

INDEPENDENT BANK CORP /MI/  
Form 10-Q  
May 05, 2014

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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 March 31, 2014

Commission file number 0-7818

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

Michigan 38-2032782  
(State or jurisdiction of (I.R.S. Employer Identification  
Incorporation or Organization) 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 22,924,740  
Class Outstanding at May 5, 2014



## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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FORWARD-LOOKING STATEMENTS

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

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

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all inclusive. The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, 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.

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Part I - Item 1.

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Financial Condition

|  | March 31,<br>2014<br>(unaudited)     | December<br>31,<br>2013 |
|--|--------------------------------------|-------------------------|
|  | (In thousands, except share amounts) |                         |
| Assets   |                                      |                         |
| Cash and due from banks  | \$53,815                             | \$48,156                |
| Interest bearing deposits                                      | 78,125                               | 70,925                  |
| Cash and Cash Equivalents                                      | 131,940                              | 119,081                 |
| Interest bearing deposits - time                               | 16,875                               | 17,999                  |
| Trading securities   | 610                                  | 498                     |
| Securities available for sale                                  | 522,935                              | 462,481                 |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 23,419                               | 23,419                  |
| Loans held for sale, carried at fair value                     | 14,700                               | 20,390                  |
| Loans  |                                      |                         |
| Commercial   | 642,051                              | 635,234                 |
| Mortgage   | 475,580                              | 486,633                 |
| Installment  | 188,337                              | 192,065                 |
| Payment plan receivables                                       | 54,544                               | 60,638                  |
| Total Loans  | 1,360,512                            | 1,374,570               |
| Allowance for loan losses                                      | (30,437 )                            | (32,325 )               |
| Net Loans  | 1,330,075                            | 1,342,245               |
| Other real estate and repossessed assets                       | 18,001                               | 18,282                  |
| Property and equipment, net                                    | 47,872                               | 48,594                  |
| Bank-owned life insurance                                      | 52,571                               | 52,253                  |
| Deferred tax assets, net                                       | 55,248                               | 57,550                  |
| Capitalized mortgage loan servicing rights                     | 13,273                               | 13,710                  |
| Vehicle service contract counterparty receivables, net         | 7,096                                | 7,716                   |
| Other intangibles  | 3,029                                | 3,163                   |
| Accrued income and other assets                                | 21,995                               | 22,562                  |
| Total Assets   | \$2,259,639                          | \$2,209,943             |
| Liabilities and Shareholders' Equity                           |                                      |                         |
| Deposits   |                                      |                         |
| Non-interest bearing   | \$531,355                            | \$518,658               |
| Savings and interest-bearing checking                          | 958,486                              | 910,352                 |
| Reciprocal   | 77,082                               | 83,527                  |
| Retail time  | 358,588                              | 358,800                 |
| Brokered time  | 13,231                               | 13,469                  |
| Total Deposits   | 1,938,742                            | 1,884,806               |
| Other borrowings   | 12,943                               | 17,188                  |
| Subordinated debentures  | 40,723                               | 40,723                  |
| Vehicle service contract counterparty payables                 | 3,761                                | 4,089                   |
| Accrued expenses and other liabilities                         | 26,884                               | 31,556                  |
| Total Liabilities  | 2,023,053                            | 1,978,362               |

|  |             |             |
|--|-------------|-------------|
| Shareholders' Equity   |             |             |
| Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding   | -           | -           |
| Common stock, no par value, 500,000,000 shares authorized; issued and outstanding:<br>22,921,774 shares at March 31, 2014 and 22,819,136 shares at December 31, 2013 | 351,439     | 351,173     |
| Accumulated deficit  | (107,209 )  | (110,347 )  |
| Accumulated other comprehensive loss   | (7,644 )    | (9,245 )    |
| Total Shareholders' Equity   | 236,586     | 231,581     |
| Total Liabilities and Shareholders' Equity   | \$2,259,639 | \$2,209,943 |

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  
ended  
March 31,  
2014 2013  
(unaudited)  
(In thousands)

|  |          |          |
|--|----------|----------|
| Interest Income  |          |          |
| Interest and fees on loans                                     | \$18,215 | \$20,710 |
| Interest on securities   |          |          |
| Taxable  | 1,383    | 670      |
| Tax-exempt   | 262      | 238      |
| Other investments  | 423      | 332      |
| Total Interest Income  | 20,283   | 21,950   |
| Interest Expense   |          |          |
| Deposits   | 1,293    | 1,529    |
| Other borrowings   | 512      | 865      |
| Total Interest Expense   | 1,805    | 2,394    |
| Net Interest Income  | 18,478   | 19,556   |
| Provision for loan losses                                      | 428      | (691 )   |
| Net Interest Income After Provision for Loan Losses            | 18,050   | 20,247   |
| Non-interest Income  |          |          |
| Service charges on deposit accounts                            | 3,055    | 3,406    |
| Interchange income   | 1,941    | 1,757    |
| Net gains on assets  |          |          |
| Mortgage loans   | 1,144    | 3,637    |
| Securities   | 112      | 84       |
| Mortgage loan servicing  | 264      | 622      |
| Title insurance fees   | 274      | 484      |
| Increase in fair value of U.S. Treasury warrant                | -        | (1,045 ) |
| Other  | 2,165    | 2,123    |
| Total Non-interest Income                                      | 8,955    | 11,068   |
| Non-Interest Expense   |          |          |
| Compensation and employee benefits                             | 11,238   | 11,307   |
| Occupancy, net   | 2,483    | 2,424    |
| Data processing  | 2,086    | 1,916    |
| Loan and collection  | 1,465    | 2,226    |
| Furniture, fixtures and equipment                              | 1,069    | 1,032    |
| Communications   | 789      | 780      |
| Advertising  | 519      | 570      |
| FDIC deposit insurance   | 417      | 630      |
| Interchange expense  | 402      | 410      |
| Legal and professional   | 401      | 692      |
| Credit card and bank service fees                              | 263      | 334      |
| Vehicle service contract counterparty contingencies            | 68       | 127      |
| Costs (recoveries) related to unfunded lending commitments     | 10       | (19 )    |
| Provision for loss reimbursement on sold loans                 | (481 )   | 663      |
| Net (gains) losses on other real estate and repossessed assets | (87 )    | 652      |

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|  |         |          |
|--|---------|----------|
| Other  | 1,758   | 1,729    |
| Total Non-interest Expense                       | 22,400  | 25,473   |
| Income Before Income Tax                         | 4,605   | 5,842    |
| Income tax expense                               | 1,467   | 35       |
| Net Income                                       | \$3,138 | \$5,807  |
| Preferred stock dividends and discount accretion | -       | (1,095 ) |
| Net Income Applicable to Common Stock            | \$3,138 | \$4,712  |
| Net Income Per Common Share                      |         |          |
| Basic  | \$0.14  | \$0.51   |
| Diluted  | \$0.13  | \$0.27   |
| Dividends Per Common Share                       |         |          |
| Declared   | \$-     | \$-      |
| Paid   | \$-     | \$-      |

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>March 31,<br>2014 2013<br>(unaudited)<br>(In thousands) |         |
|--|--|---------|
| Net income   | \$3,138  | \$5,807 |
| Other comprehensive income, before tax   |  |         |
| Available for sale securities  |  |         |
| Unrealized gain arising during period  | 2,250  | 974     |
| Change in unrealized losses for which a portion of other than temporary impairment has been recognized in earnings | 119  | 33      |
| Reclassification adjustment for other than temporary impairment included in earnings                               | -  | -       |
| Reclassification adjustments for losses included in earnings   | -  | 7       |
| Unrealized gains recognized in other comprehensive income on available for sale securities                         | 2,369  | 1,014   |
| Income tax expense   | 830  | -       |
| Unrealized gains recognized in other comprehensive income on available for sale securities, net of tax             | 1,539  | 1,014   |
| Derivative instruments   |  |         |
| Unrealized loss arising during period  | -  | (3 )    |
| Reclassification adjustment for expense recognized in earnings   | -  | 94      |
| Reclassification adjustment for accretion on settled derivatives   | 95   | -       |
| Unrealized gains recognized in other comprehensive income on derivative instruments                                | 95   | 91      |
| Income tax expense   | 33   | -       |
| Unrealized gains recognized in other comprehensive income on derivative instruments, net of tax                    | 62   | 91      |
| Other comprehensive income   | 1,601  | 1,105   |
| Comprehensive income   | \$4,739  | \$6,912 |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2014                            | 2013      |
|   | (unaudited - In<br>thousands)   |           |
| Net Income  | \$3,138                         | \$5,807   |
| Adjustments to Reconcile Net Income to Net Cash from Operating Activities                                       |                                 |           |
| Proceeds from sales of loans held for sale  | 48,232                          | 131,495   |
| Disbursements for loans held for sale   | (41,398 )                       | (117,925) |
| Provision for loan losses   | 428                             | (691 )    |
| Deferred federal income tax expense   | 2,302                           | -         |
| Deferred loan fees  | (5 )                            | 133       |
| Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities and loans | 373                             | (1,040 )  |
| Net gain on sale of property and equipment  | -                               | (1 )      |
| Net gains on mortgage loans   | (1,144 )                        | (3,637 )  |
| Net gains on securities   | (112 )                          | (84 )     |
| Net (gains) losses on other real estate and repossessed assets  | (87 )                           | 652       |
| Vehicle service contract counterparty contingencies   | 68                              | 127       |
| Share based compensation  | 255                             | 236       |
| (Increase) decrease in accrued income and other assets  | (176 )                          | 2,573     |
| Increase (decrease) in accrued expenses and other liabilities   | (4,513 )                        | 823       |
| Total Adjustments   | 4,223                           | 12,661    |
| Net Cash From Operating Activities  | 7,361                           | 18,468    |
| Cash Flow used in Investing Activities  |                                 |           |
| Proceeds from the sale of securities available for sale   | -                               | 1,800     |
| Proceeds from the maturity of securities available for sale   | 15,030                          | 22,820    |
| Principal payments received on securities available for sale  | 17,852                          | 6,487     |
| Purchases of securities available for sale  | (91,556 )                       | (103,259) |
| Purchases of interest bearing deposits  | -                               | (6,986 )  |
| Proceeds from the maturity of interest bearing deposits   | 1,090                           | -         |
| Net decrease in portfolio loans (loans originated, net of principal payments)                                   | 13,221                          | 26,729    |
| Net cash from branch sale   | -                               | 3,292     |
| Proceeds from the collection of vehicle service contract counterparty receivables                               | 256                             | 169       |
| Proceeds from the sale of other real estate and repossessed assets  | 1,195                           | 3,511     |
| Proceeds from the sale of property and equipment  | -                               | 3         |
| Capital expenditures  | (964 )                          | (2,119 )  |
| Net Cash used in Investing Activities   | (43,876 )                       | (47,553 ) |
| Cash Flow from Financing Activities   |                                 |           |
| Net increase in total deposits  | 53,936                          | 71,256    |
| Net increase (decrease) in other borrowings   | (5 )                            | 5         |
| Payments of Federal Home Loan Bank advances   | (4,240 )                        | -         |
| Net decrease in vehicle service contract counterparty payables  | (328 )                          | (1,282 )  |
| Proceeds from issuance of common stock  | 11                              | 954       |
| Net Cash from Financing Activities  | 49,374                          | 70,933    |
| Net Increase in Cash and Cash Equivalents   | 12,859                          | 41,848    |
| Cash and Cash Equivalents at Beginning of Period  | 119,081                         | 179,782   |

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|   |            |            |
|---|------------|------------|
| Cash and Cash Equivalents at End of Period  | \$ 131,940 | \$ 221,630 |
| Cash paid during the period for   |            |            |
| Interest  | \$ 1,821   | \$ 1,810   |
| Income taxes  | 1          | 6          |
| Transfers to other real estate and repossessed assets                                     | 827        | 1,669      |
| Transfer of payment plan receivables to vehicle service contract counterparty receivables | 131        | 79         |
| Purchase of securities available for sale not yet settled                                 | -          | 2,565      |

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2014                            | 2013      |
|   | (unaudited)                     |           |
|   | (In thousands)                  |           |
| Balance at beginning of period  | \$231,581                       | \$134,975 |
| Net income  | 3,138                           | 5,807     |
| Issuance of common stock  | 11                              | 1,962     |
| Share based compensation  | 255                             | 236       |
| Net change in accumulated other comprehensive loss, net of related tax effect | 1,601                           | 1,105     |
| Balance at end of period  | \$236,586                       | \$144,085 |

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, 2013 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 March 31, 2014 and December 31, 2013, and the results of operations for the three-month periods ended March 31, 2014 and 2013. The results of operations for the three-month period ended March 31, 2014, 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 2013 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In July, 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-11, “Income Taxes (Topic 740), Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists”. This ASU amends existing guidance so that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. This amended guidance became effective for us on January 1, 2014 and did not have a material impact on our consolidated operating results or financial condition.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

3. Securities

Securities available for sale consist of the following:

|  | Amortized Unrealized |         |         | Fair<br>Value |
|--|----------------------|---------|---------|---------------|
|  | Cost                 | Gains   | Losses  |               |
|  | (In thousands)       |         |         |               |
| March 31, 2014                                   |                      |         |         |               |
| U.S. agency                                      | \$48,024             | \$18    | \$388   | \$47,654      |
| U.S. agency residential mortgage-backed          | 235,601              | 1,573   | 429     | 236,745       |
| U.S. agency commercial mortgage-backed           | 12,640               | 27      | 27      | 12,640        |
| Private label residential mortgage-backed        | 7,052                | 137     | 546     | 6,643         |
| Other asset backed                               | 43,425               | 45      | 156     | 43,314        |
| Obligations of states and political subdivisions | 156,342              | 738     | 3,150   | 153,930       |
| Corporate  | 19,503               | 83      | 21      | 19,565        |
| Trust preferred                                  | 2,904                | -       | 460     | 2,444         |
| Total  | \$525,491            | \$2,621 | \$5,177 | \$522,935     |
| December 31, 2013                                |                      |         |         |               |
| U.S. agency                                      | \$32,106             | \$44    | \$342   | \$31,808      |
| U.S. agency residential mortgage-backed          | 202,649              | 1,343   | 532     | 203,460       |
| Private label residential mortgage-backed        | 7,294                | 112     | 618     | 6,788         |
| Other asset backed                               | 45,369               | 10      | 194     | 45,185        |
| Obligations of states and political subdivisions | 157,966              | 496     | 4,784   | 153,678       |
| Corporate  | 19,120               | 43      | 26      | 19,137        |
| Trust preferred                                  | 2,902                | -       | 477     | 2,425         |
| Total  | \$467,406            | \$2,048 | \$6,973 | \$462,481     |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Less Than Twelve<br>Months |                      | Twelve Months or<br>More |                      | Total         |                      |
|--|----------------------------|----------------------|--------------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value              | Unrealized<br>Losses | Fair<br>Value            | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|  | (In thousands)             |                      |                          |                      |               |                      |
| March 31, 2014                                   |                            |                      |                          |                      |               |                      |
| U.S. agency                                      | \$36,853                   | \$ 388               | \$-                      | \$ -                 | \$36,853      | \$ 388               |
| U.S. agency residential mortgage-backed          | 52,705                     | 315                  | 23,242                   | 114                  | 75,947        | 429                  |
| U.S. agency commercial mortgage-backed           | 4,318                      | 27                   | -                        | -                    | 4,318         | 27                   |
| Private label residential mortgage-backed        | 167                        | 1                    | 4,485                    | 545                  | 4,652         | 546                  |
| Other asset backed                               | 28,442                     | 156                  | -                        | -                    | 28,442        | 156                  |
| Obligations of states and political subdivisions | 70,657                     | 2,607                | 11,521                   | 543                  | 82,178        | 3,150                |
| Corporate  | 5,844                      | 21                   | -                        | -                    | 5,844         | 21                   |
| Trust preferred                                  | -                          | -                    | 2,444                    | 460                  | 2,444         | 460                  |
| Total  | \$198,986                  | \$ 3,515             | \$41,692                 | \$ 1,662             | \$240,678     | \$ 5,177             |
| December 31, 2013                                |                            |                      |                          |                      |               |                      |
| U.S. agency                                      | \$16,715                   | \$ 342               | \$-                      | \$ -                 | \$16,715      | \$ 342               |
| U.S. agency residential mortgage-backed          | 78,256                     | 532                  | -                        | -                    | 78,256        | 532                  |
| Private label residential mortgage-backed        | 407                        | 6                    | 4,602                    | 612                  | 5,009         | 618                  |
| Other asset backed                               | 33,862                     | 194                  | -                        | -                    | 33,862        | 194                  |
| Obligations of states and political subdivisions | 103,942                    | 4,645                | 4,805                    | 139                  | 108,747       | 4,784                |
| Corporate  | 7,105                      | 26                   | -                        | -                    | 7,105         | 26                   |
| Trust preferred                                  | -                          | -                    | 2,425                    | 477                  | 2,425         | 477                  |
| Total  | \$240,287                  | \$ 5,745             | \$11,832                 | \$ 1,228             | \$252,119     | \$ 6,973             |

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.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at March 31, 2014 we had 21 U.S. agency, 33 U.S. agency residential mortgage-backed securities and seven U.S. agency commercial mortgage-backed 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 March 31, 2014 we had five of this 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 one is 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 (69%) and Alt A (31%) at March 31, 2014.

| March 31, 2014 |                     | December 31, 2013 |                     |
|----------------|---------------------|-------------------|---------------------|
| Fair Value     | Net Unrealized Loss | Fair Value        | Net Unrealized Loss |
| (In thousands) |                     |                   |                     |

Private label residential mortgage-backed

|       |         |           |         |           |
|-------|---------|-----------|---------|-----------|
| Jumbo | \$4,563 | \$ (371 ) | \$4,687 | \$ (441 ) |
| Alt-A | 2,080   | (38 )     | 2,101   | (65 )     |

All of these securities are receiving 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.

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 10% to 15% CPR. For fixed rate collateral (one transaction), the prepayment speeds are projected to remain stable.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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 12 months. Severity is expected to decline after this period 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 March 31, 2014 three below investment grade private label residential mortgage-backed securities had credit related OTTI and are summarized as follows:

|                                | Super<br>Senior<br>Security | Senior<br>Senior<br>Security | Senior<br>Support<br>Security | Total   |
|--------------------------------|-----------------------------|------------------------------|-------------------------------|---------|
| (In thousands)                 |                             |                              |                               |         |
| As of March 31, 2014           |                             |                              |                               |         |
| Fair value                     | \$2,426                     | \$ 1,712                     | \$ 45                         | \$4,183 |
| Amortized cost                 | 2,697                       | 1,622                        | -                             | 4,319   |
| Non-credit unrealized loss     | 271                         | -                            | -                             | 271     |
| Unrealized gain                | -                           | 90                           | 45                            | 135     |
| 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 March 31,

|      |     |      |      |     |
|------|-----|------|------|-----|
| 2014 | \$- | \$ - | \$ - | \$- |
| 2013 | -   | -    | -    | -   |

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. Two of these securities have unrealized gains and one has an unrealized loss at March 31, 2014. Prior to the second quarter of 2013 all three of these securities had an unrealized loss. The original amortized cost for each of these securities has been permanently adjusted downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for two of these securities is now less than previously recorded credit related OTTI amounts. The remaining non-credit related unrealized loss in the senior security is attributed to other factors and is reflected in other comprehensive income during those same periods.

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

Other asset backed — at March 31, 2014 we had 20 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to widening discount margins. 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.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Obligations of states and political subdivisions — at March 31, 2014 we had 96 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to increases in interest rates since the securities acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at March 31, 2014 we had eight corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at March 31, 2014 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 (a Bank of America issuance) is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.8 million as of March 31, 2014, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of March 31, 2014 and December 31, 2013:

| March 31, 2014 |                 | December 31, 2013 |                 |
|----------------|-----------------|-------------------|-----------------|
| Net            |                 | Net               |                 |
| Fair Value     | Unrealized Loss | Fair Value        | Unrealized Loss |
| (In thousands) |                 |                   |                 |

## Trust preferred securities

|                |         |           |         |           |
|----------------|---------|-----------|---------|-----------|
| Rated issues   | \$1,619 | \$ (285 ) | \$1,600 | \$ (302 ) |
| Unrated issues | 825     | (175 )    | 825     | (175 )    |

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

We recorded no credit related OTTI charges in earnings on securities available for sale during the three month periods ended March 31, 2014 and 2013, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A roll forward of credit losses recognized in earnings on securities available for sale for the three month periods ending March 31, follows:

|  | 2014           | 2013    |
|--|----------------|---------|
|  | (In thousands) |         |
| Balance at beginning of year   | \$1,835        | \$1,809 |
| 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  | -              | -       |
| Total  | \$1,835        | \$1,809 |

The amortized cost and fair value of securities available for sale at March 31, 2014, by contractual maturity, follow:

|  | Amortized Fair |           |
|--|----------------|-----------|
|  | Cost           | Value     |
|  | (In thousands) |           |
| Maturing within one year                       | \$15,809       | \$15,837  |
| Maturing after one year but within five years  | 86,513         | 86,741    |
| Maturing after five years but within ten years | 50,721         | 50,491    |
| Maturing after ten years                       | 73,730         | 70,524    |
|  | 226,773        | 223,593   |
| U.S. agency residential mortgage-backed        | 235,601        | 236,745   |
| U.S. agency commercial mortgage-backed         | 12,640         | 12,640    |
| Private label residential mortgage-backed      | 7,052          | 6,643     |
| Other asset backed                             | 43,425         | 43,314    |
| Total  | \$525,491      | \$522,935 |

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

Gains and losses realized on the sale of securities available for sale are determined using the specific identification method and are recognized on a trade-date basis. A summary of proceeds from the sale of securities available for sale and gains and losses for the three month periods ending March 31, follows:

|      | Realized       |       |        |
|------|----------------|-------|--------|
|      | Proceeds       | Gains | Losses |
|      | (In thousands) |       |        |
| 2014 | \$-            | \$ -  | \$ -   |
| 2013 | 1,800          | -     | 7      |

During 2014 and 2013, our trading securities consisted of various preferred stocks. During the first three months of 2014 and 2013, we recognized gains on trading securities of \$0.112 million and \$0.091 million, respectively, that are included in net gains 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.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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 March 31, follows:

|                                     | Commercial     | Mortgage  | Installment | Payment<br>Plan<br>Receivables | Unallocated | Total    |
|-------------------------------------|----------------|-----------|-------------|--------------------------------|-------------|----------|
|                                     | (In thousands) |           |             |                                |             |          |
| 2014                                |                |           |             |                                |             |          |
| Balance at beginning of period      | \$6,827        | \$ 17,195 | \$ 2,246    | \$ 97                          | \$ 5,960    | \$32,325 |
| Additions (deductions)              |                |           |             |                                |             |          |
| Provision for loan losses           | 507            | 193       | 176         | (14 )                          | (434 )      | 428      |
| Recoveries credited to allowance    | 355            | 458       | 251         | 4                              | -           | 1,068    |
| Loans charged against the allowance | (1,926 )       | (846 )    | (612 )      | -                              | -           | (3,384 ) |
| Balance at end of period            | \$5,763        | \$ 17,000 | \$ 2,061    | \$ 87                          | \$ 5,526    | \$30,437 |
| 2013                                |                |           |             |                                |             |          |
| Balance at beginning of period      | \$11,402       | \$ 21,447 | \$ 3,378    | \$ 144                         | \$ 7,904    | \$44,275 |
| Additions (deductions)              |                |           |             |                                |             |          |
| Provision for loan losses           | (272 )         | (139 )    | 375         | (4 )                           | (651 )      | (691 )   |
| Recoveries credited to allowance    | 536            | 622       | 286         | 7                              | -           | 1,451    |
| Loans charged against the allowance | (1,608 )       | (1,767 )  | (877 )      | (18 )                          | -           | (4,270 ) |
| Balance at end of period            | \$10,058       | \$ 20,163 | \$ 3,162    | \$ 129                         | \$ 7,253    | \$40,765 |

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) |           |             |                                |             |             |
| March 31, 2014                                   |                |           |             |                                |             |             |
| Allowance for loan losses:                       |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$3,289        | \$10,912  | \$785       | \$-                            | \$-         | \$14,986    |
| Collectively evaluated for impairment            | 2,474          | 6,088     | 1,276       | 87                             | 5,526       | 15,451      |
| Total ending allowance balance                   | \$5,763        | \$17,000  | \$2,061     | \$87                           | \$5,526     | \$30,437    |
| Loans  |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$40,014       | \$77,159  | \$7,126     | \$-                            |             | \$124,299   |
| Collectively evaluated for impairment            | 603,533        | 400,598   | 181,856     | 54,544                         |             | 1,240,531   |
| Total loans recorded investment                  | 643,547        | 477,757   | 188,982     | 54,544                         |             | 1,364,830   |
| Accrued interest included in recorded investment | 1,496          | 2,177     | 645         | -                              |             | 4,318       |
| Total loans                                      | \$642,051      | \$475,580 | \$188,337   | \$54,544                       |             | \$1,360,512 |
| December 31, 2013                                |                |           |             |                                |             |             |
| Allowance for loan losses:                       |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$3,878        | \$10,488  | \$792       | \$-                            | \$-         | \$15,158    |
| Collectively evaluated for impairment            | 2,949          | 6,707     | 1,454       | 97                             | 5,960       | 17,167      |
| Total ending allowance balance                   | \$6,827        | \$17,195  | \$2,246     | \$97                           | \$5,960     | \$32,325    |
| Loans  |                |           |             |                                |             |             |
| Individually evaluated for impairment            | \$40,623       | \$78,022  | \$7,068     | \$-                            |             | \$125,713   |
| Collectively evaluated for impairment            | 596,235        | 410,887   | 185,676     | 60,638                         |             | 1,253,436   |
| Total loans recorded investment                  | 636,858        | 488,909   | 192,744     | 60,638                         |             | 1,379,149   |
| Accrued interest included in recorded investment | 1,624          | 2,276     | 679         | -                              |             | 4,579       |
| Total loans                                      | \$635,234      | \$486,633 | \$192,065   | \$60,638                       |             | \$1,374,570 |

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 |
|---|---|-----------------|-----------------------------------|
| March 31, 2014  |   |                 |                                   |
| Commercial  |   |                 |                                   |
| Income producing - real estate                        | \$ 115  | \$ 3,443        | \$ 3,558                          |
| Land, land development and construction - real estate | -   | 904             | 904                               |
| Commercial and industrial                             | -   | 3,351           | 3,351                             |
| Mortgage  |   |                 |                                   |
| 1-4 family  | -   | 6,655           | 6,655                             |
| Resort lending  | -   | 3,371           | 3,371                             |
| Home equity - 1st lien                                | -   | 430             | 430                               |
| Home equity - 2nd lien                                | -   | 747             | 747                               |
| Installment   |   |                 |                                   |
| Home equity - 1st lien                                | -   | 859             | 859                               |
| Home equity - 2nd lien                                | -   | 511             | 511                               |
| Loans not secured by real estate                      | -   | 432             | 432                               |
| Other   | -   | 2               | 2                                 |
| Payment plan receivables                              |   |                 |                                   |
| Full refund   | -   | 5               | 5                                 |
| Partial refund  | -   | -               | -                                 |
| Other   | -   | 1               | 1                                 |
| Total recorded investment                             | \$ 115  | \$ 20,711       | \$ 20,826                         |
| Accrued interest included in recorded investment      | \$-   | \$-             | \$ -                              |
| December 31, 2013                                     |   |                 |                                   |
| Commercial  |   |                 |                                   |
| Income producing - real estate                        | \$-   | \$ 1,899        | \$ 1,899                          |
| Land, land development and construction - real estate | -   | 1,036           | 1,036                             |
| Commercial and industrial                             | -   | 2,434           | 2,434                             |
| Mortgage  |   |                 |                                   |
| 1-4 family  | -   | 6,594           | 6,594                             |
| Resort lending  | -   | 2,668           | 2,668                             |
| Home equity - 1st lien                                | -   | 415             | 415                               |
| Home equity - 2nd lien                                | -   | 689             | 689                               |
| Installment   |   |                 |                                   |
| Home equity - 1st lien                                | -   | 938             | 938                               |
| Home equity - 2nd lien                                | -   | 571             | 571                               |
| Loans not secured by real estate                      | -   | 638             | 638                               |
| Other   | -   | -               | -                                 |
| Payment plan receivables                              |   |                 |                                   |
| Full refund   | -   | 20              | 20                                |
| Partial refund  | -   | 3               | 3                                 |

|  |     |          |           |
|--|-----|----------|-----------|
| Other  | -   | -        | -         |
| Total recorded investment                        | \$- | \$17,905 | \$ 17,905 |
| Accrued interest included in recorded investment | \$- | \$-      | \$ -      |

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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)  |                |               |             |          |                       |                |
| March 31, 2014  |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$506          | \$391         | \$2,505     | \$3,402  | \$248,983             | \$252,385      |
| Land, land development and construction - real estate | 43             | -             | 328         | 371      | 33,855                | 34,226         |
| Commercial and industrial                             | 2,235          | 809           | 1,441       | 4,485    | 352,451               | 356,936        |
| Mortgage  |                |               |             |          |                       |                |
| 1-4 family  | 2,440          | 1,284         | 6,655       | 10,379   | 264,136               | 274,515        |
| Resort lending  | 1,182          | 235           | 3,371       | 4,788    | 137,395               | 142,183        |
| Home equity - 1st lien                                | 262            | -             | 430         | 692      | 18,609                | 19,301         |
| Home equity - 2nd lien                                | 227            | 318           | 747         | 1,292    | 40,466                | 41,758         |
| Installment   |                |               |             |          |                       |                |
| Home equity - 1st lien                                | 382            | 50            | 859         | 1,291    | 25,042                | 26,333         |
| Home equity - 2nd lien                                | 188            | 105           | 511         | 804      | 35,698                | 36,502         |
| Loans not secured by real estate                      | 443            | 259           | 432         | 1,134    | 122,571               | 123,705        |
| Other   | 15             | 20            | 2           | 37       | 2,405                 | 2,442          |
| Payment plan receivables                              |                |               |             |          |                       |                |
| Full refund   | 1,076          | 192           | 5           | 1,273    | 40,611                | 41,884         |
| Partial refund  | 192            | 34            | -           | 226      | 5,348                 | 5,574          |
| Other   | 164            | 10            | 1           | 175      | 6,911                 | 7,086          |
| Total recorded investment                             | \$9,355        | \$3,707       | \$17,287    | \$30,349 | \$1,334,481           | \$1,364,830    |
| Accrued interest included in recorded investment      | \$61           | \$54          | \$-         | \$115    | \$4,203               | \$4,318        |
| December 31, 2013                                     |                |               |             |          |                       |                |
| Commercial  |                |               |             |          |                       |                |
| Income producing - real estate                        | \$1,014        | \$428         | \$878       | \$2,320  | \$249,313             | \$251,633      |
| Land, land development and construction - real estate | 781            | 129           | 256         | 1,166    | 30,670                | 31,836         |
| Commercial and industrial                             | 1,155          | 1,665         | 318         | 3,138    | 350,251               | 353,389        |
| Mortgage  |                |               |             |          |                       |                |
| 1-4 family  | 3,750          | 224           | 6,594       | 10,568   | 270,855               | 281,423        |
| Resort lending  | 698            | 234           | 2,668       | 3,600    | 142,356               | 145,956        |
| Home equity - 1st lien                                | 172            | -             | 415         | 587      | 18,214                | 18,801         |
| Home equity - 2nd lien                                | 663            | 73            | 689         | 1,425    | 41,304                | 42,729         |
| Installment   |                |               |             |          |                       |                |
| Home equity - 1st lien                                | 557            | 134           | 938         | 1,629    | 25,513                | 27,142         |
| Home equity - 2nd lien                                | 536            | 136           | 571         | 1,243    | 36,701                | 37,944         |
| Loans not secured by real estate                      | 833            | 281           | 638         | 1,752    | 123,295               | 125,047        |
| Other   | 22             | 12            | -           | 34       | 2,577                 | 2,611          |
| Payment plan receivables                              |                |               |             |          |                       |                |
| Full refund   | 1,364          | 349           | 20          | 1,733    | 46,344                | 48,077         |

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|  |          |         |          |          |             |             |
|--|----------|---------|----------|----------|-------------|-------------|
| Partial refund                                   | 190      | 20      | 3        | 213      | 4,840       | 5,053       |
| Other  | 122      | 4       | -        | 126      | 7,382       | 7,508       |
| Total recorded investment                        | \$11,857 | \$3,689 | \$13,988 | \$29,534 | \$1,349,615 | \$1,379,149 |
| Accrued interest included in recorded investment | \$100    | \$26    | \$-      | \$126    | \$4,453     | \$4,579     |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans are as follows :

|  | March<br>31,<br>2014 | December<br>31,<br>2013 |
|--|----------------------|-------------------------|
| Impaired loans with no allocated allowance             |                      |                         |
| TDR  | \$11,911             | \$13,006                |
| Non - TDR  | 911                  | 334                     |
| Impaired loans with an allocated allowance             |                      |                         |
| TDR - allowance based on collateral                    | 11,435               | 10,085                  |
| TDR - allowance based on present value cash flow       | 98,187               | 101,131                 |
| Non - TDR - allowance based on collateral              | 1,433                | 688                     |
| Non - TDR - allowance based on present value cash flow | -                    | -                       |
| Total impaired loans                                   | \$123,877            | \$125,244               |
| Amount of allowance for loan losses allocated          |                      |                         |
| TDR - allowance based on collateral                    | \$3,224              | \$3,127                 |
| TDR - allowance based on present value cash flow       | 11,262               | 11,777                  |
| Non - TDR - allowance based on collateral              | 500                  | 254                     |
| Non - TDR - allowance based on present value cash flow | -                    | -                       |
| Total amount of allowance for loan losses allocated    | \$14,986             | \$15,158                |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows (1):

|   | March 31, 2014      |                          |                   | December 31, 2013   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | 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                    | \$8,883             | \$9,151                  | \$ -              | \$7,042             | \$7,178                  | \$ -              |
| Land, land development & construction-real estate | 770                 | 1,817                    | -                 | 2,185               | 3,217                    | -                 |
| Commercial and industrial                         | 3,166               | 3,136                    | -                 | 4,110               | 4,087                    | -                 |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 8                   | 8                        | -                 | 8                   | 8                        | -                 |
| Resort lending                                    | 35                  | 163                      | -                 | 35                  | 163                      | -                 |
| Home equity - 1st lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity - 2nd lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity - 2nd lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Loans not secured by real estate                  | -                   | -                        | -                 | -                   | -                        | -                 |
| Other   | -                   | -                        | -                 | -                   | -                        | -                 |
|   | 12,862              | 14,275                   | -                 | 13,380              | 14,653                   | -                 |
| With an allowance recorded:                       |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 13,513              | 14,809                   | 1,341             | 14,538              | 15,631                   | 1,161             |
| Land, land development & construction-real estate | 4,688               | 5,466                    | 725               | 3,366               | 4,130                    | 686               |
| Commercial and industrial                         | 8,994               | 10,098                   | 1,223             | 9,382               | 9,529                    | 2,031             |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 57,301              | 60,286                   | 7,153             | 57,612              | 60,768                   | 7,236             |
| Resort lending                                    | 19,620              | 20,112                   | 3,728             | 20,171              | 20,608                   | 3,221             |
| Home equity - 1st lien                            | 153                 | 163                      | 11                | 154                 | 164                      | 11                |
| Home equity - 2nd lien                            | 42                  | 118                      | 20                | 42                  | 118                      | 20                |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | 2,881               | 3,053                    | 230               | 2,959               | 3,115                    | 254               |
| Home equity - 2nd lien                            | 3,484               | 3,480                    | 480               | 3,352               | 3,347                    | 462               |
| Loans not secured by real estate                  | 746                 | 914                      | 74                | 741                 | 902                      | 75                |
| Other   | 15                  | 15                       | 1                 | 16                  | 16                       | 1                 |
|   | 111,437             | 118,514                  | 14,986            | 112,333             | 118,328                  | 15,158            |
| Total   |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 22,396              | 23,960                   | 1,341             | 21,580              | 22,809                   | 1,161             |
| Land, land development & construction-real estate | 5,458               | 7,283                    | 725               | 5,551               | 7,347                    | 686               |
| Commercial and industrial                         | 12,160              | 13,234                   | 1,223             | 13,492              | 13,616                   | 2,031             |
| Mortgage  |                     |                          |                   |                     |                          |                   |

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|                                  |           |           |          |           |           |          |
|----------------------------------|-----------|-----------|----------|-----------|-----------|----------|
| 1-4 family                       | 57,309    | 60,294    | 7,153    | 57,620    | 60,776    | 7,236    |
| Resort lending                   | 19,655    | 20,275    | 3,728    | 20,206    | 20,771    | 3,221    |
| Home equity - 1st lien           | 153       | 163       | 11       | 154       | 164       | 11       |
| Home equity - 2nd lien           | 42        | 118       | 20       | 42        | 118       | 20       |
| Installment                      |           |           |          |           |           |          |
| Home equity - 1st lien           | 2,881     | 3,053     | 230      | 2,959     | 3,115     | 254      |
| Home equity - 2nd lien           | 3,484     | 3,480     | 480      | 3,352     | 3,347     | 462      |
| Loans not secured by real estate | 746       | 914       | 74       | 741       | 902       | 75       |
| Other                            | 15        | 15        | 1        | 16        | 16        | 1        |
| Total                            | \$124,299 | \$132,789 | \$14,986 | \$125,713 | \$132,981 | \$15,158 |

Accrued interest included in recorded investment

\$422

\$469

(1) There were no impaired payment plan receivables at March 31, 2014 or December 31, 2013.

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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 March 31, follows (1):

|   | 2014                              |                                  | 2013                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | 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                    | \$7,963                           | \$ 175                           | \$4,475                           | \$ 63                            |
| Land, land development & construction-real estate | 1,478                             | 43                               | 3,127                             | 42                               |
| Commercial and industrial                         | 3,638                             | 93                               | 3,641                             | 38                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 8                                 | -                                | -                                 | -                                |
| Resort lending                                    | 35                                | -                                | 18                                | -                                |
| Home equity - 1st lien                            | -                                 | -                                | -                                 | -                                |
| Home equity - 2nd lien                            | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | -                                 | -                                | 2,058                             | 24                               |
| Home equity - 2nd lien                            | -                                 | -                                | 2,297                             | 29                               |
| Loans not secured by real estate                  | -                                 | -                                | 608                               | 8                                |
| Other   | -                                 | -                                | 20                                | 1                                |
|   | 13,122                            | 311                              | 16,244                            | 205                              |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 14,026                            | 66                               | 21,354                            | 137                              |
| Land, land development & construction-real estate | 4,027                             | 12                               | 8,341                             | 56                               |
| Commercial and industrial                         | 9,188                             | 26                               | 15,036                            | 140                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 57,457                            | 630                              | 63,617                            | 706                              |
| Resort lending                                    | 19,896                            | 191                              | 22,973                            | 219                              |
| Home equity - 1st lien                            | 154                               | 1                                | 110                               | 1                                |
| Home equity - 2nd lien                            | 42                                | 1                                | 43                                | 1                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | 2,920                             | 45                               | 1,092                             | 12                               |
| Home equity - 2nd lien                            | 3,418                             | 49                               | 1,150                             | 13                               |
| Loans not secured by real estate                  | 744                               | 10                               | 204                               | 2                                |
| Other   | 16                                | -                                | -                                 | -                                |
|   | 111,888                           | 1,031                            | 133,920                           | 1,287                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 21,989                            | 241                              | 25,829                            | 200                              |
| Land, land development & construction-real estate | 5,505                             | 55                               | 11,468                            | 98                               |
| Commercial and industrial                         | 12,826                            | 119                              | 18,677                            | 178                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 57,465                            | 630                              | 63,617                            | 706                              |
| Resort lending                                    | 19,931                            | 191                              | 22,991                            | 219                              |

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|                                  |           |          |           |          |
|----------------------------------|-----------|----------|-----------|----------|
| Home equity - 1st lien           | 154       | 1        | 110       | 1        |
| Home equity - 2nd lien           | 42        | 1        | 43        | 1        |
| Installment                      |           |          |           |          |
| Home equity - 1st lien           | 2,920     | 45       | 3,150     | 36       |
| Home equity - 2nd lien           | 3,418     | 49       | 3,447     | 42       |
| Loans not secured by real estate | 744       | 10       | 812       | 10       |
| Other                            | 16        | -        | 20        | 1        |
| Total                            | \$125,010 | \$ 1,342 | \$150,164 | \$ 1,492 |

(1) There were no impaired payment plan receivables during the three month periods ended March 31, 2014 and 2013, respectively.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our average investment in impaired loans was approximately \$125.0 million and \$150.2 million for the three-month periods ended March 31, 2014 and 2013, 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 first three months of 2014 and 2013 was approximately \$1.3 million and \$1.5 million, respectively.

Troubled debt restructurings follow:

|                         | March 31, 2014 |                      |           |
|-------------------------|----------------|----------------------|-----------|
|                         | Commercial     | Retail               | Total     |
|                         | (In thousands) |                      |           |
| Performing TDR's        | \$32,208       | \$78,152             | \$110,360 |
| Non-performing TDR's(1) | 5,354          | 5,819 <sup>(2)</sup> | 11,173    |
| Total                   | \$37,562       | \$83,971             | \$121,533 |

|                         | December 31, 2013 |                      |           |
|-------------------------|-------------------|----------------------|-----------|
|                         | Commercial        | Retail               | Total     |
|                         | (In thousands)    |                      |           |
| Performing TDR's        | \$35,134          | \$79,753             | \$114,887 |
| Non-performing TDR's(1) | 4,347             | 4,988 <sup>(2)</sup> | 9,335     |
| Total                   | \$39,481          | \$84,741             | \$124,222 |

(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 \$14.5 million and \$14.9 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of March 31, 2014 and December 31, 2013, respectively.

During the three months ended March 31, 2014 and 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan have generally been for periods ranging from 9 months to 36 months but have extended to as much as 480 months in certain circumstances. Modifications involving an extension of the maturity date have generally been for periods ranging from 1 month to 60 months but have extended to as much as 220 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 March 31 follow:

|   |                        | Pre-modification | Post-modification |
|---|------------------------|------------------|-------------------|
|   | Number                 | Recorded         | Recorded          |
|   | of                     | Balance          | Balance           |
|   | Contributions          |                  |                   |
|   | (Dollars in thousands) |                  |                   |
| 2014  |                        |                  |                   |
| Commercial  |                        |                  |                   |
| Income producing - real estate                    | 2                      | \$ 213           | \$ 210            |
| Land, land development & construction-real estate | -                      | -                | -                 |
| Commercial and industrial                         | 4                      | 190              | 189               |
| Mortgage  |                        |                  |                   |
| 1-4 family  | 4                      | 724              | 739               |
| Resort lending                                    | 2                      | 294              | 293               |
| Home equity - 1st lien                            | -                      | -                | -                 |
| Home equity - 2nd lien                            | -                      | -                | -                 |
| Installment                                       |                        |                  |                   |
| Home equity - 1st lien                            | 3                      | 106              | 78                |
| Home equity - 2nd lien                            | 3                      | 221              | 220               |
| Loans not secured by real estate                  | 2                      | 33               | 29                |
| Other   | -                      | -                | -                 |
| Total   | 20                     | \$ 1,781         | \$ 1,758          |
| 2013  |                        |                  |                   |
| Commercial  |                        |                  |                   |
| Income producing - real estate                    | 3                      | \$ 4,083         | \$ 3,822          |
| Land, land development & construction-real estate | 1                      | 16               | 15                |
| Commercial and industrial                         | 13                     | 840              | 834               |
| Mortgage  |                        |                  |                   |
| 1-4 family  | 7                      | 791              | 786               |
| Resort lending                                    | 3                      | 799              | 795               |
| Home equity - 1st lien                            | 1                      | 95               | 96                |
| Home equity - 2nd lien                            | -                      | -                | -                 |
| Installment                                       |                        |                  |                   |
| Home equity - 1st lien                            | 7                      | 173              | 176               |
| Home equity - 2nd lien                            | 6                      | 148              | 148               |
| Loans not secured by real estate                  | 2                      | 57               | 28                |
| Other   | -                      | -                | -                 |
| Total   | 43                     | \$ 7,002         | \$ 6,700          |

The troubled debt restructurings described above for 2014 increased the allowance for loan losses by \$0.03 million and resulted in zero charge offs while the troubled debt restructurings described above for 2013 increased the allowance for loan losses by \$0.1 million and resulted in \$0.3 million of charge offs.

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 March 31 follow:

|   | Number<br>of Recorded<br>Contracts<br>(Dollars in<br>thousands) | Balance |
|---|---|---------|
| 2014  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | -   | -       |
| Commercial and industrial                         | -   | -       |
| Mortgage  |   |         |
| 1-4 family  | -   | -       |
| Resort lending                                    | -   | -       |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | -   | \$ -    |
| 2013  |   |         |
| Commercial  |   |         |
| Income producing - real estate                    | -   | \$ -    |
| Land, land development & construction-real estate | 1   | 334     |
| Commercial and industrial                         | 1   | 81      |
| Mortgage  |   |         |
| 1-4 family  | 1   | 106     |
| Resort lending                                    | 1   | 156     |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Installment                                       |   |         |
| Home equity - 1st lien                            | -   | -       |
| Home equity - 2nd lien                            | -   | -       |
| Loans not secured by real estate                  | -   | -       |
| Other   | -   | -       |
|   | 4   | \$ 677  |

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 increased the allowance for loan losses by \$0.2 million and resulted in zero charge offs.

The terms of certain other loans were modified during the three months ended March 31, 2014 and 2013 in a manner that did not meet the definition of a troubled debt restructuring. The modification of these loans could have included modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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.

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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<br>(In<br>thousands) | Non-<br>Accrual<br>10-11 | Total     |
|---|------------------|--------------|--|--------------------------|-----------|
|   | Non-watch<br>1-6 | Watch<br>7-8 |  |                          |           |
| March 31, 2014  |                  |              |  |                          |           |
| Income producing - real estate                        | \$232,004        | \$14,954     | \$ 1,984   | \$ 3,443                 | \$252,385 |
| Land, land development and construction - real estate | 28,003           | 4,874        | 445  | 904                      | 34,226    |
| Commercial and industrial                             | 323,840          | 23,590       | 6,155  | 3,351                    | 356,936   |
| Total   | \$583,847        | \$43,418     | \$ 8,584   | \$ 7,698                 | \$643,547 |
| Accrued interest included in total                    | \$1,336          | \$130        | \$ 30  | \$ -                     | \$1,496   |
| December 31, 2013                                     |                  |              |  |                          |           |
| Income producing - real estate                        | \$227,957        | \$17,882     | \$ 3,895   | \$ 1,899                 | \$251,633 |
| Land, land development and construction - real estate | 25,654           | 4,829        | 317  | 1,036                    | 31,836    |
| Commercial and industrial                             | 318,183          | 26,303       | 6,469  | 2,434                    | 353,389   |
| Total   | \$571,794        | \$49,014     | \$ 10,681  | \$ 5,369                 | \$636,858 |
| Accrued interest included in total                    | \$1,433          | \$147        | \$ 44  | \$ -                     | \$1,624   |

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 tables summarize 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) |           |          |          |           |
| March 31, 2014                     |                |           |          |          |           |
| 800 and above                      | \$23,475       | \$13,325  | \$3,985  | \$4,951  | \$45,736  |
| 750-799                            | 58,164         | 54,523    | 4,885    | 11,518   | 129,090   |
| 700-749                            | 56,805         | 35,389    | 3,266    | 8,186    | 103,646   |
| 650-699                            | 47,072         | 21,516    | 2,305    | 7,184    | 78,077    |
| 600-649                            | 34,714         | 8,144     | 2,545    | 5,101    | 50,504    |
| 550-599                            | 24,248         | 3,035     | 1,122    | 2,415    | 30,820    |
| 500-549                            | 14,486         | 2,253     | 625      | 1,438    | 18,802    |
| Under 500                          | 9,240          | 1,150     | 322      | 357      | 11,069    |
| Unknown                            | 6,311          | 2,848     | 246      | 608      | 10,013    |
| Total                              | \$274,515      | \$142,183 | \$19,301 | \$41,758 | \$477,757 |
| Accrued interest included in total | \$1,274        | \$614     | \$88     | \$201    | \$2,177   |
| December 31, 2013                  |                |           |          |          |           |
| 800 and above                      | \$23,924       | \$13,487  | \$3,650  | \$5,354  | \$46,415  |
| 750-799                            | 60,728         | 56,880    | 4,560    | 11,809   | 133,977   |
| 700-749                            | 58,269         | 35,767    | 3,289    | 8,628    | 105,953   |
| 650-699                            | 49,771         | 21,696    | 2,316    | 7,145    | 80,928    |
| 600-649                            | 34,991         | 8,555     | 2,621    | 5,141    | 51,308    |
| 550-599                            | 24,616         | 3,261     | 1,165    | 2,485    | 31,527    |
| 500-549                            | 14,823         | 2,271     | 644      | 1,560    | 19,298    |
| Under 500                          | 9,492          | 1,160     | 323      | 360      | 11,335    |
| Unknown                            | 4,809          | 2,879     | 233      | 247      | 8,168     |
| Total                              | \$281,423      | \$145,956 | \$18,801 | \$42,729 | \$488,909 |
| Accrued interest included in total | \$1,300        | \$650     | \$97     | \$229    | \$2,276   |

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

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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)             |                               |   |         |           |
| March 31, 2014                     |                            |                               |   |         |           |
| 800 and above                      | \$2,820                    | \$2,925                       | \$23,090  | \$49    | \$28,884  |
| 750-799                            | 6,405                      | 10,735                        | 49,649  | 568     | 67,357    |
| 700-749                            | 4,317                      | 9,392                         | 25,296  | 636     | 39,641    |
| 650-699                            | 4,630                      | 6,483                         | 14,850  | 568     | 26,531    |
| 600-649                            | 3,054                      | 2,700                         | 4,914   | 238     | 10,906    |
| 550-599                            | 2,778                      | 1,920                         | 2,375   | 198     | 7,271     |
| 500-549                            | 1,437                      | 1,617                         | 1,594   | 121     | 4,769     |
| Under 500                          | 733                        | 689                           | 481   | 26      | 1,929     |
| Unknown                            | 159                        | 41                            | 1,456   | 38      | 1,694     |
| Total                              | \$26,333                   | \$36,502                      | \$123,705                                       | \$2,442 | \$188,982 |
| Accrued interest included in total | \$105                      | \$135                         | \$386   | \$19    | \$645     |
| December 31, 2013                  |                            |                               |   |         |           |
| 800 and above                      | \$2,977                    | \$3,062                       | \$23,649  | \$53    | \$29,741  |
| 750-799                            | 6,585                      | 11,197                        | 48,585  | 557     | 66,924    |
| 700-749                            | 4,353                      | 9,487                         | 25,343  | 683     | 39,866    |
| 650-699                            | 4,815                      | 6,832                         | 15,256  | 646     | 27,549    |
| 600-649                            | 3,173                      | 2,824                         | 5,289   | 258     | 11,544    |
| 550-599                            | 2,843                      | 2,084                         | 2,785   | 213     | 7,925     |
| 500-549                            | 1,483                      | 1,715                         | 1,732   | 130     | 5,060     |
| Under 500                          | 751                        | 663                           | 516   | 29      | 1,959     |
| Unknown                            | 162                        | 80                            | 1,892   | 42      | 2,176     |
| Total                              | \$27,142                   | \$37,944                      | \$125,047                                       | \$2,611 | \$192,744 |
| Accrued interest included in total | \$114                      | \$144                         | \$399   | \$22    | \$679     |

(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 March 31, 2014, approximately 76.8% 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 10.2% of Mepco’s outstanding payment plan receivables as of March 31, 2014, relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the refund owing upon cancellation only with respect to the unearned portion previously funded by Mepco to the administrator (but not to the service contract seller). These receivables are shown as “Partial Refund” in the table below. The balance of Mepco’s outstanding payment plan receivables relate to programs in which there is no insurer or risk retention group that has

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                   | Payment Plan Receivables |                |         |          |
|-------------------|--------------------------|----------------|---------|----------|
|                   | Full Refund              | Partial Refund | Other   | Total    |
|                   | (In thousands)           |                |         |          |
| March 31, 2014    |                          |                |         |          |
| AM Best rating    |                          |                |         |          |
| A+                | \$-                      | \$20           | \$-     | \$20     |
| A                 | 17,174                   | 4,565          | -       | 21,739   |
| A-                | 2,623                    | 989            | 7,080   | 10,692   |
| Not rated         | 22,087                   | -              | 6       | 22,093   |
| Total             | \$41,884                 | \$5,574        | \$7,086 | \$54,544 |
| December 31, 2013 |                          |                |         |          |
| AM Best rating    |                          |                |         |          |
| A                 | \$20,203                 | \$4,221        | \$-     | \$24,424 |
| A-                | 4,058                    | 832            | 7,496   | 12,386   |
| Not rated         | 23,816                   | -              | 12      | 23,828   |
| Total             | \$48,077                 | \$5,053        | \$7,508 | \$60,638 |

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

## 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.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                   | IB             | Mepco    | Other(1)  | Elimination(2) | Total       |
|-------------------|----------------|----------|-----------|----------------|-------------|
|                   | (In thousands) |          |           |                |             |
| Total assets      |                |          |           |                |             |
| March 31, 2014    | \$2,161,267    | \$87,461 | \$277,271 | \$ (266,360 )  | \$2,259,639 |
| December 31, 2013 | 2,104,550      | 94,648   | 272,348   | (261,603 )     | 2,209,943   |

For the three months ended March 31,  
2014

|                                 |          |         |        |       |          |
|---------------------------------|----------|---------|--------|-------|----------|
| Interest income                 | \$18,198 | \$2,085 | \$-    | \$ -  | \$20,283 |
| Net interest income             | 17,083   | 1,682   | (287 ) | -     | 18,478   |
| Provision for loan losses       | 443      | (15 )   | -      | -     | 428      |
| Income (loss) before income tax | 4,678    | 356     | (405 ) | (24 ) | 4,605    |
| Net income (loss)               | 3,182    | 243     | (263 ) | (24 ) | 3,138    |

2013

|                                 |          |         |          |       |          |
|---------------------------------|----------|---------|----------|-------|----------|
| Interest income                 | \$18,780 | \$3,170 | \$-      | \$ -  | \$21,950 |
| Net interest income             | 17,616   | 2,521   | (581 )   | -     | 19,556   |
| Provision for loan losses       | (687 )   | (4 )    | -        | -     | (691 )   |
| Income (loss) before income tax | 6,819    | 823     | (1,776 ) | (24 ) | 5,842    |
| Net income (loss)               | 7,064    | 543     | (1,776 ) | (24 ) | 5,807    |

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

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

6. Earnings Per Common Share

|   | Three Months<br>Ended<br>March 31, |         |
|---|------------------------------------|---------|
|   | 2014                               | 2013    |
| Net income applicable to common stock   | \$3,138                            | \$4,712 |
| Convertible preferred stock dividends   | -                                  | 1,095   |
| Net income applicable to common stock for calculation of diluted earnings per share | \$3,138                            | \$5,807 |
| Weighted average shares outstanding (1)   | 22,888                             | 9,266   |
| Restricted stock units  | 304                                | 361     |
| Effect of stock options   | 124                                | 61      |
| Stock units for deferred compensation plan for non-employee directors               | 120                                | 117     |
| Effect of convertible preferred stock   | -                                  | 12,026  |
| Weighted average shares outstanding for calculation of diluted earnings per share   | 23,436                             | 21,831  |

Net income per common share

|           |        |        |
|-----------|--------|--------|
| Basic (1) | \$0.14 | \$0.51 |
| Diluted   | \$0.13 | \$0.27 |

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Weighted average stock options outstanding that were not included in weighted average shares outstanding for calculation of diluted earnings per share because they were anti-dilutive totaled 0.03 million and 0.04 million for the three-month periods ended March 31, 2014 and 2013, respectively. The warrant to purchase 346,154 shares of our common stock (see Note #15) was not included in weighted average shares outstanding for calculation of diluted earnings per share in 2013 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.

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

|  | March 31, 2014         |          |        |
|--|------------------------|----------|--------|
|  |                        | Average  |        |
|  | Notional               | Maturity | Fair   |
|  | Amount                 | (years)  | Value  |
|  | (Dollars in thousands) |          |        |
| No hedge designation                         |                        |          |        |
| Mandatory commitments to sell mortgage loans | \$28,936               | 0.1      | \$ 45  |
| Rate-lock mortgage loan commitments          | 15,234                 | 0.1      | 352    |
| Total  | \$44,170               | 0.1      | \$ 397 |

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 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.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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, 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. During the third quarter of 2013 we repurchased the Amended Warrant from the UST (see Note #15).

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 |               |                      |               |
|--|-------------------|---------------|----------------------|---------------|-----------------------|---------------|----------------------|---------------|
|  | March 31,<br>2014 |               | December 31,<br>2013 |               | March 31,<br>2014     |               | December 31,<br>2013 |               |
|  | 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 not designated as<br>hedging instruments |                   |               |                      |               |                       |               |                      |               |
| Rate-lock mortgage loan<br>commitments               | Other<br>assets   | \$ 352        | Other<br>assets      | \$ 366        | Other<br>liabilities  | \$ -          | Other<br>liabilities | \$ -          |
| Mandatory commitments to sell<br>mortgage loans      | Other<br>assets   | 45            | Other<br>assets      | 128           | Other<br>liabilities  | -             | Other<br>liabilities | -             |
| Total derivatives                                    |                   | \$ 397        |                      | \$ 494        |                       | \$ -          |                      | \$ -          |

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 March 31,

|  | Gain<br>(Loss)<br>Recognized<br>in Other<br>Comprehensive<br>Income | Location of Gain (Loss)<br>Reclassified from Accumulated<br>Other Comprehensive Income<br>(Effective Portion)<br>2014 | 2013 | Gain (Loss)<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss into<br>Income<br>(Effective<br>Portion)<br>2014 | 2013 | Location of Gain<br>(Loss) Recognized<br>in Income (1) | Gain (Loss)<br>Recognized in<br>Income |           |
|--|---|---|------|---|------|--|--|-----------|
|  |   |   |      |   |      |  | 2014                                   | 2013      |
| (In thousands)                                     |   |   |      |   |      |  |  |           |
| Cash Flow Hedges                                   |   |   |      |   |      |  |  |           |
| Pay-fixed interest<br>rate swap<br>agreements      | \$- \$ (3 )   | Interest expense  |      | \$ (95 ) \$ (94 )   |      |  | \$- \$-                                |           |
| Total  | \$- \$ (3 )   |   |      | \$ (95 ) \$ (94 )   |      |  | \$- \$-                                |           |
| No hedge designation                               |   |   |      |   |      |  |  |           |
| Rate-lock mortgage<br>loan commitments             |   |   |      |   |      | Net mortgage loan<br>gains                             | \$(14)                                 | \$(209 )  |
| Mandatory<br>commitments to sell<br>mortgage loans |   |   |      |   |      | Net mortgage loan<br>gains                             | (83)                                   | (64 )     |
|  |   |   |      |   |      | Increase in fair<br>value of U.S.<br>Treasury warrant  | -                                      | (1,045)   |
| Amended warrant                                    |   |   |      |   |      |  |  |           |
| Total  |   |   |      |   |      |  | \$(97)                                 | \$(1,318) |

(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:

|   | March 31, 2014              |                             | December 31, 2013           |                             |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| (In thousands)                              |                             |                             |                             |                             |
| Amortized intangible assets - core deposits | \$23,703                    | \$ 20,674                   | \$23,703                    | \$ 20,540                   |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization of other intangibles has been estimated through 2019 and thereafter in the following table.

|                                      | (In<br>thousands) |
|--------------------------------------|-------------------|
| Nine months ending December 31, 2014 | \$ 402            |
| 2015                                 | 347               |
| 2016                                 | 347               |
| 2017                                 | 346               |
| 2018                                 | 346               |
| 2019 and thereafter                  | 1,241             |
| Total                                | \$ 3,029          |

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 0.4 million shares of common stock as of March 31, 2014. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of March 31, 2014. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

During the first quarter of 2014, pursuant to our performance-based compensation plans, we granted 0.07 million shares of restricted stock and 0.03 million performance stock units (“PSU”) to certain officers. The shares of restricted stock vest ratably over three years and the PSU’s cliff vest after a period of three years. The performance feature of the PSU’s is based on a comparison of our total shareholder return over the three year period starting on the grant date to the total shareholder return over that period for a banking index of our peers. There were no grants pursuant to our performance-based compensation plans during the first quarter of 2013.

Our directors may elect 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 fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.004 million shares and 0.024 million shares to directors during the first quarter of 2014 and 2013, respectively and expensed their value during those same periods.

During 2013 a portion of our president’s annual salary was paid in the form of common stock. The annual amount paid in common stock (also referred to as “salary stock”) was \$0.020 million for 2013.

Total compensation expense recognized for grants pursuant to our performance-based compensation plans was \$0.2 million and \$0.1 million during the three months ended March 31, 2014 and 2013 respectively. The corresponding tax benefit relating to this expense was \$0.1 million and zero for each respective period. Total expense recognized for non-employee director share based payments was \$0.05 million and \$0.09 million during the three months ended March 31, 2014 and 2013, respectively. The corresponding tax benefit relating to this expense was \$0.02 million and zero for each respective period.





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

At March 31, 2014, the total expected compensation cost related to non-vested stock options, restricted stock, PSU's and restricted stock unit awards not yet recognized was \$2.3 million. The weighted-average period over which this amount will be recognized is 2.4 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, 2014                | 320,300                | \$ 4.52                      |   |   |
| Granted                                       | -                      |                              |   |   |
| Exercised                                     | (1,935 )               | 5.25                         |   |   |
| Forfeited                                     | (2,401 )               | 4.12                         |   |   |
| Expired                                       | (284 )                 | 3.46                         |   |   |
| Outstanding at March 31, 2014                 | 315,680                | \$ 4.52                      | 7.84  | \$ 2,749  |
| Vested and expected to vest at March 31, 2014 | 303,702                | \$ 4.52                      | 7.80  | \$ 2,649  |
| Exercisable at March 31, 2014                 | 131,297                | \$ 5.13                      | 6.91  | \$ 1,108  |

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

|                                | Number<br>of<br>Shares | Weighted-<br>Average<br>Grant<br>Date<br>Fair Value |
|--------------------------------|------------------------|---|
| Outstanding at January 1, 2014 | 303,980                | \$ 3.77   |
| Granted                        | 101,104                | 13.86   |
| Vested                         | -                      |   |
| Forfeited                      | -                      |   |
| Outstanding at March 31, 2014  | 405,084                | \$ 6.29   |

Certain information regarding options exercised during the periods follows:

| Three<br>Months<br>Ended<br>March 31,<br>2014 | 2013 |
|---|------|
|   |      |

|                        |                   |       |  |
|------------------------|-------------------|-------|--|
|                        | (In<br>thousands) |       |  |
| Intrinsic value        | \$ 15             | \$ 15 |  |
| Cash proceeds received | \$ 10             | \$ 11 |  |
| Tax benefit realized   | \$ 5              | \$ -  |  |

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

10. Income Tax

Income tax expense was \$1.5 million and \$0.04 million during the three months ended March 31, 2014 and 2013, respectively. 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 the first quarter of 2013, the income tax expense related to any income before income tax was largely being offset by changes in the deferred tax valuation allowance.

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 concluded that the realization of substantially all of our deferred tax assets was now more likely than not. This conclusion was primarily based upon the following factors:

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

We have also concluded subsequent to June 30, 2013, that the realization of substantially all of our deferred tax assets continues to be more likely than not for substantially the same reasons as enumerated above, including three additional quarterly profits since June 30, 2013.

The valuation allowance against our deferred tax assets totaled \$1.1 million at both March 31, 2014 and December 31, 2013, respectively. 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.

At both March 31, 2014 and December 31, 2013, we had approximately \$1.7 million 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 2014.

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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 March 31, 2014, the Bank had negative undivided profits of \$46.6 million. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2014, we requested regulatory approval for a \$15.0 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on March 28, 2014 and the Bank returned \$15.0 million of capital to the parent company on April 9, 2014. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total 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 March 31, 2014 and December 31, 2013 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.

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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) |         |  |        |   |         |
| March 31, 2014                         |                        |         |  |        |   |         |
| Total capital to risk-weighted assets  |                        |         |  |        |   |         |
| Consolidated                           | \$251,431              | 17.82 % | \$112,869  | 8.00 % | NA  | NA      |
| Independent Bank                       | 240,390                | 17.05   | 112,792  | 8.00   | \$140,990                                       | 10.00 % |
| Tier 1 capital to risk-weighted assets |                        |         |  |        |   |         |
| Consolidated                           | \$233,544              | 16.55 % | \$56,434   | 4.00 % | NA  | NA      |
| Independent Bank                       | 222,517                | 15.78   | 56,396   | 4.00   | \$84,594  | 6.00 %  |
| Tier 1 capital to average assets       |                        |         |  |        |   |         |
| Consolidated                           | \$233,544              | 10.73 % | \$87,031   | 4.00 % | NA  | NA      |
| Independent Bank                       | 222,517                | 10.23   | 86,988   | 4.00   | \$108,735                                       | 5.00 %  |
| December 31, 2013                      |                        |         |  |        |   |         |
| Total capital to risk-weighted assets  |                        |         |  |        |   |         |
| Consolidated                           | \$245,284              | 17.35 % | \$113,086  | 8.00 % | NA  | NA      |
| Independent Bank                       | 234,078                | 16.57   | 113,013  | 8.00   | \$141,267                                       | 10.00 % |
| Tier 1 capital to risk-weighted assets |                        |         |  |        |   |         |
| Consolidated                           | \$227,338              | 16.08 % | \$56,543   | 4.00 % | NA  | NA      |
| Independent Bank                       | 216,146                | 15.30   | 56,507   | 4.00   | 84,760  | 6.00 %  |
| Tier 1 capital to average assets       |                        |         |  |        |   |         |
| Consolidated                           | \$227,338              | 10.61 % | \$85,729   | 4.00 % | NA  | NA      |
| Independent Bank                       | 216,146                | 10.09   | 85,681   | 4.00   | 107,101   | 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     |                         |
|---|----------------------|-------------------------|----------------------|-------------------------|
|   | March<br>31,<br>2014 | December<br>31,<br>2013 | March<br>31,<br>2014 | December<br>31,<br>2013 |
|   | (In thousands)       |                         |                      |                         |
| Total shareholders' equity  | \$236,586            | \$231,581               | \$255,333            | \$250,306               |
| Add (deduct)  |                      |                         |                      |                         |
| Qualifying trust preferred securities   | 39,500               | 39,500                  | -                    | -                       |
| Accumulated other comprehensive loss  | 7,644                | 9,245                   | 7,644                | 9,245                   |
| Intangible assets   | (3,029 )             | (3,163 )                | (3,029 )             | (3,163 )                |
| Disallowed deferred tax assets  | (46,760 )            | (49,609 )               | (37,034 )            | (40,026 )               |
| Disallowed capitalized mortgage loan servicing rights   | (397 )               | (216 )                  | (397 )               | (216 )                  |
| Tier 1 capital  | 233,544              | 227,338                 | 222,517              | 216,146                 |
| Qualifying trust preferred securities   | -                    | -                       | -                    | -                       |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 17,887               | 17,946                  | 17,873               | 17,932                  |
| Total risk-based capital  | \$251,431            | \$245,284               | \$240,390            | \$234,078               |

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).

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 March 31, 2014 and December 31, 2013, 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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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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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) |
|---|--|---|---|---|
|   |  | Significant Other Observable Inputs (Level 2)                               | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| March 31, 2014:                                   |  |   |   |   |
| Measured at Fair Value on a Recurring Basis:      |  |   |   |   |
| Assets  |  |   |   |   |
| Trading securities                                | \$610  | \$610   | \$ -  | \$ -                                      |
| Securities available for sale                     |  |   |   |   |
| U.S. agency                                       | 47,654   | -   | 47,654  | -   |
| U.S. agency residential mortgage-backed           | 236,745  | -   | 236,745                                       | -   |
| U.S. agency commercial mortgage-backed            | 12,640   | -   | 12,640  | -   |
| Private label residential mortgage-backed         | 6,643  | -   | 6,643   | -   |
| Other asset backed                                | 43,314   | -   | 43,314  | -   |
| Obligations of states and political subdivisions  | 153,930  | -   | 153,930                                       | -   |
| Corporate   | 19,565   | -   | 19,565  | -   |
| Trust preferred                                   | 2,444  | -   | 2,444   | -   |
| Loans held for sale                               | 14,700   | -   | 14,700  | -   |
| Derivatives (1)                                   | 397  | -   | 397   | -   |
| Liabilities                                       |  |   |   |   |
| Derivatives (2)                                   | -  | -   | -   | -   |
| Measured at Fair Value on a Non-recurring basis:  |  |   |   |   |
| Assets  |  |   |   |   |
| Capitalized mortgage loan servicing rights (3)    | 7,307  | -   | -   | 7,307                                     |
| Impaired loans (4)                                |  |   |   |   |
| Commercial  |  |   |   |   |
| Income producing - real estate                    | 2,315  | -   | -   | 2,315                                     |
| Land, land development & construction-real estate | 741  | -   | -   | 741                                       |
| Commercial and industrial                         | 4,254  | -   | -   | 4,254                                     |
| Mortgage  |  |   |   |   |
| 1-4 Family  | 1,369  | -   | -   | 1,369                                     |
| Resort Lending                                    | 465  | -   | -   | 465                                       |

## Other real estate (5)

## Commercial

|   |       |   |   |       |
|---|-------|---|---|-------|
| Income producing - real estate                    | 559   | - | - | 559   |
| Land, land development & construction-real estate | 1,047 | - | - | 1,047 |
| Commercial and industrial                         | 213   | - | - | 213   |
| Mortgage  |       |   |   |       |
| 1-4 Family  | 171   | - | - | 171   |
| Resort Lending                                    | 1,099 | - | - | 1,099 |
| Installment                                       |       |   |   |       |
| Home equity installment - 1st lien                | 29    | - | - | 29    |
| 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 for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|--|---|---|
| December 31, 2013:                                |  |   |   |
| Measured at Fair Value on a Recurring Basis:      |  |   |   |
| Assets  |  |   |   |
| Trading securities                                | \$498  | \$498   | \$ -                                      |
| Securities available for sale                     |  |   |   |
| U.S. agency                                       | 31,808   | -   | 31,808                                    |
| U.S. agency residential mortgage-backed           | 203,460  | -   | 203,460                                   |
| Private label residential mortgage-backed         | 6,788  | -   | 6,788                                     |
| Other asset backed                                | 45,185   | -   | 45,185                                    |
| Obligations of states and political subdivisions  | 153,678  | -   | 153,678                                   |
| Corporate   | 19,137   | -   | 19,137                                    |
| Trust preferred                                   | 2,425  | -   | 2,425                                     |
| Loans held for sale                               | 20,390   | -   | 20,390                                    |
| Derivatives (1)                                   | 494  | -   | 494                                       |
| Liabilities                                       |  |   |   |
| Derivatives (2)                                   | -  | -   | -   |
| Measured at Fair Value on a Non-recurring basis:  |  |   |   |
| Assets  |  |   |   |
| Capitalized mortgage loan servicing rights (3)    | 7,773  | -   | 7,773                                     |
| Impaired loans (4)                                |  |   |   |
| Commercial  |  |   |   |
| Income producing - real estate                    | 1,997  | -   | 1,997                                     |
| Land, land development & construction-real estate | 673  | -   | 673                                       |
| Commercial and industrial                         | 2,927  | -   | 2,927                                     |
| Mortgage  |  |   |   |
| 1-4 Family  | 1,455  | -   | 1,455                                     |
| Resort Lending                                    | 340  | -   | 340                                       |
| Other real estate (5)                             |  |   |   |
| Commercial  |  |   |   |
| Income producing - real estate                    | 559  | -   | 559                                       |
| Land, land development & construction-real estate | 1,047  | -   | 1,047                                     |
| Mortgage  |  |   |   |

|                            |       |   |   |       |
|----------------------------|-------|---|---|-------|
| 1-4 Family                 | 337   | - | - | 337   |
| Resort Lending             | 1,257 | - | - | 1,257 |
| Installment                |       |   |   |       |
| Home equity - 1st lien     | 29    | - | - | 29    |
| 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)

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2014 and 2013.

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 Three-Month<br>Periods Ended March 31 for Items Measured at<br>Fair Value Pursuant to Election of the Fair Value Option<br>2014 |       |  | 2013                            |        |  |
|---------------------|--|-------|--|---------------------------------|--------|--|
|                     | Net Gains (Losses)<br>on Assets  |       | Total<br>Change<br>in Fair<br>Values<br>Included<br>in Current<br>Period<br>Earnings | Net Gains (Losses)<br>on Assets |        | Total<br>Change<br>in Fair<br>Values<br>Included<br>in Current<br>Period<br>Earnings |
|                     | Securities   | Loans |  | Securities                      | Loans  |  |
| Trading securities  | \$ 112   | \$ -  | \$ 112   | \$ 91                           | \$ -   | \$ 91  |
| Loans held for sale | -  | 30    | 30   | -                               | (694 ) | (694 )   |

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 month periods ended March 31, 2014 and 2013 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 \$7.3 million which is net of a valuation allowance of \$3.1 million at March 31, 2014 and had a carrying amount of \$7.8 million which is net of a valuation allowance of \$2.9 million at December 31, 2013. A recovery (charge) of \$(0.3) million and \$0.8 million was included in our results of operations for the three month periods ending March 31, 2014 and 2013, respectively.

Loans which are measured for impairment using the fair value of collateral for collateral dependent loans, had a carrying amount of \$12.9 million, with a valuation allowance of \$3.7 million at March 31, 2014 and had a carrying amount of \$10.8 million, with a valuation allowance of \$3.4 million at December 31, 2013. The provision for loan losses included in our results of operations relating to impaired loans was an expense of \$1.5 million and a credit of \$0.3 million for the three month periods ending March 31, 2014 and 2013, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$5.8 million which is net of a valuation allowance of \$3.7 million at March 31, 2014 and a carrying amount of \$5.9 million which is net of a valuation allowance of \$4.0 million at December 31, 2013. An additional charge relating to ORE measured at fair value of \$0.1 million and \$0.7 million was included in our results of operations during the three month periods ended March 31, 2014 and 2013, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A reconciliation for all liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31 follows:

|  | (Liability)<br>Amended<br>Warrant<br>2014 | 2013      |
|--|---|-----------|
| Beginning balance  | \$-                                       | \$(459 )  |
| Total losses realized and unrealized:  |   |           |
| Included in results of operations  | -   | (1,045)   |
| Included in other comprehensive income   | -   | -         |
| Purchases, issuances, settlements, maturities and calls  | -   | -         |
| Transfers in and/or out of Level 3   | -   | -         |
| Ending balance   | \$-                                       | \$(1,504) |
| Amount of total losses for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at March 31 | \$-                                       | \$(1,045) |

Because of certain anti-dilution features included in the Amended Warrant, it was not 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. During the third quarter of 2013 we repurchased the Amended Warrant from the UST (see Note #15).

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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          |                |
|--|----------------------|--|--|------------------------|------------------------------|----------------|
| March 31, 2014                             |                      |  |  |                        |                              |                |
| Capitalized mortgage loan servicing rights | \$7,307              | Present value of net servicing revenue | Discount rate<br>Cost to service<br>Ancillary income<br>Float rate |                        | 10.06<br>\$ 83<br>29<br>1.80 | %<br><br><br>% |
| Impaired loans Commercial                  | 7,310                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 0.7                          | %              |
|  |                      | Income approach                        | Capitalization rate  |                        | 9.3                          |                |
| Mortgage                                   | 1,834                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 2.5                          |                |
| Other real estate Commercial               | 1,819                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | (3.2)                        | )              |
| Mortgage and installment                   | 1,299                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 64.1                         |                |
| Payment plan receivables                   | 2,668                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 10.4                         |                |
| December 31, 2013                          |                      |  |  |                        |                              |                |
| Capitalized mortgage loan servicing rights | \$7,773              | Present value of net servicing revenue | Discount rate<br>Cost to service<br>Ancillary income<br>Float rate |                        | 10.09<br>\$ 81<br>29<br>1.79 | %<br><br><br>% |
| Impaired loans Commercial                  | 5,597                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | (1.9)                        | )%             |
|  |                      | Income approach                        | Capitalization rate  |                        | 9.3                          |                |
| Mortgage                                   | 1,795                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 3.2                          |                |
| Other real estate Commercial               | 1,606                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | (5.7)                        | )              |
| Mortgage and installment                   | 1,623                | Sales comparison approach              | Adjustment for differences between comparable sales                |                        | 55.7                         |                |



|                          |       |                           |   |      |
|--------------------------|-------|---------------------------|---|------|
| Payment plan receivables | 2,668 | Sales comparison approach | Adjustment for differences between comparable sales | 10.4 |
|--------------------------|-------|---------------------------|---|------|

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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 |                            |            |                          |
| March 31, 2014      | \$ 14,700                  | \$ 396     | \$ 14,304                |
| December 31, 2013   | 20,390                     | 366        | 20,024                   |

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.

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

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The estimated recorded book balances and fair values follow:

|  | Recorded<br>Book<br>Balance<br>(In thousands) | Fair Value  | Fair Value Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
|--|---|-------------|---|---|---|
| March 31, 2014                             |   |             |   |   |   |
| Assets                                     |   |             |   |   |   |
| Cash and due from banks                    | \$53,815                                      | \$53,815    | \$53,815  | \$ -  | \$ -  |
| Interest bearing deposits                  | 78,125  | 78,125      | 78,125  | -   | -   |
| Interest bearing deposits - time           | 16,875  | 16,907      | -   | 16,907  | -   |
| Trading securities                         | 610   | 610         | 610   | -   | -   |
| Securities available for sale              | 522,935                                       | 522,935     | -   | 522,935   | -   |
| Federal Home Loan Bank and Federal Reserve |   |             |   |   |   |
| Bank Stock                                 | 23,419  | NA          | NA  | NA  | NA  |
| Net loans and loans held for sale          | 1,344,775                                     | 1,337,875   | -   | 14,700  | 1,323,175   |
| Accrued interest receivable                | 6,093   | 6,093       | 7   | 1,740   | 4,346   |
| Derivative financial instruments           | 397   | 397         | -   | 397   | -   |
| Liabilities                                |   |             |   |   |   |
| Deposits with no stated maturity (1)       | \$1,500,125                                   | \$1,500,125 | \$1,500,125   | \$ -  | \$ -  |
| Deposits with stated maturity (1)          | 438,617                                       | 438,727     | -   | 438,727   | -   |
| Other borrowings                           | 12,943  | 12,943      | -   | 12,943  | -   |
| Subordinated debentures                    | 40,723  | 27,862      | -   | 27,862  | -   |
| Accrued interest payable                   | 430   | 430         | 20  | 410   | -   |
| Derivative financial instruments           | -   | -           | -   | -   | -   |
| December 31, 2013                          |   |             |   |   |   |
| Assets                                     |   |             |   |   |   |
| Cash and due from banks                    | \$48,156                                      | \$48,156    | \$48,156  | \$ -  | \$ -  |
| Interest bearing deposits                  | 70,925  | 70,925      | 70,925  | -   | -   |
| Interest bearing deposits - time           | 17,999  | 18,000      | -   | 18,000  | -   |
| Trading securities                         | 498   | 498         | 498   | -   | -   |
| Securities available for sale              | 462,481                                       | 462,481     | -   | 462,481   | -   |
| Federal Home Loan Bank and Federal Reserve |   |             |   |   |   |
| Bank Stock                                 | 23,419  | NA          | NA  | NA  | NA  |
| Net loans and loans held for sale          | 1,362,635                                     | 1,333,229   | -   | 20,390  | 1,312,839   |
| Accrued interest receivable                | 5,948   | 5,948       | 1   | 1,426   | 4,521   |
| Derivative financial instruments           | 494   | 494         | -   | 494   | -   |
| Liabilities                                |   |             |   |   |   |

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|                                      |             |             |             |         |     |
|--------------------------------------|-------------|-------------|-------------|---------|-----|
| Deposits with no stated maturity (1) | \$1,440,225 | \$1,440,225 | \$1,440,225 | \$-     | \$- |
| Deposits with stated maturity (1)    | 444,581     | 446,366     | -           | 446,366 | -   |
| Other borrowings                     | 17,188      | 19,726      | -           | 19,726  | -   |
| Subordinated debentures              | 40,723      | 27,871      | -           | 27,871  | -   |
| Accrued interest payable             | 445         | 445         | 20          | 425     | -   |
| Derivative financial instruments     | -           | -           | -           | -       | -   |

(1) Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$10.3 million and \$11.2 million at March 31, 2014 and December 31, 2013, respectively. Deposits with a stated maturity include reciprocal deposits with a recorded book balance of \$66.8 million and \$72.3 million at March 31, 2014 and December 31, 2013, respectively.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

14. Contingent Liabilities

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$0.5 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages and involve claims for which, at this point, we believe have little to no merit, 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 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 March 31, 2014, the aggregate amount of such obligations owing to Mepco by counterparties, net of write-downs and reserves made through the recognition of vehicle service contract counterparty contingencies expense, totaled \$7.1 million. This compares to a balance of \$7.7 million at December 31, 2013. Mepco is currently in the process of working to recover these receivables, primarily through litigation against counterparties.

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

When counterparties do not honor their contractual obligations to Mepco to repay funds, we recognize estimated losses. Mepco pursues collection (including commencing legal action if necessary) of funds due to it under its various contracts with counterparties. Mepco has had to initiate litigation against certain counterparties, including third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. Charges related to estimated losses for vehicle service contract counterparty contingencies included in non-interest expense totaled \$0.1 million for both the three month periods ended March 31, 2014 and 2013. 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.

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. The provision for loss reimbursement on sold loans was a credit of \$0.5 million and an expense of \$0.7 million in the first quarters of 2014 and 2013, respectively. The credit provision in the first quarter of 2014 is due primarily to the rescission of certain loss reimbursement requests by Freddie Mac that had been pending and accrued for at the end of 2013.

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Historically, loss reimbursements on mortgage loans sold without recourse were 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 from 2010 to 2013 as Fannie Mae and Freddie Mac, in particular, were doing more reviews of mortgage loans where they had incurred or expected to incur a loss and were more aggressive in pursuing loss reimbursements from the sellers of such mortgage loans. In November 2013, we executed a Resolution Agreement with Fannie Mae to resolve our existing and future repurchase and make whole obligations (collectively “Repurchase Obligations”) related to mortgage loans originated between January 1, 2000 and December 31, 2008 and delivered to them by January 31, 2009. Under the terms of the Resolution Agreement, we paid Fannie Mae approximately \$1.5 million in November 2013 with respect to the Repurchase Obligations. We believe that it was in our best interest to execute the Resolution Agreement in order to bring finality to the loss reimbursement exposure with Fannie Mae for these years and reduce the resources spent on individual file reviews and defending loss reimbursement requests. In addition, we were notified by Freddie Mac in January 2014 that they had completed their review of mortgage loans that we originated between January 1, 2000 and December 31, 2008 and delivered to them. The reserve for loss reimbursements on sold mortgage loans totaled \$0.7 million and \$1.4 million at March 31, 2014 and December 31, 2013, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at March 31, 2014 and December 31, 2013 also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

15. Shareholders’ Equity

On July 26, 2013 we executed a Securities Purchase Agreement (“SPA”) with the UST. Under the terms of the SPA, we 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 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”). On August 30, 2013 we closed the SPA transaction with the UST and we exited the Troubled Asset Relief Program (“TARP”). On that date the Series B Preferred Stock and Amended Warrant had book balances of \$87.2 million (including accrued dividends) and \$1.5 million, respectively. This transaction resulted in a discount of \$7.7 million of which \$7.6 million was allocated to the Series B Preferred Stock and included in net income applicable to common stock and \$0.1 million was allocated to the Amended Warrant and recorded to common stock.

On August 28, 2013 we sold 11.5 million shares of our common stock for gross proceeds of \$89.1 million in a public offering and on September 10, 2013 we sold an additional 1.725 million shares of our common stock for gross proceeds of \$13.4 million pursuant to the underwriters’ overallotment option (collectively, the “Common Stock Offering”). The net proceeds from the Common Stock Offering were approximately \$97.1 million.

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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.

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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.

16. Accumulated Other Comprehensive Loss (“AOCL”)

A summary of changes in AOCL follows (1):

|   | Unrealized  | Dispropor-<br>tionate<br>Tax<br>Effects | Unrealized<br>Losses<br>on<br>Cash<br>Flow<br>Hedges | Unrealized<br>Losses<br>on<br>Settled<br>Derivatives | Dispropor-<br>tionate<br>Tax<br>Effects<br>from Cash<br>Flow<br>Hedges | Total      |
|---|-------------|---|--|--|--|------------|
| For the three months ended March 31,<br>2014                  |             |   |  |  |  |            |
| Balances at beginning of period                               | \$ (3,200 ) | \$ (5,798 )                             | \$-  | \$ (247 )  | \$ -   | \$ (9,245) |
| Other comprehensive income before<br>reclassifications        | 1,539       | -                                       | -  | -  | -  | 1,539      |
| Amounts reclassified from AOCL                                | -           | -                                       | -  | 62   | -  | 62         |
| Net current period other comprehensive income                 | 1,539       | -                                       | -  | 62   | -  | 1,601      |
| Balances at end of period                                     | \$ (1,661 ) | \$ (5,798 )                             | \$-  | \$ (185 )  | \$ -   | \$ (7,644) |
| For the three months ended March 31,<br>2013                  |             |   |  |  |  |            |
| Balances at beginning of period                               | \$ (516 )   | \$ (5,617 )                             | \$ (739)   | \$ -   | \$ (1,186 )  | \$ (8,058) |
| Other comprehensive income (loss) before<br>reclassifications | 1,007       | -                                       | (3 )   | -  | -  | 1,004      |
| Amounts reclassified from AOCL                                | 7           | -                                       | 94   | -  | -  | 101        |
| Net current period other comprehensive income                 | 1,014       | -                                       | 91   | -  | -  | 1,105      |
| Balances at end of period                                     | \$ 498      | \$ (5,617 )                             | \$ (648)   | \$ -   | \$ (1,186 )  | \$ (6,953) |

(1) 2014 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).

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.

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A summary of reclassifications out of each component of AOCL for the three months ended March 31 follows:

| AOCL Component                                     | Amount<br>Reclassified<br>From<br>AOCL<br>(In<br>thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|--|---|--|
| 2014   |   |  |
| Unrealized losses on available for sale securities | \$ -  | Net gains on securities  |
|  | -   | Net impairment loss recognized in earnings                               |
|  | -   | Total reclassifications before tax                                       |
|  | -   | Tax expense (benefit)  |
|  | \$ -  | Reclassifications, net of tax  |
| Unrealized losses on settled derivatives           | \$ 95   | Interest expense   |
|  | 33  | Tax expense (benefit)  |
|  | \$ 62   | Reclassification, net of tax   |
|  | \$ 62   | Total reclassifications for the period, net of tax                       |
| 2013   |   |  |
| Unrealized losses on available for sale securities | \$ (7   | ) Net gains on securities  |
|  | -   | Net impairment loss recognized in earnings                               |
|  | (7  | ) Total reclassifications before tax                                     |
|  | -   | Tax expense (benefit)  |
|  | \$ (7   | ) Reclassifications, net of tax  |
| Unrealized losses on cash flow hedges              | \$ (94  | ) Interest expense   |
|  | -   | Tax expense (benefit)  |
|  | \$ (94  | ) Reclassification, net of tax   |
|  | \$ (101   | ) Total reclassifications for the period, net of tax                     |

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ITEM 2.

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

**Introduction.** The following section presents additional information to assess the financial condition and results of operations of Independent Bank Corporation, its wholly-owned bank, Independent Bank (the "Bank"), and their subsidiaries. This section should be read in conjunction with the Condensed Consolidated Financial Statements. We also encourage you to read our 2013 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC"). That report includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

**Overview.** We provide banking services to customers located primarily in Michigan's Lower Peninsula. As a result, our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula. We have in general experienced a difficult economy in Michigan since 2001, which has had significant adverse effects on our performance. As a result of the recession, we incurred net losses from 2008 through 2011 and found it necessary to take certain steps to preserve capital and maintain our regulatory capital ratios.

Economic conditions in Michigan began to show signs of improvement during 2010. Generally, these improvements have continued into 2014, albeit at an uneven pace, as evidenced, in part, by an overall decline in the unemployment rate (although Michigan's unemployment rate has been consistently above the national average). In addition, housing prices and other related statistics (such as home sales and new building permits) have generally been improving. In addition, since early- to mid-2009, we have seen an improvement in asset quality metrics. In particular, since early 2012, we have generally experienced a decline in non-performing assets, reduced levels of new loan defaults, and reduced levels of net loan charge-offs. As a result of the foregoing factors and others, we returned to profitability in 2012 and have now been profitable for nine consecutive quarters. In addition, we have completed various transactions to improve our capital structure, as described below.

**Recent Developments.** In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was enacted. 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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In 2013, we successfully completed the implementation of a capital plan we had adopted to restore and improve our capital position. In particular, during the last half of 2013, we completed the following:

On July 26, 2013, we executed a Securities Purchase Agreement (“SPA”) with the United States Department of the Treasury (“UST”), pursuant to which we 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”);

In the third quarter of 2013, we sold a total of 13.225 million shares of our common stock in a public offering for total net proceeds of \$97.1 million (including 11.5 million shares sold on August 28, 2013, and 1.725 million shares sold on September 10, 2013 pursuant to the underwriters’ overallotment option), after payment of \$5.4 million in underwriting discounts and other offering expenses (the “Common Stock Offering”);

On August 29, 2013, we brought current the interest payments and quarterly dividends we had been deferring since the fourth quarter of 2009 on all of our subordinated debentures and trust preferred securities;

On August 30, 2013, we completed the redemption of the Series B Preferred Stock and Amended Warrant from the UST pursuant to the terms of the Securities Purchase Agreement described above, which resulted in our exit from the Troubled Asset Relief Program (TARP); and

On October 11, 2013, we redeemed all of the 8.25% trust preferred securities (with an aggregate liquidation amount of \$9.2 million) issued by IBC Capital Finance II.

On July 2, 2013, the Federal Reserve Board (the “FRB”) approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”). The rule 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 2.5% 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. We believe that we currently exceed all of the capital ratio requirements of the New Capital Rules.

It is against this backdrop that we discuss our results of operations and financial condition in the first quarter of 2014 as compared to 2013.

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## RESULTS OF OPERATIONS

Summary. We recorded net income and net income applicable to common stock of \$3.1 million during the three months ended March 31, 2014, compared to net income of \$5.8 million and net income applicable to common stock of \$4.7 million during the three months ended March 31, 2013. The decline in net income is primarily due to decreases in net interest income and non-interest income and increases in the provision for loan losses and income tax expense that were partially offset by a decline in non-interest expenses.

Key performance ratios<sup>(a)</sup>

|                                     | Three months<br>ended March<br>31,<br>2014 |        | 2013 |
|-------------------------------------|--|--------|------|
| Net income (annualized) to          |  |        |      |
| Average assets                      | 0.57%                                      | 0.93   | %    |
| Average common shareholders' equity | 5.41                                       | 34.76  |      |
| Net income per common share         |  |        |      |
| Basic                               | \$0.14                                     | \$0.51 |      |
| Diluted                             | 0.13                                       | 0.27   |      |

<sup>(a)</sup> For 2013 these amounts are calculated using net income applicable to common stock.

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.

Net interest income totaled \$18.5 million during the first quarter of 2014, which represents a \$1.1 million, or 5.5% decrease, from the comparable quarter one year earlier. The decrease in net interest income in 2014 compared to 2013 primarily reflects a 46 basis point decrease in our tax equivalent net interest income as a percent of average interest-earning assets (the "net interest margin") that was partially offset by a \$115.9 million increase in average interest-earning assets.

The decline in our net interest margin is primarily due to the prolonged low interest rate environment and a shift in our average interest-earning assets mix, as higher yielding loans have declined and lower yielding investment securities have increased.



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Interest rates have generally been at extremely low levels over the past five to six years due primarily to the FRB'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 FRB, short-term interest rates are expected to remain extremely low until at least 2015. However, during 2013, mid- to long-term interest rates began to increase (for example the 10-year U.S. treasury yield increased to 2.73% at the end of the first quarter of 2014 from 1.87% at the end of the first 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.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the first quarter of 2014 non-accrual loans averaged \$18.6 million compared to \$31.0 million in the first quarter of 2013.

## Average Balances and Rates

|   | Three Months Ended |          |                     | 2013            |          |                     |
|---|--------------------|----------|---------------------|-----------------|----------|---------------------|
|   | March 31, 2014     |          |                     | Average         |          |                     |
|   | Average Balance    | Interest | Rate <sup>(3)</sup> | Average Balance | Interest | Rate <sup>(3)</sup> |
| (Dollars in thousands)  |                    |          |                     |                 |          |                     |
| Assets <sup>(1)</sup>   |                    |          |                     |                 |          |                     |
| Taxable loans   | \$1,369,065        | \$18,162 | 5.36 %              | \$1,436,527     | \$20,649 | 5.81 %              |
| Tax-exempt loans <sup>(2)</sup>                                     | 5,193              | 82       | 6.40                | 5,884           | 94       | 6.48                |
| Taxable securities  | 441,783            | 1,383    | 1.27                | 199,876         | 670      | 1.36                |
| Tax-exempt securities <sup>(2)</sup>                                | 41,023             | 399      | 3.94                | 24,200          | 362      | 6.07                |
| Cash – interest bearing   | 108,855            | 91       | 0.34                | 186,065         | 120      | 0.26                |
| Other investments   | 23,419             | 332      | 5.75                | 20,838          | 212      | 4.13                |
| Interest Earning Assets   | 1,989,338          | 20,449   | 4.16                | 1,873,390       | 22,107   | 4.77                |
| Cash and due from banks   | 45,439             |          |                     | 45,583          |          |                     |
| Other assets, net   | 188,246            |          |                     | 142,300         |          |                     |
| Total Assets  | \$2,223,023        |          |                     | \$2,061,273     |          |                     |
| Liabilities   |                    |          |                     |                 |          |                     |
| Savings and interest-bearing checking                               | \$946,295          | 263      | 0.11                | \$894,348       | 282      | 0.13                |
| Time deposits   | 443,630            | 1,030    | 0.94                | 423,713         | 1,247    | 1.19                |
| Other borrowings  | 54,329             | 512      | 3.82                | 67,802          | 865      | 5.17                |
| Interest Bearing Liabilities  | 1,444,254          | 1,805    | 0.51                | 1,385,863       | 2,394    | 0.70                |
| Non-interest bearing deposits                                       | 511,463            |          |                     | 493,952         |          |                     |
| Other liabilities   | 32,284             |          |                     | 41,683          |          |                     |
| Shareholders' equity  | 235,022            |          |                     | 139,775         |          |                     |
| Total liabilities and shareholders' equity                          | \$2,223,023        |          |                     | \$2,061,273     |          |                     |
| Net Interest Income   |                    | \$18,644 |                     |                 | \$19,713 |                     |
| Net Interest Income as a Percent of Average Interest Earning Assets |                    |          | 3.79 %              |                 |          | 4.25 %              |

(1) All domestic.

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

(3) Annualized.



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Provision for loan losses. The provision for loan losses was an expense of \$0.4 million and a credit of \$0.7 million in the first quarters of 2014 and 2013, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See “Portfolio Loans and asset quality” for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the first quarter of 2014.

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 \$9.0 million during the first three months of 2014 compared to \$11.1 million in 2013.

## Non-Interest Income

|   | Three months<br>ended<br>March 31,<br>2014 2013<br>(In thousands) |          |
|---|---|----------|
| Service charges on deposit accounts             | \$3,055   | \$3,406  |
| Interchange income                              | 1,941   | 1,757    |
| Net gains on assets                             |   |          |
| Mortgage loans                                  | 1,144   | 3,637    |
| Securities                                      | 112   | 84       |
| Mortgage loan servicing                         | 264   | 622      |
| Investment and insurance commissions            | 402   | 450      |
| Bank owned life insurance                       | 319   | 338      |
| Title insurance fees                            | 274   | 484      |
| Increase in fair value of U.S. Treasury warrant | -   | (1,045 ) |
| Other   | 1,444   | 1,335    |
| Total non-interest income                       | \$8,955   | \$11,068 |

Service charges on deposit accounts totaled \$3.1 million in the first quarter of 2014, a \$0.4 million, or 10.3%, decrease from the comparable period in 2013. The decrease in such service charges in 2014 principally results from a decline in non-sufficient funds (“NSF”) occurrences and related NSF fees. We believe the decline in NSF occurrences is principally due to our customers managing their finances more closely in order to reduce NSF activity and avoid the associated fees.

Interchange income increased by \$0.2 million, or 10.5%, in the first quarter of 2014 compared to the year ago period. The increase in interchange income primarily results from increased debit card transaction activity. In January 2014, we executed a new Debit Brand Agreement with MasterCard (which replaces our former agreement with VISA). We expect to convert our debit card base to MasterCard in May and June of 2014, and assuming similar future transaction volumes, we expect this new agreement to result in an increase in our annual interchange net revenues of approximately \$1 million.

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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 significantly lower than previous averages. However, debit card issuers with less than \$10 billion in assets (like us) are exempt from this rule. On a long-term basis, it is not clear how competitive market factors may impact debit card issuers who are exempt from the rule. However, we have been experiencing some reduction in per transaction interchange revenue due to certain transaction routing changes, particularly at large merchants.

Net gains on mortgage loans were \$1.1 million and \$3.6 million in the first quarters of 2014 and 2013, respectively. Mortgage loan sales totaled \$47.1 million in the first quarter of 2014 compared to \$130.5 million in the first quarter of 2013. Mortgage loans originated totaled \$44.2 million in the first quarter of 2014 compared to \$128.7 million in the comparable quarter of 2013. The declines in mortgage loan originations, sales and net gains in 2014 as compared to 2013 is due primarily to an increase in mortgage loan interest rates that significantly reduced mortgage loan refinance volumes.

## Mortgage Loan Activity

|  | Three months ended     |           |
|--|------------------------|-----------|
|  | March 31,              |           |
|  | 2014                   | 2013      |
|  | (Dollars in thousands) |           |
| Mortgage loans originated  | \$44,241               | \$128,732 |
| Mortgage loans sold  | 47,118                 | 130,456   |
| Mortgage loans sold with servicing rights released                     | 7,861                  | 14,537    |
| Net gains on the sale of mortgage loans                                | 1,144                  | 3,637     |
| Net gains as a percentage of mortgage loans sold (“Loan Sales Margin”) | 2.43 %                 | 2.79 %    |
| Fair value adjustments included in the Loan Sales Margin               | (0.14 )                | (0.74 )   |

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. 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 2.57% and 3.53% in the first quarters of 2014 and 2013, respectively. The decrease in the Loan Sales Margin (excluding fair value adjustments) in 2014 was generally due to a narrowing of primary-to-secondary market pricing spreads reflecting increased price competition.

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We recorded securities net gains of approximately \$0.1 million in both the first quarter of 2014 and 2013. These securities net gains are due to an increase in the fair value of our trading securities.

We recorded no net impairment losses in either the first quarter of 2014 or 2013, for other than temporary impairment of securities available for sale. (See "Securities.")

Mortgage loan servicing generated income of \$0.3 million and \$0.6 million in the first quarters of 2014 and 2013, respectively. This quarterly comparative variance is primarily due to changes in the valuation allowance on and the amortization of capitalized mortgage loan servicing rights. The period end valuation allowance is based on the valuation of the mortgage loan servicing portfolio. Activity related to capitalized mortgage loan servicing rights is as follows:

| Capitalized Mortgage Loan Servicing Rights | Three months ended |          |
|--|--------------------|----------|
|  | March 31, 2014     | 2013     |
|  | (In thousands)     |          |
| Balance at beginning of period             | \$13,710           | \$11,013 |
| Originated servicing rights capitalized    | 382                | 1,029    |
| Amortization                               | (534 )             | (1,210 ) |
| (Increase) decrease in valuation allowance | (285 )             | 758      |
| Balance at end of period                   | \$13,273           | \$11,590 |
| Valuation allowance at end of period       | \$3,140            | \$5,329  |

At March 31, 2014 we were servicing approximately \$1.72 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.50% and a weighted average service fee of approximately 25.3 basis points. Remaining capitalized mortgage loan servicing rights at March 31, 2014 totaled \$13.3 million, representing approximately 77 basis points on the related amount of mortgage loans serviced for others. The capitalized mortgage loan servicing had an estimated fair market value of \$14.3 million at March 31, 2014.

Investment and insurance commissions declined modestly (by \$0.048 million) during the first quarter of 2014 as compared to the year ago period due primarily to a change in sales mix.

We earned \$0.3 million in both the first quarter of 2014 and 2013, principally as a result of increases in the cash surrender value of our separate account bank owned life insurance. Our separate account is primarily invested in agency mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The slight decline in earnings in 2014 primarily reflects lower returns on agency mortgage-backed securities. The total cash surrender value of our bank owned life insurance was \$52.6 million and \$52.3 million at March 31, 2014 and December 31, 2013, respectively.

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Title insurance fees totaled \$0.3 million and \$0.5 million in the first quarters of 2014 and 2013, respectively. The amount of title insurance fees is primarily a function of the level of mortgage loans that we originated.

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). (See "Liquidity and capital resources.") The Amended Warrant was purchased from the UST and retired on August 30, 2013 pursuant to the SPA.

Two significant inputs in the valuation model for the Amended Warrant were our common stock price and the probability of triggering anti-dilution provisions in this instrument related to certain equity transactions. The fair value of the Amended Warrant increased by \$1.0 million in the first quarter of 2013 due primarily to a rise in our common stock price during that quarter.

Other non-interest income totaled \$1.4 million and \$1.3 million during the first quarters of 2014 and 2013, respectively. This increase is primarily due to an increase in rental income on other real estate owned ("ORE").

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 totaled \$22.4 million in the first quarter of 2014 compared to \$25.5 million in the year ago period. This decrease was primarily due to declines in credit related costs (loan and collection expenses, net losses on ORE and repossessed assets and vehicle service contract counterparty contingencies), FDIC deposit insurance, legal and professional fees, and the provision for loss reimbursement on sold loans.

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## Non-Interest Expense

|  | Three months<br>ended<br>March 31, |          |
|--|------------------------------------|----------|
|  | 2014                               | 2013     |
|  | (In thousands)                     |          |
| Compensation   | \$8,308                            | \$8,205  |
| Performance-based compensation                                 | 912                                | 1,062    |
| Payroll taxes and employee benefits                            | 2,018                              | 2,040    |
| Compensation and employee benefits                             | 11,238                             | 11,307   |
| Occupancy, net   | 2,483                              | 2,424    |
| Data processing  | 2,086                              | 1,916    |
| Loan and collection  | 1,465                              | 2,226    |
| Furniture, fixtures and equipment                              | 1,069                              | 1,032    |
| Communications   | 789                                | 780      |
| Advertising  | 519                                | 570      |
| FDIC deposit insurance   | 417                                | 630      |
| Interchange expense  | 402                                | 410      |
| Legal and professional fees                                    | 401                                | 692      |
| Credit card and bank service fees                              | 263                                | 334      |
| Supplies   | 239                                | 250      |
| Amortization of intangible assets                              | 134                                | 203      |
| Vehicle service contract counterparty contingencies            | 68                                 | 127      |
| Cost (recoveries) related to unfunded lending commitments      | 10                                 | (19 )    |
| Net (gains) losses on other real estate and repossessed assets | (87 )                              | 652      |
| Provision for loss reimbursement on sold loans                 | (481 )                             | 663      |
| Other  | 1,385                              | 1,276    |
| Total non-interest expense                                     | \$22,400                           | \$25,473 |

Compensation and employee benefits expenses, in total, decreased by \$0.07 million, or 0.6%, in the first quarter of 2014, primarily because of staffing reductions.

Compensation expense increased by \$0.1 million, or 1.3%. Average full-time equivalent employees ("FTE's") were reduced by 38.5, or 4.5%, during the first quarter of 2014 compared to the year ago quarter. However, the impact of the FTE reductions was more than offset by a \$0.3 million reduction in the amount of deferred compensation related to direct loan origination costs because of the reduced levels of new loan volume in 2014.

Performance-based compensation decreased by \$0.2 million in 2014 due primarily to a lower accrual for the anticipated employee stock ownership plan contribution and due to reduced commissions for loan personnel.

Payroll taxes and employee benefits decreased slightly in 2014 due primarily to declines in payroll taxes and medical and dental insurance costs principally resulting from the FTE reductions enumerated above.

Occupancy, net, increased slightly in the first quarter of 2014 compared to 2013 because of a \$0.2 million increase in snow removal costs associated with the harsh Michigan winter in 2014.

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Data processing expense increased \$0.2 million, or 8.9%, in the first quarter of 2014 compared to the year earlier period due primarily to the write-off of certain deferred but unamortized costs related to our core data processing contract that was scheduled to expire in April 2015. In March 2014, we entered into a new seven-year core data processing contract which replaced the contract expiring in April 2015. Under the terms of the new contract, we expect to reduce core data processing costs by approximately \$1 million annually beginning in the second quarter of 2014.

Loan and collection expenses primarily reflect costs related to the management and collection of non-performing loans and other problem credits. These expenses have further declined in 2014, which primarily reflects the overall year-over-year decrease in non-performing assets and “watch” credits. (See “Portfolio Loans and asset quality.”)

Furniture, fixtures and equipment, communications, advertising, interchange and supplies expenses were collectively relatively unchanged at a total of approximately \$3.0 million in both the first quarter of 2014 and 2013.

FDIC deposit insurance expense totaled \$0.4 million and \$0.6 million in the first quarters of 2014 and 2013, respectively. The decline in 2014 principally reflects a reduction in the Bank’s risk based premium rate that occurred in the fourth quarter of 2013 due to our improved financial metrics.

Legal and professional fees decreased \$0.3 million, or 42.1%, in the first quarter of 2014 compared to the year earlier period due primarily to a decline in legal fees at Mepco related to counterparty litigation associated with collection matters and a decline in consulting fees at the Bank.

Credit card and bank service fees decreased primarily due to a decline in the number of payment plans being serviced by Mepco in the first quarter of 2014 compared to the first quarter of 2013.

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 \$3.0 million and \$3.2 million at March 31, 2014 and December 31, 2013, respectively. See Note #8 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets.

We record estimated incurred losses associated with Mepco’s vehicle service contract payment plan receivables in our provision for loan losses and establish a related allowance for loan losses. (See “Portfolio Loans and asset quality.”) We record estimated incurred losses associated with defaults by Mepco’s counterparties as “vehicle service contract counterparty contingencies expense,” which is included in non-interest expenses in our Condensed Consolidated Statements of Operations. Such expenses totaled \$0.1 million in both the first quarter of 2014 and 2013.

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, 2013, Mepco has had to initiate litigation against certain counterparties, including third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. In addition, see Note #14 to the Condensed Consolidated Financial Statements included within this report for more information about Mepco's business, certain risks and difficulties we currently face with respect to that business, and reserves we have established (through vehicle service contract counterparty contingencies expense) for losses related to the business.

The changes in cost (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.

Net (gains) losses on ORE and repossessed assets primarily represent the gain or loss on the sale or additional write downs on these assets subsequent to the transfer of the asset from our loan portfolio. This transfer occurs at the time we acquire the collateral that secured the loan. At the time of acquisition, the other real estate or repossessed asset is valued at fair value, less estimated costs to sell, which becomes the new basis for the asset. Any write-downs at the time of acquisition are charged to the allowance for loan losses. The modest net gain of \$0.1 million in 2014 (as compared to a net loss of \$0.7 million in 2013) primarily reflects greater stability in real estate prices during the last twelve months, with some markets even experiencing price increases.

The provision for loss reimbursement on sold loans was a credit of \$0.5 million and an expense of \$0.7 million in the first quarters of 2014 and 2013, respectively, and represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae and Freddie Mac). The credit provision in the first quarter of 2014 is due primarily to the rescission of certain loss reimbursement requests by Freddie Mac that had been pending and accrued for at the end of 2013. Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. Historically, loss reimbursements on mortgage loans sold without recourse were 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 from 2010 to 2013 as Fannie Mae and Freddie Mac, in particular, were doing more reviews of mortgage loans where they had incurred or expected to incur a loss and were more aggressive in pursuing loss reimbursements from the sellers of such mortgage loans. In November 2013, we executed a Resolution Agreement with Fannie Mae to resolve our existing and future repurchase and make whole obligations (collectively "Repurchase Obligations") related to mortgage loans originated between January 1, 2000 and December 31, 2008 and delivered to them by January 31, 2009. Under the terms of the Resolution Agreement, we paid Fannie Mae approximately \$1.5 million in November 2013 with respect to the Repurchase Obligations. We believe that it was in our best interest to execute the Resolution Agreement in order to bring finality to the loss reimbursement exposure with Fannie Mae for these years and reduce the resources spent on individual file reviews and defending loss reimbursement requests. In addition, we were notified by Freddie Mac in January 2014 that they had completed their review of mortgage loans that we originated between January 1, 2000 and December 31, 2008 and delivered to them. The reserve for loss reimbursements on sold mortgage loans totaled \$0.7 million and \$1.4 million at March 31, 2014 and December 31, 2013, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at March 31, 2014 and December 31, 2013 also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

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Other non-interest expenses increased by \$0.1 million in the first quarter of 2014 compared to 2013 due primarily to an increase in fraud related costs.

Income tax expense. We recorded an income tax expense of \$1.5 million and \$0.035 million in the first quarters of 2014 and 2013, respectively. 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 the first quarter of 2013, the income tax expense related to our income before income tax was largely offset by the change in the deferred tax valuation allowance.

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 concluded that the realization of substantially all of our deferred tax assets was more likely than not. That conclusion was primarily based upon the following factors:

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

We have also concluded subsequent to June 30, 2013, that the realization of substantially all of our deferred tax assets continues to be more likely than not for substantially the same reasons as enumerated above, including three additional quarterly profits since the second quarter of 2013. In 2013, we recorded a \$56.0 million reduction in the valuation allowance on our deferred tax assets.

The valuation allowance against our deferred tax assets totaled approximately \$1.1 million, \$1.1 million and \$62.5 million at March 31, 2014, December 31, 2013 and March 31, 2013, respectively. The portion of the valuation allowance on our deferred tax assets that we did not reverse in 2013 primarily relates to state income taxes at our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business over the past three years.

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Because of our net operating loss and tax credit carryforwards, we are still subject to the rules of Section 382 of the Internal Revenue Code of 1986, as amended. An ownership change, as defined by these rules, would negatively affect our ability to utilize our net operating loss carryforwards and other deferred tax assets in the future. If such an ownership change were to occur, we may suffer higher-than-anticipated tax expense, and consequently lower net income and cash flow, in those future years. Although we cannot control market purchases or sales of our common stock, we have in place a Tax Benefits Preservation Plan to dissuade any movement in our stock that would trigger an ownership change, and we limited the size of our Common Stock Offering 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 and also for the first quarter of 2013, the impact of the change 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.

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

## Business Segments

|                      | Three months<br>ended March 31, |         |
|----------------------|---------------------------------|---------|
|                      | 2014                            | 2013    |
|                      | (In thousands)                  |         |
| Independent Bank     | \$3,182                         | \$7,064 |
| Mepco                | 243                             | 543     |
| Other <sup>(1)</sup> | (263 )                          | (1,776) |
| Elimination          | (24 )                           | (24 )   |
| Net income           | \$3,138                         | \$5,807 |

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

The decline in net income at Independent Bank in 2014 compared to 2013 is primarily due to decreases in net interest income and non-interest income and increases in the provision for loan losses and income tax expense that were partially offset by a decline in non-interest expense. (See “Net interest income,” “Non-interest income,” “Non-interest expense,” “Income tax expense,” “Provision for loan losses,” and “Portfolio Loans and asset quality.”)

The decline in Mepco’s net income to \$0.2 million in the first quarter of 2014 from \$0.5 million in the first quarter of 2013 is due to a decrease in net interest income as a result of the reduction in payment plan receivables. All of Mepco’s funding is provided by Independent Bank through an intercompany loan (that is eliminated in consolidation). The rate on this intercompany loan is based on the Prime Rate (currently 3.25%). Mepco might not be able to obtain such favorable funding costs on its own in the open market.

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The change in other in the table above (a net loss of \$0.3 million in the first quarter of 2014 as compared to a net loss of \$1.8 million in the first quarter of 2013) is due primarily to lower interest expense in 2014 and to the first quarter 2013 change in fair value of the Amended Warrant (see "Non-interest income").

## FINANCIAL CONDITION

**Summary.** Our total assets increased by \$49.7 million during the first three months of 2014 due primarily to increases in cash and cash equivalents and securities available for sale that were partially offset by a decline in loans. Loans, excluding loans held for sale ("Portfolio Loans"), totaled \$1.36 billion at March 31, 2014, down 1.0% from \$1.37 billion at December 31, 2013. (See "Portfolio Loans and asset quality.")

Deposits totaled \$1.94 billion at March 31, 2014, compared to \$1.88 billion at December 31, 2013. The \$53.9 million increase in total deposits during the period is primarily due to growth in checking and savings account balances.

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

## Securities

|                               | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-------------------------------|-------------------|---------------------|----------------------|---------------|
|                               |                   | (In<br>thousands)   |                      |               |
| Securities available for sale |                   |                     |                      |               |
| March 31, 2014                | \$ 525,491        | \$ 2,621            | \$ 5,177             | \$ 522,935    |
| December 31, 2013             | 467,406           | 2,048               | 6,973                | 462,481       |

Securities available for sale increased during 2014 due primarily to the purchase of U.S. government-sponsored agency mortgage-backed securities, asset-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 loans held for sale as well as from the increase in total deposits. (See "Deposits" and "Liquidity and capital resources.")

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Our portfolio of available-for-sale securities is reviewed quarterly for impairment in value. In performing this review, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet these recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income or loss. We recorded no net other than temporary impairment charges in earnings on securities in either of the first quarters of 2014 or 2013.

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

|                        | Three months<br>ended<br>March 31,<br>2014 2013<br>(In thousands) |         |
|------------------------|---|---------|
| Proceeds               | \$-   | \$1,800 |
| Gross gains            | \$-   | \$-     |
| Gross losses           | -   | (7 )    |
| Net impairment charges | -   | -       |
| Fair value adjustments | 112   | 91      |
| Net gains              | \$112   | \$84    |

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

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

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

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

|  | March<br>31,<br>2014      | December<br>31,<br>2013 |        |   |
|--|---------------------------|-------------------------|--------|---|
|  | (Dollars in<br>thousands) |                         |        |   |
| Non-accrual loans  | \$20,711                  | \$ 17,905               |        |   |
| Loans 90 days or more past due and still accruing interest     | 115                       | -                       |        |   |
| Total non-performing loans                                     | 20,826                    | 17,905                  |        |   |
| Other real estate and repossessed assets                       | 18,001                    | 18,282                  |        |   |
| Total non-performing assets                                    | \$38,827                  | \$ 36,187               |        |   |
| As a percent of Portfolio Loans                                |                           |                         |        |   |
| Non-performing loans   | 1.53                      | %                       | 1.30   | % |
| Allowance for loan losses                                      | 2.24                      |                         | 2.35   |   |
| Non-performing assets to total assets                          | 1.72                      |                         | 1.64   |   |
| Allowance for loan losses as a percent of non-performing loans | 146.15                    |                         | 180.54 |   |

<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”)

|                                     | March 31, 2014 |                      |            |
|-------------------------------------|----------------|----------------------|------------|
|                                     | Commercial     | Retail               | Total      |
|                                     | (In thousands) |                      |            |
| Performing TDR’s                    | \$32,208       | \$78,152             | \$ 110,360 |
| Non-performing TDR’s <sup>(1)</sup> | 5,354          | 5,819 <sup>(2)</sup> | 11,173     |
| Total                               | \$37,562       | \$83,971             | \$ 121,533 |

|                                     | December 31,<br>2013 |                      |            |
|-------------------------------------|----------------------|----------------------|------------|
|                                     | Commercial           | Retail               | Total      |
|                                     | (In thousands)       |                      |            |
| Performing TDR’s                    | \$35,134             | \$79,753             | \$ 114,887 |
| Non-performing TDR’s <sup>(1)</sup> | 4,347                | 4,988 <sup>(2)</sup> | 9,335      |
| Total                               | \$39,481             | \$84,741             | \$ 124,222 |

<sup>(1)</sup> Included 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.

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Non-performing loans increased by \$2.9 million, or 16.3%, during the first quarter of 2014 due principally to an increase in non-performing commercial loans. Non-performing commercial loans increased by \$2.4 million during the first quarter of 2014 due principally to two relationships that moved into non-accrual, which had been categorized as substandard accruing watch credits at year-end 2013. 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 economic conditions, which still remain somewhat challenging, and soft real estate values in certain markets outside of Michigan 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 \$110.4 million, or 8.11% of total Portfolio Loans, and \$114.9 million, or 8.36% of total Portfolio Loans, at March 31, 2014 and December 31, 2013, respectively. The decrease in the amount of performing TDRs in the first quarter of 2014 reflects declines in both commercial loan and retail loan TDR’s.

ORE and repossessed assets totaled \$18.0 million at March 31, 2014, compared to \$18.3 million at December 31, 2013. This decrease is primarily the result of sales of ORE being in excess of the migration of non-performing loans secured by real estate into ORE as the foreclosure process is completed 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 Portfolio Loans was 0.69% on an annualized basis in the first quarter of 2014 compared to 0.82% in the first quarter of 2013. The \$0.5 million decline in loan net charge-offs is primarily due to a \$1.0 million decline in mortgage and consumer/installment loan net charge-offs that was partially offset by a \$0.5 million increase in commercial loan net charge-offs. The overall decrease in loan net charge-offs primarily reflects a year-over-year reduction in non-performing loans and improvement in collateral liquidation values.

| Allowance for loan losses   | Three months ended     |                         |          |                         |
|---|------------------------|-------------------------|----------|-------------------------|
|   | March 31,<br>2014      |                         | 2013     |                         |
|   | Loans                  | Unfunded<br>Commitments | Loans    | Unfunded<br>Commitments |
|   | (Dollars in thousands) |                         |          |                         |
| Balance at beginning of period  | \$32,325               | \$ 508                  | \$44,275 | \$ 598                  |
| Additions (deduction)   |                        |                         |          |                         |
| Provision for loan losses   | 428                    | -                       | (691 )   | -                       |
| Recoveries credited to allowance  | 1,068                  | -                       | 1,451    | -                       |
| Loans charged against the allowance   | (3,384 )               | -                       | (4,270 ) | -                       |
| Additions (deductions) included in non-interest expense                         | -                      | 10                      | -        | (19 )                   |
| Balance at end of period  | \$30,437               | \$ 518                  | \$40,765 | \$ 579                  |
| Net loans charged against the allowance to average Portfolio Loans (annualized) | 0.69                   | %                       | 0.82     | %                       |

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## Allocation of the Allowance for Loan Losses

|  | March          | December  |
|--|----------------|-----------|
|  | 31,            | 31,       |
|  | 2014           | 2013      |
|  | (In thousands) |           |
| Specific allocations                               | \$ 14,986      | \$ 15,158 |
| Other adversely rated commercial loans             | 1,108          | 1,358     |
| Historical loss allocations                        | 8,817          | 9,849     |
| Additional allocations based on subjective factors | 5,526          | 5,960     |
| Total  | \$30,437       | \$ 32,325 |

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 \$0.015 million credit and a \$0.004 million credit in the first quarters of 2014 and 2013, respectively, for its provision for loan losses. Mepco's allowance for loan losses totaled \$0.1 million at both March 31, 2014 and December 31, 2013. 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 \$1.9 million to \$30.4 million at March 31, 2014 from \$32.3 million at December 31, 2013 and was equal to 2.24% of total Portfolio Loans at March 31, 2014 compared to 2.35% at December 31, 2013. All four components of the allowance for loan losses outlined above declined in the first quarter of 2014. The allowance for loan losses related to specific loans decreased \$0.2 million in 2014 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 \$0.3 million in 2014 primarily due to lower expected loss given default rates as well as a decrease in the balance of such loans included in this component to \$36.0 million at March 31, 2014 from \$39.4 million at December 31, 2013. The allowance for loan losses related to historical losses decreased \$1.0 million during 2014 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 \$0.4 million during 2014 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. 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 \$1.94 billion and \$1.88 billion at March 31, 2014 and December 31, 2013, respectively. The \$53.9 million increase in deposits in 2014 is primarily due to growth in checking and savings deposit account balances. Reciprocal deposits totaled \$77.1 million and \$83.5 million at March 31, 2014 and December 31, 2013, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network’s Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At March 31, 2014, we had approximately \$339.3 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

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

Other borrowings, comprised almost entirely of advances from the Federal Home Loan Bank (the “FHLB”), totaled \$12.9 million and \$17.2 million at March 31, 2014 and December 31, 2013, 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 March 31, 2014, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$103.3 million, or 5.3% 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.

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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 June 2013, we terminated our last remaining interest-rate swap, which had an aggregate notional amount of \$10.0 million. We may begin to again utilize interest-rate swaps in 2014, primarily relating to our commercial lending activities.

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 Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus our liquidity management on maintaining adequate levels of liquid assets (primarily funds on deposit with the FRB and certain investment securities) as well as developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for purchasing investment securities or originating Portfolio Loans as well as to be able to respond to unforeseen liquidity needs.

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

At March 31, 2014, we had \$317.3 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$1.50 billion of our deposits at March 31, 2014 were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

We also believe that the available cash on hand of approximately \$11.4 million at the parent company as of March 31, 2014 (which was increased by \$15.0 million in April 2014 as a result of a transfer of funds from the Bank to the parent company through a return of capital as discussed below) provide sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures and to pay a cash dividend on our common stock for the foreseeable future.

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

## Capitalization

|   | March 31,<br>2014 | December<br>31,<br>2013 |
|---|-------------------|-------------------------|
|   | (In thousands)    |                         |
| Subordinated debentures                     | \$40,723          | \$40,723                |
| Amount not qualifying as regulatory capital | (1,223 )          | (1,223 )                |
| Amount qualifying as regulatory capital     | 39,500            | 39,500                  |
| Shareholders' equity                        |                   |                         |
| Common stock                                | 351,439           | 351,173                 |
| Accumulated deficit                         | (107,208)         | (110,347)               |
| Accumulated other comprehensive loss        | (7,644 )          | (9,245 )                |
| Total shareholders' equity                  | 236,587           | 231,581                 |
| Total capitalization                        | \$276,087         | \$271,081               |

We currently have three special purpose entities that issued \$39.5 million of cumulative trust preferred securities. These special purpose entities issued common securities and provided cash to our parent company that in turn, issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Consolidated Statements of Financial Condition. On October 11, 2013, we redeemed all (\$9.2 million in aggregate liquidation amount) of the outstanding trust preferred securities remaining issued by IBC Capital Finance II and liquidated this entity shortly thereafter. The trust preferred securities issued by IBC Capital Finance II had an interest rate of 8.25%. The redemption of these securities has reduced our interest expense by approximately \$0.8 million annually.

The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at March 31, 2014 and December 31, 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.

On August 30, 2013, we redeemed the Series B Preferred Stock and the Amended Warrant from the UST and exited TARP by making an \$81.0 million payment to the UST pursuant to the SPA. See note #15 to the Condensed Consolidated Financial Statements included within this report for additional information about the Series B Preferred Stock and the Amended Warrant.

Common shareholders' equity increased to \$236.6 million at March 31, 2014 from \$231.6 million at December 31, 2013 due primarily to our net income in the first quarter of 2014. Our tangible common equity ("TCE") totaled \$233.6 million and \$228.4 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 10.35% at both March 31, 2014 and December 31, 2013.

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Because the Bank currently has negative “undivided profits” (i.e. a retained deficit) of \$46.6 million at March 31, 2014, under Michigan banking regulations, the Bank is not currently permitted to pay a dividend. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2014, we requested regulatory approval for a \$15.0 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on March 28, 2014 and the Bank returned \$15.0 million of capital to the parent company on April 9, 2014. Also see note #11 to the Condensed Consolidated Financial Statements included within this report.

On April 16, 2014, our Board of Directors declared a quarterly cash dividend on our common stock of six cents per share. This dividend is payable on May 15, 2014 to shareholders of record on April 30, 2014. This is our first dividend payment since the third quarter of 2009.

As of March 31, 2014 and December 31, 2013, our Bank (and holding company) continued to meet the requirements to be considered “well-capitalized” under federal regulatory standards (also see note #11 to the Condensed Consolidated Financial Statements included within this report).

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

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

We employ simulation analyses to monitor our interest-rate risk profile and evaluate potential changes in our net interest income and market value of portfolio equity that result from changes in interest rates. The purpose of these simulations is to identify sources of interest-rate risk 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)   |                                     |                |                        |                |
| March 31, 2014           |                                     |                |                        |                |
| 200 basis point rise     | \$407,700                           | 8.63 %         | \$ 76,600              | 5.22 %         |
| 100 basis point rise     | 393,600                             | 4.88           | 74,400                 | 2.20           |
| Base-rate scenario       | 375,300                             | -              | 72,800                 | -              |
| 100 basis point decline  | 350,000                             | (6.74 )        | 71,400                 | (1.92 )        |
| December 31, 2013        |                                     |                |                        |                |
| 200 basis point rise     | \$412,200                           | 8.33 %         | \$ 77,800              | 5.56 %         |
| 100 basis point rise     | 398,200                             | 4.65           | 75,300                 | 2.17           |
| Base-rate scenario       | 380,500                             | -              | 73,700                 | -              |
| 100 basis point decline  | 356,400                             | (6.33 )        | 72,500                 | (1.63 )        |

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

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

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

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

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



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LITIGATION MATTERS

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

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

CRITICAL ACCOUNTING POLICIES

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for other than temporary impairment of investment securities, the allowance for loan losses, originated mortgage loan servicing rights, vehicle service contract payment plan counterparty contingencies, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.



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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 March 31, 2014, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended March 31, 2014, 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, 2013.

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 first quarter of 2014, the Company issued 2,691 shares of common stock to non-employee directors on a current basis and 1,172 shares of common stock to the trust for distribution to directors on a deferred basis. The shares were issued on January 1, 2014, at a price of \$12.00 per share, representing aggregate fees of \$0.05 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 repurchases of common stock for the three-months ended March 31, 2014:

| Period        | Total<br>Number<br>of<br>Shares<br>Purchased<br>(1) | Average<br>Price<br>Paid<br>Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of a<br>Publicly<br>Announced<br>Plan | Remaining<br>Number of<br>Shares Authorized<br>for Purchase<br>Under the Plan |
|---------------|---|--|--|---|
| January 2014  | -   | \$ -                                     | -  | NA  |
| February 2014 | -   | -  | -  | NA  |
| March 2014    | 71,813  | 13.33                                    | -  | NA  |
| Total         | 71,813  | \$ 13.33                                 | -  | NA  |

(1) Represents shares of our common stock purchased in the open market by the Independent Bank Corporation Employee Stock Ownership Trust as part of our employee stock ownership plan ("ESOP").

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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:

Form of TSR Performance Share Award Agreement as executed with certain executive officers effective 10.1\*February 7, 2014 (incorporated by reference to Exhibit 10.12 to our Annual Report on Form 10-K filed March 7, 2014).

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

\*Represents a compensation plan.

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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 May 5, 2014 By/s/ Robert N. Shuster  
Robert N. Shuster, Principal Financial  
Officer

Date May 5, 2014 By/s/ James J. Twarozynski  
James J. Twarozynski, Principal  
Accounting Officer

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