |          |                     | 163,608            |          |                     |
| Total Assets                                       | \$2,070,672        |          |                     | \$2,377,118        |          |                     |
| Liabilities  |                    |          |                     |                    |          |                     |
| Savings and NOW                                    | \$900,535          | 570      | 0.13                | \$1,067,013        | 958      | 0.18                |
| Time deposits                                      | 423,057            | 2,422    | 1.15                | 574,028            | 3,771    | 1.32                |
| Other borrowings                                   | 67,786             | 1,741    | 5.18                | 76,605             | 2,292    | 6.02                |
| Interest Bearing Liabilities                       | 1,391,378          | 4,733    | 0.69                | 1,717,646          | 7,021    | 0.82                |
| Demand deposits                                    | 493,942            |          |                     | 513,833            |          |                     |
| Other liabilities                                  | 40,340             |          |                     | 39,442             |          |                     |
| Shareholders' equity                               | 145,012            |          |                     | 106,197            |          |                     |
| Total liabilities and shareholders' equity         | \$2,070,672        |          |                     | \$2,377,118        |          |                     |
| Net Interest Income                                |                    | \$39,395 |                     |                    | \$44,292 |                     |
| Net Interest Income as a Percent of Earning Assets |                    |          | 4.20 %              |                    |          | 4.12 %              |

(1) All domestic.

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

(3) Annualized.

Provision for loan losses. The provision for loan losses was a credit of \$2.1 million and an expense of \$1.1 million during the three months ended June 30, 2013 and 2012, respectively. During the six-month periods ended June 30, 2013 and 2012, the provision was a credit of \$2.8 million and an expense of \$6.2 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. The decrease in the provision for loan losses in the second quarter and first half of 2013 primarily reflects reduced levels of non-performing loans, lower total loan balances and a decline in loan net charge-offs. See "Portfolio Loans and asset quality" for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the second quarter and first half of 2013.

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

Non-interest income totaled \$13.0 million during the three months ended June 30, 2013, essentially unchanged from the comparable period in 2012. For the first six months of 2013 non-interest income totaled \$24.1 million, a \$3.5 million decrease from the comparable period in 2012. The year-to-date decline is primarily due to decreases in service charges on deposit accounts, interchange income, net gains on mortgage loans, net gains on securities, increase in fair value of U.S. Treasury warrant and other non-interest income that were partially offset by an increase in mortgage loan servicing income.

## Non-Interest Income

|   | Three months ended |          | Six months ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30, 2013      | 2012     | June 30, 2013    | 2012     |
|   | (In thousands)     |          |                  |          |
| Service charges on deposit accounts                         | \$3,583            | \$4,552  | \$6,989          | \$8,753  |
| Interchange income  | 1,933              | 2,407    | 3,690            | 4,729    |
| Net gains (losses) on assets:                               |                    |          |                  |          |
| Mortgage loans  | 3,208              | 3,579    | 6,845            | 7,439    |
| Securities  | 107                | 169      | 191              | 853      |
| Other than temporary loss on securities available for sale: |                    |          |                  |          |
| Total impairment loss                                       | (26 )              | (85 )    | (26 )            | (262 )   |
| Recognized in other comprehensive loss                      | -                  | -        | -                | -        |
| Net impairment loss in earnings                             | (26 )              | (85 )    | (26 )            | (262 )   |
| Mortgage loan servicing                                     | 1,654              | (1,088 ) | 2,276            | (352 )   |
| Investment and insurance commissions                        | 383                | 648      | 833              | 1,095    |
| Bank owned life insurance                                   | 337                | 399      | 675              | 823      |
| Title insurance fees  | 368                | 489      | 852              | 997      |
| (Increase) decrease in fair value of U.S. Treasury warrant  | 20                 | (25 )    | (1,025 )         | (179 )   |
| Other   | 1,444              | 1,997    | 2,779            | 3,730    |
| Total non-interest income                                   | \$13,011           | \$13,042 | \$24,079         | \$27,626 |

Service charges on deposit accounts declined on both a comparative quarterly and year-to-date basis in 2013 as compared to 2012. The decrease in such service charges in 2013 principally results from the Branch Sale. In addition, even after considering the Branch Sale, we have generally experienced a decline in non-sufficient funds (“NSF”) occurrences and related NSF fees. We believe the decline in NSF occurrences is principally due to our customers managing their finances more closely in order to reduce NSF activity and avoid the associated fees.

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Interchange income declined on both a comparative quarterly and year-to-date basis in 2013 as compared to 2012.

The decrease in interchange income primarily results from the Branch Sale. As described earlier, the Dodd-Frank Act includes a provision under which interchange fees for debit cards are set by the FRB under a restrictive “reasonable and proportional cost” per transaction standard. On June 29, 2011 the FRB issued final rules (that were effective October 1, 2011) on interchange fees for debit cards. Overall, these final rules established price caps for debit card interchange fees that were approximately 50% lower than previous averages. However, debit card issuers with less than \$10 billion in assets (like us) are exempt from this rule. On a long-term basis, it is not clear how competitive market factors may impact debit card issuers who are exempt from the rule. However, we have been experiencing some reduction in interchange income due to certain transaction routing changes, particularly at large merchants.

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

## Mortgage Loan Activity

|   | Three months ended<br>June 30, |            | Six months ended<br>June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2013                           | 2012       | 2013                         | 2012       |
|   | (Dollars in thousands)         |            |                              |            |
| Mortgage loans originated   | \$ 121,054                     | \$ 136,835 | \$ 249,786                   | \$ 249,633 |
| Mortgage loans sold   | 112,873                        | 127,013    | 243,329                      | 239,154    |
| Mortgage loans sold with servicing rights released                  | 15,696                         | 22,555     | 30,233                       | 37,895     |
| Net gains on the sale of mortgage loans                             | 3,208                          | 3,579      | 6,845                        | 7,439      |
| Net gains as a percent of mortgage loans sold (“Loan Sales Margin”) | 2.84                           | % 2.82     | % 2.81                       | % 3.11     |
| Fair value adjustments included in the Loan Sales Margin            | (0.13                          | ) 0.19     | (0.46                        | ) 0.53     |

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

Net gains as a percentage of mortgage loans sold (our “Loan Sales Margin”) are impacted by several factors including competition and the manner in which the loan is sold (with servicing rights retained or released). Our decision to sell or retain mortgage loan servicing rights is primarily influenced by an evaluation of the price being paid for mortgage loan servicing by outside third parties compared to our calculation of the economic value of retaining such servicing. The sale of mortgage loan servicing rights may result in declines in mortgage loan servicing income in future periods. Net gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding the aforementioned accounting adjustments, the Loan Sales Margin would have been 2.97% and 2.63% in the second quarters of 2013 and 2012, respectively and 3.27% and 2.58% for the comparative 2013 and 2012 year-to-date periods, respectively. The increase in the Loan Sales Margin (excluding fair value adjustments) in 2013 was generally due to somewhat more favorable competitive conditions including wider primary-to-secondary market pricing spreads. The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale.

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Net securities gains totaled \$0.1 million and \$0.2 million during the three and six months ended June 30, 2013, respectively, and \$0.2 million and \$0.9 million for the respective comparable periods in 2012. The 2013 net securities gains were due primarily to an increase in the fair value of trading securities. The 2012 net securities gains were due primarily to the sale of U.S. agency residential mortgage-backed investment securities.

We recorded net other than temporary impairment charges on securities available for sale of \$0.026 million during both the three and six months ended June 30, 2013, and \$0.1 million and \$0.3 million for the respective comparable periods in 2012. These impairment charges all related to private label residential mortgage-backed investment securities. (See "Securities.")

Mortgage loan servicing generated income of \$1.7 million and \$2.3 million in the second quarter and first six months of 2013, respectively, compared to a loss of \$1.1 million and \$0.4 million in the corresponding periods of 2012, respectively. These variances are primarily due to changes in the valuation allowance on and the amortization of capitalized mortgage loan servicing rights. The period end valuation allowance is based on the valuation of the mortgage loan servicing portfolio. The recovery of previously recorded impairment charges in 2013 reflects higher mortgage loan interest rates during the year resulting in lower estimated future prepayment rates being used in the quarter end valuations. The impairment charge incurred in the second quarter of 2012 primarily reflected lower mortgage loan interest rates during that quarter resulting in higher estimated future prepayment rates being used in that quarter end valuation. Activity related to capitalized mortgage loan servicing rights is as follows:

## Capitalized Mortgage Loan Servicing Rights

|   | Three months<br>ended<br>June 30, |          | Six months ended<br>June 30, |          |
|---|-----------------------------------|----------|------------------------------|----------|
|   | 2013                              | 2012     | 2013                         | 2012     |
|   | (In thousands)                    |          |                              |          |
| Balance at beginning of period            | \$11,590                          | \$11,795 | \$11,013                     | \$11,229 |
| Originated servicing rights capitalized   | 860                               | 1,028    | 1,889                        | 1,952    |
| Amortization                              | (1,108)                           | (1,237)  | (2,318)                      | (2,299)  |
| (Increase)/decrease in impairment reserve | 1,695                             | (935)    | 2,453                        | (231)    |
| Balance at end of period                  | \$13,037                          | \$10,651 | \$13,037                     | \$10,651 |
| Impairment reserve at end of period       | \$3,634                           | \$6,775  | \$3,634                      | \$6,775  |

At June 30, 2013 we were servicing approximately \$1.74 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.59% and a weighted average service fee of approximately 25.4 basis points. Remaining capitalized mortgage loan servicing rights at June 30, 2013 totaled \$13.0 million, representing approximately 75 basis points on the related amount of mortgage loans serviced for others. The capitalized mortgage loan servicing had an estimated fair market value of \$13.9 million at June 30, 2013.

Investment and insurance commissions decreased on both a comparative quarterly and year-to-date basis in 2013 compared to 2012. These decreases primarily reflect the impact of the Branch Sale.



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Income from bank owned life insurance decreased on both a comparative quarterly and year-to-date basis in 2013 compared to 2012 primarily reflecting a lower average crediting rate on our cash surrender value due to reduced total returns on the underlying separate account assets. Our separate account is primarily invested in U.S. agency residential mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our bank owned life insurance was \$51.6 million and \$50.9 million at June 30, 2013 and December 31, 2012, respectively.

Title insurance fees were lower on both a comparative quarterly and year-to-date basis in 2013 as compared to 2012 primarily as a result of a change in mix in our mortgage loan origination volume. The percentage of refinances as a total of mortgage loan origination volume declined in 2013. Our title insurance agency captures (for the sale of title insurance) a much higher percentage of our mortgage loan refinances as compared to purchase transactions.

Changes in the fair value of the Amended Warrant issued to the UST in April 2010 had been recorded as a component of non-interest income. Up until April 16, 2013, the fair value of this Amended Warrant was included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. The provision in the Amended Warrant which caused it to be accounted for as a derivative and included in accrued expenses and other liabilities expired on April 16, 2013. As a result, the Amended Warrant was reclassified into shareholders' equity on that date at its then fair value (which was approximately \$1.5 million). The fair value of the warrant was \$0.5 million at December 31, 2012. (See "Liquidity and capital resources.")

Two significant inputs in the valuation model for the Amended Warrant were our common stock price and the probability percentage of triggering anti-dilution provisions in this instrument related to certain equity transactions. The fair value of the Amended Warrant was relatively unchanged in the second quarters of 2013 (through April 16) and 2012. The fair value of the Amended Warrant increased by \$1.0 million and by \$0.2 million in the first half of 2013 (through April 16) and 2012, respectively, due primarily to a rise in our common stock price during the relevant periods.

Other non-interest income decreased on both a comparative quarterly and year-to-date basis in 2013 compared to 2012. This decrease is primarily due to declines in certain revenue categories (ATM fees, check charges, money order fees, and safe deposit box rental) primarily as a result of the Branch Sale as well as a decline in rental income on other real estate ("ORE") due to a decline in the amount of such properties.

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

Non-interest expense decreased by \$1.7 million to \$27.7 million and by \$4.3 million to \$53.2 million during the three- and six-month periods ended June 30, 2013, respectively, compared to the like periods in 2012. These decreases were primarily due to the Branch Sale. In addition, the decreases were also due to declines in credit related costs (loan and collection expenses and net losses on ORE and repossessed assets). Partially offsetting these declines were increases in vehicle service contract counterparty contingencies expense on both a comparative quarterly and year to date basis as described in more detail below.

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## Non-Interest Expense

|  | Three months ended |          | Six months ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30, 2013      | 2012     | June 30, 2013    | 2012     |
|  | (in thousands)     |          |                  |          |
| Compensation   | \$8,346            | \$9,551  | \$16,551         | \$19,496 |
| Performance-based compensation                             | 1,520              | 1,735    | 2,582            | 1,820    |
| Payroll taxes and employee benefits                        | 1,849              | 2,220    | 3,889            | 4,672    |
| Compensation and employee benefits                         | 11,715             | 13,506   | 23,022           | 25,988   |
| Occupancy, net   | 2,147              | 2,490    | 4,571            | 5,206    |
| Data processing  | 2,042              | 2,003    | 3,958            | 3,936    |
| Loan and collection  | 1,702              | 2,407    | 3,928            | 5,297    |
| Vehicle service contract counterparty contingencies        | 3,127              | 326      | 3,254            | 797      |
| Furniture, fixtures and equipment                          | 1,088              | 1,211    | 2,120            | 2,407    |
| Communications   | 730                | 922      | 1,510            | 1,895    |
| Legal and professional fees                                | 664                | 1,268    | 1,356            | 2,165    |
| FDIC deposit insurance                                     | 711                | 816      | 1,341            | 1,673    |
| Advertising  | 659                | 639      | 1,229            | 1,195    |
| Provision for loss reimbursement on sold loans             | 356                | 126      | 1,019            | 558      |
| Net losses on ORE and repossessed assets                   | 320                | 633      | 972              | 1,620    |
| Interchange expense  | 418                | 447      | 828              | 853      |
| Credit card and bank service fees                          | 331                | 624      | 665              | 1,275    |
| Supplies   | 244                | 340      | 494              | 734      |
| Amortization of intangible assets                          | 203                | 272      | 406              | 544      |
| Costs (recoveries) related to unfunded lending commitments | 48                 | (12 )    | 29               | (59 )    |
| Other  | 1,237              | 1,465    | 2,513            | 1,448    |
| Total non-interest expense                                 | \$27,742           | \$29,483 | \$53,215         | \$57,532 |

Compensation and employee benefits expenses, in total, decreased by \$1.8 million, or 13.3%, and by \$3.0 million, or 11.4%, in the second quarter and first six months of 2013, respectively, compared to the like periods in 2012. These decreases are primarily because of the Branch Sale and the branch closings/consolidations we completed in 2012.

Compensation expense decreased by \$1.2 million, or 12.6%, and by \$2.9 million, or 15.1%, in the second quarter and first six months of 2013, respectively, compared to the like periods in 2012. These declines are due primarily to a reduction of 201 average full-time equivalent employees (“FTE’s”), or 19.0%, and 214 average FTE’s, or 20.0%, during the second quarter and first six months of 2013, respectively, compared to the year ago periods. The FTE reduction was due to the Branch Sale, branch closings or consolidations during 2012 and other FTE reductions. The impact of the FTE reductions was partially offset by merit raises in 2013.

Performance-based compensation decreased by \$0.2 million and increased by \$0.8 million in the second quarter and first six months of 2013, respectively, compared to the like periods in 2012. The quarterly comparative decline was primarily due to the second quarter of 2012 including higher incentive based compensation and employee stock ownership plan accruals. Because we did not expect to make such payments as of March 31, 2012, an accrual had not been made in the first quarter of that year. The year-to-date comparative increase is due primarily to an increased accrual for incentive based compensation under our Management Incentive Compensation Plan due to our improved financial performance.

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Payroll taxes and employee benefits decreased by \$0.4 million and by \$0.8 million in the second quarter and first six months of 2013, respectively, compared to the like periods in 2012, due primarily to declines in payroll taxes and medical and dental insurance costs principally resulting from the FTE reductions enumerated above.

Occupancy, net, furniture, fixtures and equipment, communications, FDIC deposit insurance and supplies expenses collectively decreased by \$0.9 million, or 14.9%, and by \$1.9 million, or 15.8%, in the second quarter and first six months of 2013, respectively, compared to the like periods in 2012. These declines are due primarily to the Branch Sale and branch closings and consolidations that occurred in the fourth quarter of 2012.

Data processing, advertising and interchange expenses were all relatively unchanged in the second quarter and first six months of 2013 as compared to the year ago periods. Reductions in data processing and interchange expenses related to the Branch Sale were offset by increased costs due to other factors [such as increased software amortization and system maintenance costs at Mepco Finance Corporation (“Mepco”)].

Loan and collection expenses primarily reflect costs related to the management and collection of non-performing loans and other problem credits. These expenses (although still at an elevated level compared to historic norms) have further declined in 2013, which primarily reflects the overall decrease in the volume of problem credits (non-performing loans and “watch” credits). (See “Portfolio Loans and asset quality.”)

We record estimated incurred losses associated with Mepco’s vehicle service contract payment plan receivables in our provision for loan losses and establish a related allowance for loan losses. (See “Portfolio Loans and asset quality.”) We record estimated incurred losses associated with defaults by Mepco’s counterparties as “vehicle service contract counterparty contingencies expense,” which is included in non-interest expenses in our Condensed Consolidated Statements of Operations.

We recorded an expense of \$3.1 million and \$3.3 million for vehicle service contract payment plan counterparty contingencies in the second quarter and first six months of 2013, respectively, compared to \$0.3 million and \$0.8 million, respectively, for the comparable periods in 2012. The significant increase in this expense in 2013 is due to write-downs of vehicle service contract counterparty receivables in the second quarter of 2013. We reached tentative settlements in certain litigation to collect these receivables. Given the costs and uncertainty of continued litigation, we determined it was in our best interest to resolve these matters.

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

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In particular, as noted in our Risk Factors included in Part I - Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012, Mepco has had to initiate litigation against certain counterparties, including one of the respective third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. In July 2013 Mepco reached a tentative settlement with the third party insurer related to this litigation. In addition, see Note #14 to the Interim Condensed Consolidated Financial Statements included within this report for more information about Mepco's business, certain risks and difficulties we currently face with respect to that business, and reserves we have established (through vehicle service contract counterparty contingencies expense) for losses related to the business.

Legal and professional fees decreased on both a comparative quarterly and year-to-date basis due primarily to a decline in legal fees at Mepco related to counterparty litigation associated with collection matters as further described below. In addition, 2012 included expenses associated with certain consulting services, various regulatory matters, and the Branch Sale.

The provision for loss reimbursement on sold loans represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae and Freddie Mac). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. Historically, loss reimbursements on mortgage loans sold without recourse were very rare. In 2009, we had only one actual loss reimbursement (for \$0.06 million). Prior to 2009, we had years in which we incurred no such loss reimbursements. However, our loss reimbursements increased to \$0.2 million in 2010 and to \$0.5 million and \$1.2 million in 2011 and 2012, respectively, as over the past two years Fannie Mae and Freddie Mac, in particular, have been doing more reviews of mortgage loans where they have incurred or expect to incur a loss and have been more aggressive in pursuing loss reimbursements from the sellers of such mortgage loans. Actual loss reimbursements in the second quarter and first six months of 2013 totaled \$0.1 million and \$0.2 million, respectively. Although we are successful in the vast majority of cases where file reviews are conducted on mortgage loans that we have sold to investors and actual loss reimbursements remain relatively modest, the levels of such file reviews and loss reimbursement requests have increased. As a result, we have established a reserve (which totaled \$2.2 million and \$1.4 million at June 30, 2013 and December 31, 2012, respectively) for loss reimbursements on sold mortgage loans. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. While we believe that the amounts we have accrued for incurred losses on sold loans are appropriate given these analyses, future losses could exceed our current estimate.

Net losses on ORE and repossessed assets primarily represent the loss on the sale or additional write downs on these assets subsequent to the transfer of the asset from our loan portfolio. This transfer occurs at the time we acquire the collateral that secured the loan. At the time of acquisition, the other real estate or repossessed asset is valued at fair value, less estimated costs to sell, which becomes the new basis for the asset. Any write-downs at the time of acquisition are charged to the allowance for loan losses. The reduced net losses in 2013, as compared to 2012, primarily reflects a decline in ORE balances as well as some stability in real estate prices during the last twelve months, with some markets even experiencing modest price increases. However, foreclosed properties generally continue to have somewhat distressed valuations.

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Credit card and bank service fees decreased on both a comparative quarterly and year-to-date basis primarily due to a decline in the number of payment plans being serviced by Mepco in 2013 compared to 2012.

The amortization of intangible assets primarily relates to branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$3.6 million and \$4.0 million at June 30, 2013 and December 31, 2012, respectively. See Note #8 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets. The decline in the amortization of intangible assets in the second quarter and first six months of 2013 as compared to the year-ago period is primarily due to a reduction in the total amount of intangible assets, which were reduced by \$2.6 million in the fourth quarter of 2012 due to the Branch Sale.

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

Other non-interest expenses decreased \$0.2 million between the second quarters of 2013 and 2012 due primarily to the Branch Sale. Other non-interest expenses increased by \$1.1 million in the first six months of 2013 compared to the like period in 2012. The first quarter of 2012 included the reversal of a \$1.4 million previously established accrual at Mepco that was determined to no longer be necessary.

Income tax benefit. We assess whether a valuation allowance on our deferred tax assets is necessary each quarter. Reversing or reducing the valuation allowance requires us to conclude that the realization of the deferred tax assets is “more likely than not.” The ultimate realization of this asset is primarily based on generating future income. As of June 30, 2013, we have concluded that the realization of substantially all of our deferred tax assets is now more likely than not. This conclusion is primarily based upon the following factors:

- Achieving a sixth consecutive quarter of profitability;
- A forecast of future profitability that supports that the realization of the deferred tax assets is more likely than not;
- and
- A forecast that future asset quality continues to be stable to improving and that other factors do not exist that could cause a significant adverse impact on future profitability.

Prior to the second quarter of 2013, we had established a deferred tax asset valuation allowance against all of our net deferred tax assets. Accordingly, in these prior periods, the income tax expense related to any income before income tax was largely being offset by changes in the deferred tax valuation allowance.

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The reversal of substantially all of the valuation allowance on our deferred tax assets resulted in our recording an income tax benefit of \$57.6 million in the second quarter of 2013. In addition, during the second quarter of 2013, we recorded \$1.4 million of income tax expense to clear from accumulated other comprehensive loss (“AOCL”) the disproportionate tax effects from cash flow hedges. These disproportionate tax effects had been charged to other comprehensive income and credited to income tax expense due to our valuation allowance on deferred tax assets as more fully discussed in Note #16 to the Interim Condensed Consolidated Financial Statements. Because we terminated our last remaining cash flow hedge in the second quarter of 2013, it was appropriate to clear these disproportionate tax effects from AOCL.

We did not reverse approximately \$1.0 million of valuation allowance on our deferred tax assets that primarily relates to state income taxes from our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business over the past three years.

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

Our actual federal income tax expense (benefit) is different than the amount computed by applying our statutory federal income tax rate to our pre-tax income (loss) primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance, as well as the impact of changes in the deferred tax asset valuation allowance.

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

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

## Business Segments

|                      | Three months ended |         | Six months ended |         |
|----------------------|--------------------|---------|------------------|---------|
|                      | June 30, 2013      | 2012    | June 30, 2013    | 2012    |
|                      | (in thousands)     |         |                  |         |
| Independent Bank     | \$57,442           | \$5,059 | \$64,506         | \$8,601 |
| Mepco                | (1,839 )           | 222     | (1,296 )         | 1,249   |
| Other <sup>(1)</sup> | 7,808              | (925 )  | 6,032            | (1,966) |
| Elimination          | (23 )              | (23 )   | (47 )            | (47 )   |
| Net income (loss)    | \$63,388           | \$4,333 | \$69,195         | \$7,837 |

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

The improvement in the results of operations of Independent Bank in 2013 compared to 2012 is primarily due to the reversal of the valuation allowance on deferred tax assets resulting in recording a significant income tax benefit, as well as a lower provision for loan losses and a decrease in non-interest expenses that were partially offset by declines in net interest income and non-interest income. See "Provision for loan losses," "Portfolio Loans and asset quality," "Net interest income," "Non-interest income," "Non-interest expense," and "Income tax benefit."

The change in Mepco's results is primarily due to a decrease in net interest income because of a decline in payment plan receivables as well as to an increase in vehicle service contract counterparty contingencies expense. See "Net interest income" and "Non-interest expense." All of Mepco's funding is provided by Independent Bank through an intercompany loan (that is eliminated in consolidation). The rate on this intercompany loan is based on the Prime Rate (currently 3.25%). Mepco might not be able to obtain such favorable funding costs on its own in the open market.

The change in Other in the table above is primarily due to the reversal of the valuation allowance on deferred tax assets resulting in recording a significant income tax benefit at the parent company. See "Income tax benefit."

## FINANCIAL CONDITION

Summary. Our total assets increased by \$110.8 million during the first six months of 2013 due primarily to an increase in securities available for sale and deferred tax assets, net that were partially offset by declines in cash and cash equivalents and loans. Loans, excluding loans held for sale ("Portfolio Loans"), totaled \$1.39 billion at June 30, 2013, down 2.3% from \$1.42 billion at December 31, 2012. (See "Portfolio Loans and asset quality").

Deposits totaled \$1.82 billion at June 30, 2013, compared to \$1.78 billion at December 31, 2012. The increase in deposits during the first six months of 2013 is primarily due to growth in checking and savings account balances.

Other borrowings totaled \$17.5 million at June 30, 2013, a decrease of \$0.1 million from December 31, 2012.

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

## Securities

|                               | Unrealized                          |         |         | Fair<br>Value |
|-------------------------------|-------------------------------------|---------|---------|---------------|
|                               | Amortized<br>Cost<br>(In thousands) | Gains   | Losses  |               |
| Securities available for sale |                                     |         |         |               |
| June 30, 2013                 | \$355,471                           | \$2,068 | \$3,764 | \$353,775     |
| December 31, 2012             | 208,929                             | 2,070   | 2,586   | 208,413       |

Securities available for sale increased during the first six months of 2013 due primarily to the purchase of U.S. government-sponsored agency residential mortgage-backed securities, municipal securities and corporate securities. The securities were purchased to utilize cash and cash equivalents as well as to utilize funds generated from the decline in Portfolio Loans and from the increase in total deposits. (See “Deposits” and “Liquidity and capital resources.”)

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

We recorded net other than temporary impairment charges on securities of \$0.026 million and \$0.1 million in the second quarters of 2013 and 2012, respectively. We recorded net other than temporary impairment charges on securities of \$0.026 million and \$0.3 million in the first six months of 2013 and 2012, respectively. In these instances, we believe that the decline in value is directly due to matters other than changes in interest rates, are not expected to be recovered within a reasonable timeframe based upon available information and are therefore other than temporary in nature. These net other than temporary impairment charges are all related to private label residential mortgage-backed securities. (See “Non-interest income” and “Asset/liability management.”)



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

|                        | Six months<br>ended<br>June 30,<br>2013    2012<br>(In thousands) |          |
|------------------------|---|----------|
| Proceeds               | \$2,940   | \$18,999 |
| Gross gains            | \$15  | \$843    |
| Gross losses           | 7   | -        |
| Net impairment charges | (26 )   | (262 )   |
| Fair value adjustments | 183   | 10       |
| Net gains              | \$165   | \$591    |

Portfolio Loans and asset quality. In addition to the communities served by our Bank branch network, our principal lending markets also include nearby communities and metropolitan areas. Subject to established underwriting criteria, we also historically participated in commercial lending transactions with certain non-affiliated banks and also purchased mortgage loans from third-party originators. We have not engaged in any new commercial loan participations with non-affiliated banks or purchased any mortgage loans from third party originators over the past several years, although we may consider new commercial loan participations in 2013.

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

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

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

|  | June 30,<br>2013       | December<br>31,<br>2012 |
|--|------------------------|-------------------------|
|  | (Dollars in thousands) |                         |
| Non-accrual loans  | \$19,973               | \$ 32,929               |
| Loans 90 days or more past due and still accruing interest     | 131                    | 7                       |
| Total non-performing loans                                     | 20,104                 | 32,936                  |
| Other real estate and repossessed assets                       | 17,790                 | 26,133                  |
| Total non-performing assets                                    | \$37,894               | \$ 59,069               |
| As a percent of Portfolio Loans                                |                        |                         |
| Non-performing loans   | 1.45 %                 | 2.32 %                  |
| Allowance for loan losses                                      | 2.65                   | 3.12                    |
| Non-performing assets to total assets                          | 1.78                   | 2.92                    |
| Allowance for loan losses as a percent of non-performing loans | 182.98                 | 134.43                  |

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

## Troubled debt restructurings (“TDR”)

|                                     | June 30, 2013     |                      |           |
|-------------------------------------|-------------------|----------------------|-----------|
|                                     | Commercial        | Retail               | Total     |
|                                     | (In thousands)    |                      |           |
| Performing TDR’s                    | \$42,543          | \$83,187             | \$125,730 |
| Non-performing TDR’s <sup>(1)</sup> | 3,298             | 6,470 <sup>(2)</sup> | 9,768     |
| Total                               | \$45,841          | \$89,657             | \$135,498 |
|                                     | December 31, 2012 |                      |           |
|                                     | Commercial        | Retail               | Total     |
|                                     | (In thousands)    |                      |           |
| Performing TDR’s                    | \$40,753          | \$85,977             | \$126,730 |
| Non-performing TDR’s <sup>(1)</sup> | 7,756             | 9,177 <sup>(2)</sup> | 16,933    |
| Total                               | \$48,509          | \$95,154             | \$143,663 |

<sup>(1)</sup> Included in non-performing loans in the “Non-performing assets” table above.

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

Non-performing loans declined by \$12.8 million, or 39.0%, during the first six months of 2013 due principally to declines in non-performing commercial loans and residential mortgage loans. These declines primarily reflect reduced levels of new defaults on loans as well as loan net charge-offs, pay-offs, negotiated transactions, and the migration of loans into ORE. Additionally, during the second quarter of 2013 we sold \$6.5 million of commercial loans (\$8.6 million of “book” balance less \$2.1 million of allocated loan loss reserves) for total proceeds of approximately \$6.7 million. Included in this sale was \$2.9 million of non-accrual commercial loans. Non-performing commercial loans relate largely to delinquencies caused by cash-flow difficulties encountered by owners of income-producing properties

(due to higher vacancy rates and/or lower rental rates). Non-performing residential mortgage loans are primarily due to delinquencies reflecting both uneven economic conditions and somewhat soft real estate values in parts of Michigan and in certain markets where we have mortgage loans secured by resort properties (see Note #4 to the Condensed Consolidated Financial Statements). Non-performing loans exclude performing loans that are classified as troubled debt restructurings (“TDRs”). Performing TDRs totaled \$125.7 million, or 9.1% of total Portfolio Loans, and \$126.7 million, or 8.9% of total Portfolio Loans, at June 30, 2013 and December 31, 2012, respectively.

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ORE and repossessed assets totaled \$17.8 million at June 30, 2013, compared to \$26.1 million at December 31, 2012. This decrease is primarily the result of sales and write-downs of ORE being in excess of the migration of non-performing loans secured by real estate into ORE as the foreclosure process is completed and any redemption period expires.

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

The ratio of loan net charge-offs to average loans was 0.68% on an annualized basis in the first six months of 2013 compared to 1.69% in the first six months of 2012. The \$8.3 million decline in loan net charge-offs primarily reflects a decrease of \$3.7 million for commercial loans and \$3.9 million for mortgage loans. These decreases in loan net charge-offs primarily reflect reduced levels of non-performing loans and some stabilization in collateral liquidation values.

| Allowance for loan losses  | Six months ended       |                         |          |                         |
|--|------------------------|-------------------------|----------|-------------------------|
|  | June 30,<br>2013       |                         | 2012     |                         |
|  | Loans                  | Unfunded<br>Commitments | Loans    | Unfunded<br>Commitments |
|  | (Dollars in thousands) |                         |          |                         |
| Balance at beginning of period   | \$44,275               | \$ 598                  | \$58,884 | \$ 1,286                |
| Additions (deduction)  |                        |                         |          |                         |
| Provision for loan losses  | (2,798 )               | -                       | 6,187    | -                       |
| Recoveries credited to allowance   | 5,409                  | -                       | 3,231    | -                       |
| Loans charged against the allowance  | (10,100)               | -                       | (16,175) | -                       |
| Reclassification to loans held for sale  | -                      | -                       | (781 )   | -                       |
| Additions (deductions) included in non-interest expense                            | -                      | 29                      | -        | (59 )                   |
| Balance at end of period   | \$36,786               | \$ 627                  | \$51,346 | \$ 1,227                |
| Net loans charged against the allowance to average Portfolio<br>Loans (annualized) | 0.68                   | %                       | 1.69     | %                       |

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## Allocation of the Allowance for Loan Losses

|  | June 30,<br>2013 | December<br>31,<br>2012 |
|--|------------------|-------------------------|
|  | (In thousands)   |                         |
| Specific allocations                               | \$17,481         | \$ 21,009               |
| Other adversely rated loans                        | 1,819            | 2,419                   |
| Historical loss allocations                        | 10,716           | 12,943                  |
| Additional allocations based on subjective factors | 6,770            | 7,904                   |
| Total  | \$36,786         | \$ 44,275               |

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

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

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

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

Mepco's allowance for losses is determined in a similar manner as discussed above, and primarily takes into account historical loss experience and other subjective factors deemed relevant to Mepco's payment plan business. Estimated incurred losses associated with Mepco's outstanding vehicle service contract payment plans are included in the provision for loan losses. Mepco recorded a \$0.02 million credit and a \$0.02 million expense in the first six months of 2013 and 2012, respectively, for its provision for loan losses. Mepco's allowance for loan losses totaled \$0.1 million and \$0.2 million at June 30, 2013 and December 31, 2012, respectively. Mepco has established procedures for vehicle service contract payment plan servicing, administration and collections, including the timely cancellation of the vehicle service contract, in order to protect our position in the event of payment default or voluntary cancellation by the customer. Mepco has also established procedures to attempt to prevent and detect fraud since the payment plan origination activities and initial customer contacts are done entirely through unrelated third parties (vehicle service contract administrators and sellers or automobile dealerships). However, there can be no assurance that the aforementioned risk management policies and procedures will prevent us from the possibility of incurring significant credit or fraud related losses in this business segment. The estimated incurred losses described in this paragraph should be distinguished from the possible losses we may incur from counterparties failing to pay their obligations to Mepco. See Note #14 to the Condensed Consolidated Financial Statements included within this report.

The allowance for loan losses decreased \$7.5 million to \$36.8 million at June 30, 2013 from \$44.3 million at December 31, 2012 and was equal to 2.65% of total Portfolio Loans at June 30, 2013 compared to 3.12% at December 31, 2012. All four components of the allowance for loan losses outlined above declined in the first six months of 2013. The allowance for loan losses related to specific loans decreased \$3.5 million in 2013 due primarily to a decline in the balance of individually impaired loans as well as charge-offs. The allowance for loan losses related to other adversely rated commercial loans decreased \$0.6 million in 2013 primarily due to a decrease in the balance of such loans included in this component to \$47.2 million at June 30, 2013 from \$52.8 million at December 31, 2012. The allowance for loan losses related to historical losses decreased \$2.2 million during 2013 due principally to the use of a lower estimated probability of default for homogenous mortgage and installment loans (resulting from lower loan net charge-offs and reduced levels of new defaults on loans) as well as due to a decline in the loan balances included in this component of the allowance calculation. The allowance for loan losses related to subjective factors decreased \$1.1 million during 2013 primarily due to the improvement of various economic indicators used in computing this portion of the allowance as well as the overall reduction in total Portfolio Loans.

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

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

Deposits totaled \$1.82 billion and \$1.78 billion at June 30, 2013 and December 31, 2012, respectively. The \$36.6 million increase in deposits in 2013 is primarily due to growth in checking and savings account balances. Reciprocal deposits totaled \$46.7 million and \$33.2 million at June 30, 2013 and December 31, 2012, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network’s Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum. With the expiration of the Transaction Account Guarantee Program (“TAGP”) on December 31, 2012, we have experienced an increase in reciprocal deposits during 2013.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be particularly susceptible to outflow. At June 30, 2013 we had approximately \$264.9 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

During the fourth quarter of 2009 we prepaid our estimated quarterly deposit insurance premium assessments to the FDIC for periods through the fourth quarter of 2012. These estimated quarterly deposit insurance premium assessments were based on projected deposit balances over the assessment periods. The prepaid deposit insurance premium assessments totaled zero and \$9.4 million at June 30, 2013 and December 31, 2012, respectively. The actual expense over the assessment periods was significantly lower than the original prepaid amount due to various factors including variances in the estimated compared to the actual assessment base and rates used during each assessment period. We received the return of the overpayment of our prepaid assessment from the FDIC in June 2013.

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

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## Alternative Sources of Funds

|                          | June 30,<br>2013       |                     |       | December 31,<br>2012 |                     |       |
|--------------------------|------------------------|---------------------|-------|----------------------|---------------------|-------|
|                          | Amount                 | Average<br>Maturity | Rate  | Amount               | Average<br>Maturity | Rate  |
|                          | (Dollars in thousands) |                     |       |                      |                     |       |
| Brokered CDs             | \$13,225               | 0.5 years           | 1.29% | \$14,591             | 0.6 years           | 1.70% |
| Fixed rate FHLB advances | 17,500                 | 4.0 years           | 6.37  | 17,622               | 4.5 years           | 6.38  |
| Total                    | \$30,725               | 2.5 years           | 4.19% | \$32,213             | 2.7 years           | 4.26% |

Other borrowings, comprised almost entirely of advances from the Federal Home Loan Bank (the "FHLB"), totaled \$17.5 million and \$17.6 million at June 30, 2013 and December 31, 2012, respectively.

As described above, we utilize wholesale funding, including FHLB borrowings and Brokered CDs to augment our core deposits and fund a portion of our assets. At June 30, 2013, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$77.5 million, or 4.2% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all.

Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. We discontinued the active use of derivative financial instruments during 2008, in part, because we could no longer get unsecured credit from our derivatives counterparties. In June 2013, we terminated our last remaining interest-rate swap, which had an aggregate notional amount of \$10.0 million.

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



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

At June 30, 2013 we had \$250.1 million of time deposits that mature in the next twelve months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$1.40 billion of our deposits at June 30, 2013 were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown (excluding the Branch Sale) or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

As described in greater detail below, we are deferring interest on our subordinated debentures and are not currently paying any dividends on our preferred or common stock. Interest on the subordinated debentures can continue to be deferred until the fourth quarter of 2014. Thus, the only use of cash at the parent company at the present time is for operating expenses. Because the Bank currently has negative “undivided profits” (i.e. a retained deficit) of \$59.3 million at June 30, 2013, under Michigan banking regulations the Bank is not currently permitted to pay a dividend. We can request regulatory approval for a return of capital from the Bank to the parent company. We can also request regulatory approval for a reclassification of capital at our Bank between additional paid in capital and undivided profits to eliminate the retained deficit. As described below we have made such a request to our bank regulators, however, regulatory approval is uncertain.

Given the execution of the SPA with the UST in July 2013, we are now focused on the following capital initiatives:

- Obtaining regulatory approval to allow us to reclassify \$59.3 million of additional paid-in capital at the Bank to retained earnings of the Bank, which would eliminate the Bank's negative undivided profits (thereby permitting the Bank to pay dividends) without having any impact on our total equity or total regulatory capital.

- Obtaining regulatory approval for a transfer of capital from our Bank to the parent company in an amount of at least \$7.5 million to permit the payment of all deferred and unpaid interest on our trust preferred securities. Such accrued interest totaled \$7.7 million at June 30, 2013.

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- Obtaining regulatory approval for the resumption of interest payments on our trust preferred securities.
- Obtaining regulatory approval for the purchase of our Series B Preferred Stock, including any and all accrued and unpaid dividends, and the purchase of the Amended Warrant for total cash consideration of \$81.0 million, all as provided for in the SPA.
- Raising a minimum of \$86.0 million in gross cash proceeds from a common stock equity offering. We intend to complete this offering no later than October 31, 2013.

We believe that our improved financial performance and asset quality metrics provide a basis for obtaining the requisite regulatory approvals outlined above. However, there is no assurance that we will receive such approvals or that, if received, the capital initiatives outlined above will be successful.

Our parent company also has access to an equity line facility that is described below. We believe that the available cash on hand of approximately \$5.5 million at the parent company as of June 30, 2013, as well as access to the equity line facility provide sufficient liquidity at the parent company to meet its operating expenses for the foreseeable future.

Effective management of capital resources is critical to our mission to create value for our shareholders. Our capital structure currently includes cumulative trust preferred securities and cumulative convertible preferred stock.

## Capitalization

|   | June 30,<br>2013 | December<br>31,<br>2012 |
|---|------------------|-------------------------|
|   | (In thousands)   |                         |
| Subordinated debentures                     | \$50,175         | \$50,175                |
| Amount not qualifying as regulatory capital | (1,507 )         | (1,507 )                |
| Amount qualifying as regulatory capital     | 48,668           | 48,668                  |
| Shareholders' Equity                        |                  |                         |
| Convertible preferred stock                 | 86,455           | 84,204                  |
| Common stock                                | 255,114          | 251,237                 |
| Accumulated deficit                         | (125,464)        | (192,408)               |
| Accumulated other comprehensive loss        | (7,270 )         | (8,058 )                |
| Total shareholders' equity                  | 208,835          | 134,975                 |
| Total capitalization                        | \$257,503        | \$183,643               |

We have four special purpose entities that originally issued \$90.1 million of cumulative trust preferred securities. On June 23, 2010, we issued 5.1 million shares of our common stock (having a fair value of approximately \$23.5 million on the date of the exchange) in exchange for \$41.4 million in liquidation amount of trust preferred securities and \$2.3 million of accrued and unpaid interest on such securities. As a result, at June 30, 2013 and December 31, 2012, \$48.7 million of cumulative trust preferred securities remained outstanding. These special purpose entities issued common securities and provided cash to our parent company that in turn, issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Condensed Consolidated Statements of Financial Condition.

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The Federal Reserve Board has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at June 30, 2013. Although the Dodd-Frank Act further limited Tier 1 treatment for trust preferred securities, those new limits did not apply to our outstanding trust preferred securities. Further, the New Capital Rules grandfathered the treatment of our trust preferred securities as qualifying regulatory capital.

In December 2008, we issued 72,000 shares of Series A, Fixed Rate Cumulative Perpetual Preferred Stock, with an original liquidation preference of \$1,000 per share (“Series A Preferred Stock”), and a warrant to purchase 346,154 shares (at \$31.20 per share) of our common stock (“Original Warrant”) to the UST in return for \$72.0 million under the TARP Capital Purchase Program. Of the total proceeds, \$68.4 million was originally allocated to the Series A Preferred Stock and \$3.6 million was allocated to the Original Warrant (included in capital surplus) based on the relative fair value of each. The \$3.6 million discount on the Series A Preferred Stock was being accreted using an effective yield method over five years. The accretion had been recorded as part of the Series A Preferred Stock dividend.

On April 16, 2010, we exchanged the Series A Preferred Stock (including accumulated but unpaid dividends) for 74,426 shares of our Series B Preferred Stock. As part of the terms of the Exchange Agreement, we also agreed to amend and restate the terms of the Original Warrant and issued the Amended Warrant. The Series B Preferred Stock and the Amended Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933. We did not receive any cash proceeds from the issuance of the Series B Preferred Stock or the Amended Warrant. In general, the terms of the Series B Preferred Stock are substantially similar to the terms of the Series A Preferred Stock that was held by the UST, except that the Series B Preferred Stock is convertible into our common stock. See Note #15 to the Condensed Consolidated Financial Statements included within this report for additional information about the terms of the Series B Preferred Stock and the Amended and Restated Warrant.

Shareholders’ equity applicable to common stock increased to \$122.4 million at June 30, 2013 from \$50.8 million at December 31, 2012 due primarily to our net income during the first six months of 2013 as well as the issuance of common stock and a reduction in our accumulated other comprehensive loss. Our tangible common equity (“TCE”) totaled \$118.8 million and \$46.8 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 5.58% at June 30, 2013 compared to 2.32% at December 31, 2012.

Dividends from the Bank are restricted as described above and are also restricted by board resolutions adopted in March 2013 in connection with the termination of the Memorandum of Understanding (“MOU”) as described in Note #11 to the Condensed Consolidated Financial Statements included within this report. In particular, those resolutions prohibit the Bank from paying any dividends to the parent company without the prior written approval of the FRB and the Michigan Department of Insurance and Financial Services (“DIFS”). Also see “Regulatory developments” below.

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Our parent company is also prohibited from paying any dividends on our common stock or on the preferred stock held by the UST while distributions on our trust preferred securities are being deferred. Moreover, the resolutions adopted by our boards in March 2013 in connection with the termination of the MOU referenced above specifically prohibit the parent company from paying any dividends on our common stock or the preferred stock held by the UST or any distributions on our trust preferred securities without, in each case, the prior written approval of the FRB and the DIFS.

Payment of dividends and distributions on our outstanding common stock, preferred stock, and trust preferred securities is also restricted and governed by the terms of those instruments, as follows:

The terms of the subordinated debentures and trust indentures (the “Indentures”) related to our trust preferred securities allow us to defer payment of interest at any time or from time to time for up to 20 consecutive quarters provided no event of default (as defined in the Indentures) has occurred and is continuing. We are not in default with respect to the Indentures, and the deferral of interest does not constitute an event of default under the Indentures. While we defer the payment of interest, we will continue to accrue the interest expense owed at the applicable interest rate. Upon the expiration of the deferral, all accrued and unpaid interest is due and payable. During the deferral period on the Indentures, we may not declare or pay any dividends or distributions on, or redeem, purchase, acquire or make a liquidation payment with respect to, any of our capital stock.

So long as any shares of the Series B Preferred Stock remain outstanding, unless all accrued and unpaid dividends for all prior dividend periods have been paid or are contemporaneously declared and paid in full, (a) no dividend may be paid or declared on our common stock or other junior stock, other than a dividend payable solely in common stock and other than certain dividends or distributions of rights in connection with a shareholders’ rights plan; and (b) with limited exceptions, neither we nor any of our subsidiaries may purchase, redeem or otherwise acquire for consideration any shares of our common stock or other junior stock unless we have paid in full all accrued dividends on the Series B Preferred Stock for all prior dividend periods.

As described above, we are pursuing regulatory approvals and capital initiatives to permit us to resume interest payments on our outstanding trust preferred securities and purchase the Series B Preferred Stock and the Amended Warrant as provided in the SPA. There can be no assurance that we will be successful in these efforts.

As of June 30, 2013, our Bank (and holding company) continued to meet the requirements to be considered “well-capitalized” under federal regulatory standards and also continued to meet the two minimum capital ratios established by our board (that are higher than the ratios required in order to be considered “well-capitalized” under federal standards). The board imposed these higher ratios in order to ensure that we have sufficient capital to withstand potential future losses based on our still somewhat elevated level of non-performing assets and given certain other risks and uncertainties we face. Set forth below are the actual capital ratios of our Bank as of June 30, 2013, the minimum capital ratios imposed by our board, and the minimum ratios necessary to be considered “well-capitalized” under federal regulatory standards.

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|  | Independent<br>Bank<br>Actual at<br>June 30,<br>2013 |   | Minimum<br>Ratios<br>Established<br>by<br>our Board |   | Required<br>to be<br>Well-<br>Capitalized |   |
|--|--|---|---|---|---|---|
| Regulatory Capital Ratios              |  |   |   |   |   |   |
| Tier 1 capital to average total assets | 10.35  | % | 8.00  | % | 5.00                                      | % |
| Total capital to risk-weighted assets  | 16.35  |   | 11.00   |   | 10.00                                     |   |

On July 7, 2010 we executed an Investment Agreement and Registration Rights Agreement with Dutchess Opportunity Fund, II, LP (“Dutchess”) for the sale of shares of our common stock. These agreements serve to establish an equity line facility as a contingent source of liquidity at the parent company level. Pursuant to the Investment Agreement, Dutchess committed to purchase up to \$15.0 million of our common stock over a 36-month period ending November 1, 2013. We have the right, but no obligation, to draw on this equity line facility from time to time during such 36-month period by selling shares of our common stock to Dutchess. The sales price is at a 5% discount to the market price of our common stock at the time of the draw (as such market price is determined pursuant to the terms of the Investment Agreement). Through June 30, 2013, we had sold a total of 1,399,422 shares (including 168,941 shares during the first six months of 2013) of our common stock to Dutchess under this equity line for total net proceeds of approximately \$4.2 million. At the present time, we have shareholder approval to sell approximately 2.6 million additional shares under this equity line.

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

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

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

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

| Change in Interest Rates | Market Value Of Portfolio Equity(1) |                | Net Interest Income(2) |                |
|--------------------------|-------------------------------------|----------------|------------------------|----------------|
|                          | Percent Change                      | Percent Change | Percent Change         | Percent Change |
| (Dollars in thousands)   |                                     |                |                        |                |
| June 30, 2013            |                                     |                |                        |                |
| 200 basis point rise     | \$ 356,200                          | 11.73 %        | \$ 79,800              | 6.97 %         |
| 100 basis point rise     | 339,700                             | 6.56           | 77,000                 | 3.22           |
| Base-rate scenario       | 318,800                             | -              | 74,600                 | -              |
| 100 basis point decline  | 293,300                             | (8.00 )        | 73,400                 | (1.61 )        |
| December 31, 2012        |                                     |                |                        |                |
| 200 basis point rise     | \$ 262,100                          | 24.81 %        | \$ 81,200              | 6.01 %         |
| 100 basis point rise     | 240,000                             | 14.29          | 78,600                 | 2.61           |
| Base-rate scenario       | 210,000                             | -              | 76,600                 | -              |
| 100 basis point decline  | 180,400                             | (14.10 )       | 75,500                 | (1.44 )        |

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

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

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

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

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



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Regulatory developments. On October 25, 2011, the respective Boards of Directors of the Company and the Bank entered into an MOU with the FRB and DIFS. The MOU largely duplicated certain provisions of board resolutions that were already in place, but also had the following specific requirements:

- Submission of a joint revised capital plan by November 30, 2011 to maintain sufficient capital at the Company on a consolidated basis and at the Bank on a stand-alone basis;
- Submission of quarterly progress reports regarding disposition plans for any assets in excess of \$1.0 million that are in ORE, are 90 days or more past due, are on our “watch list,” or were adversely classified in our most recent examination;
- Enhanced reporting and monitoring at Mepco regarding risk management and the internal classification of assets; and
- Enhanced interest rate risk modeling practices.

Effective March 26, 2013, the FRB and DIFS terminated the MOU. Also on that date, the respective Boards of Directors of the Company and the Bank passed resolutions that require the following:

- Submission of quarterly progress reports to the FRB and DIFS regarding disposition plans for any assets in excess of \$1.0 million that are in ORE, are 90 days or more past due, are on our “watch list,” or are adversely classified;
- Prior approval of the FRB and DIFS for the Bank to pay any dividend to the Company; and
- Prior approval of the FRB and DIFS for the Company to pay any dividend to its shareholders, to make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities, to increase borrowings or guarantee any debt, and/or to purchase or redeem any of its stock.

LITIGATION MATTERS

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$0.4 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.



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

CRITICAL ACCOUNTING POLICIES

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for other than temporary impairment of investment securities, the allowance for loan losses, originated mortgage loan servicing rights, vehicle service contract payment plan counterparty contingencies, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.

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Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Item 4.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

With the participation of management, our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) for the period ended June 30, 2013, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended June 30, 2013, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## Part II

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2012.

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

The Company maintains a Deferred Compensation and Stock Purchase Plan for Non-Employee Directors (the "Plan") pursuant to which non-employee directors can elect to receive shares of the Company's common stock in lieu of fees otherwise payable to the director for his or her service as a director. A director can elect to receive shares on a current basis or to defer receipt of the shares, in which case the shares are issued to a trust to be held for the account of the director and then generally distributed to the director after his or her retirement from the Board. Pursuant to this Plan, during the second quarter of 2013, the Company issued 6,088 shares of common stock to non-employee directors on a current basis and 3,981 shares of common stock to the trust for distribution to directors on a deferred basis. The shares were issued on April 1, 2013, at a price of \$8.46 per share, representing aggregate fees of \$0.1 million. The price per share was the consolidated closing bid price per share of the Company's common stock as of the date of issuance, as determined in accordance with NASDAQ Marketplace Rules. The Company issued the shares pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933 due to the fact that the issuance of the shares was made on a private basis pursuant to the Plan.

The following table shows certain information relating to purchases of common stock for the three-months ended June 30, 2013:

| Period     | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid Per<br>Share | Total<br>Number of Remaining<br>Shares<br>Purchased Number of<br>as Part of a Shares Authorized |                                |
|------------|---|---------------------------------------|---|--------------------------------|
|            |   |                                       | Publicly<br>Announced<br>Plan   | for Purchase<br>Under the Plan |
| April 2013 | -   | \$ -                                  | -   | NA                             |
| May 2013   | -   | -                                     | -   | NA                             |
| June 2013  | -   | -                                     | -   | NA                             |
| Total      | -   | \$ -                                  | -   | NA                             |

Item 3b. Defaults Upon Senior Securities

As of June 30, 2013, we were in arrears in the aggregate amount of \$12.3 million with respect to the Series B Preferred Stock we issued to the UST as a result of our decision to defer these dividends in the fourth quarter of 2009.

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Item 6. Exhibits

- (a) The following exhibits (listed by number corresponding to the Exhibit Table as Item 601 in Regulation S-K) are filed with this report:
- Securities Purchase Agreement, dated July 26, 2013, between Independent Bank Corporation and the United States Department of the Treasury (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K dated July 26, 2013, and filed on August 1, 2013).
  - 11. Computation of Earnings Per Share.
  - 31.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
  - 31.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
  - 32.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
  - 32.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
  - 101.INS Instance Document
  - 101.SCH XBRL Taxonomy Extension Schema Document
  - 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
  - 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
  - 101.LAB XBRL Taxonomy Extension Label Linkbase Document
  - 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

Date August 8, 2013 By/s/ Robert N. Shuster  
Robert N. Shuster, Principal Financial Officer

Date August 8, 2013 By/s/ James J. Twarozynski  
James J. Twarozynski, Principal Accounting Officer