

ISABELLA BANK CORP
Form 10-K
March 14, 2016
Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the fiscal year ended December 31, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from _____ to _____
Commission File Number: 0-18415

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

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

401 North Main Street, Mount Pleasant, Michigan 48858
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (989) 772-9471

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
---------------------	---

Securities registered pursuant to Section 12(g) of the Act:

Common Stock - No Par Value

(Title of Class)

Indicated by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicated by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was \$185,183,000 as of the last business day of the registrant's most recently completed second fiscal quarter.

The number of common shares outstanding of the registrant's Common Stock (no par value) was 7,804,287 as of March 7, 2016.

DOCUMENTS INCORPORATED BY REFERENCE

(Such documents are incorporated herein only to the extent specifically set forth in response to an item herein.)

Documents Part of Form 10-K Incorporated into

Portions of the Isabella Bank Corporation Proxy

Statement for its Annual Meeting of Shareholders to be Part III

held May 3, 2016

Table of Contents

ISABELLA BANK CORPORATION
ANNUAL REPORT ON FORM 10-K

Table of Contents

PART I

Item 1.	<u>Business</u>	<u>6</u>
Item 1A.	<u>Risk Factors</u>	<u>8</u>
Item 1B.	<u>Unresolved Staff Comments</u>	<u>11</u>
Item 2.	<u>Properties</u>	<u>11</u>
Item 3.	<u>Legal Proceedings</u>	<u>11</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>11</u>

PART II

Item 5.	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>12</u>
Item 6.	<u>Selected Financial Data</u>	<u>14</u>
Item 7.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>16</u>
Item 7A.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>38</u>
Item 8.	<u>Financial Statements and Supplementary Data</u>	<u>38</u>
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>88</u>
Item 9A.	<u>Controls and Procedures</u>	<u>88</u>
Item 9B.	<u>Other Information</u>	<u>89</u>

PART III

Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	<u>90</u>
Item 11.	<u>Executive Compensation</u>	<u>90</u>
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>90</u>
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	<u>91</u>

Item 14.	<u>Principal Accountant Fees and Services</u>	<u>91</u>
PART IV		<u>92</u>
Item 15.	<u>Exhibits and Financial Statement Schedules</u>	<u>92</u>
SIGNATURES		<u>94</u>

Table of Contents

Forward Looking Statements

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

Glossary of Acronyms and Abbreviations

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

AFS: Available-for-sale	GAAP: U.S. generally accepted accounting principles
ALLL: Allowance for loan and lease losses	GLB Act: Gramm-Leach-Bliley Act of 1999
AOCI: Accumulated other comprehensive income (loss)	IFRS: International Financial Reporting Standards
ASC: FASB Accounting Standards Codification	IRR: Interest rate risk
ASU: FASB Accounting Standards Update	JOBS Act: Jumpstart our Business Startups Act
ATM: Automated Teller Machine	LIBOR: London Interbank Offered Rate
BHC Act: Bank Holding Company Act of 1956	N/A: Not applicable
CFPB: Consumer Financial Protection Bureau	N/M: Not meaningful
CIK: Central Index Key	NASDAQ: NASDAQ Stock Market Index
CRA: Community Reinvestment Act	NASDAQ Banks: NASDAQ Bank Stock Index
DIF: Deposit Insurance Fund	NAV: Net asset value
DIFS: Department of Insurance and Financial Services	NOW: Negotiable order of withdrawal
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NSF: Non-sufficient funds
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	OCI: Other comprehensive income (loss)
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OMSR: Originated mortgage servicing rights
ESOP: Employee stock ownership plan	OREO: Other real estate owned
Exchange Act: Securities Exchange Act of 1934	OTTI: Other-than-temporary impairment
FASB: Financial Accounting Standards Board	PBO: Projected benefit obligation
FDI Act: Federal Deposit Insurance Act	PCAOB: Public Company Accounting Oversight Board
FDIC: Federal Deposit Insurance Corporation	Rabbi Trust: A trust established to fund the Directors Plan
FFIEC: Federal Financial Institutions Examinations Council	SEC: U.S. Securities & Exchange Commission
FRB: Federal Reserve Bank	SOX: Sarbanes-Oxley Act of 2002
FHLB: Federal Home Loan Bank	TDR: Troubled debt restructuring
Freddie Mac: Federal Home Loan Mortgage Corporation	XBRL: eXtensible Business Reporting Language
FTE: Fully taxable equivalent	

Table of Contents

Restatement of Previously Filed Reports (Dollars in thousands)

Overview of Restatement

In this Annual Report on Form 10-K, certain prior period financial information has been restated due to an accounting correction. Impacted sections of this report include:

1. Selected Financial Data in Item 6 for the years ended December 31, 2014, 2013, 2012, and 2011;
2. Management's Discussion and Analysis in Item 7 as it relates to the years ended December 31, 2014, 2013, 2012, and 2011 and interim periods ended September 30, 2015, June 30, 2015, and March 31, 2015;
3. Financial Statements in Item 8:
 - a. Consolidated Balance Sheet as of December 31, 2014, Consolidated Statements of Income for the years ended December 31, 2014 and 2013, and Consolidated Statements of Cash Flows for the years ended December 31, 2014 and 2013; and
 - b. Notes to Consolidated Financial Statements as of, and for the years ended, December 31, 2014 and 2013.

Background of Restatement

The necessary restatement was identified by management in the fourth quarter of 2015 during the course of our preparation of the consolidated financial statements and evaluation of financial results as of and for the year ended December 31, 2015. The restatements relate to the accounting for deferred costs associated with originating loans (under ASC 310-20) and the proper classification of the net deferred costs recorded in gross loans within the consolidated balance sheets and as a deferral of compensation expenses within the consolidated statements of income. Prior to December 31, 2015, loan origination cost deferrals (under ASC 310-20) were reported in loan interest and fee income instead of as a reduction of compensation and benefits, which is included in other noninterest expenses. Additionally, net deferred asset balances (under ASC 310-20) prior to December 31, 2015 were reported in other assets on the consolidated balance sheets instead of reported in gross loans. Amortization of the net deferred asset balance was recognized appropriately in loan interest and fee income.

Impact of Restatement

The overall impact of the restatement on our consolidated financial position and results of operations is not believed to be material and as such, previously filed Annual Reports on Form 10-K and Quarterly reports on Form 10-Q for the periods affected by the restatement have not been amended. The determination of materiality was, in part, concluded based on the following observations:

- No impact to net income for any prior periods;
- No impact to earnings per share, other stock data, or dividend data for any prior periods;
- No impact on total assets for any prior periods; and
- No impact on retained earnings or total equity for any prior periods.

The impact to the consolidated balance sheet as of December 31, 2014 was a \$2,968 increase in gross loans and a \$2,968 decline in other assets. There were no other changes to the consolidated balance sheets for any prior periods.

Table of Contents

The following table sets forth the effects of the restatement on items within the Consolidated Statements of Income. Since the restatement did not impact net income, pre-tax and adjustments net of tax are not included.

	December 31, 2014		December 31, 2013	
	Previously Reported	Restated	Previously Reported	Restated
Interest income				
Loans, including fees	\$39,432	\$36,629	\$41,233	\$37,575
All other interest income	14,519	14,519	12,843	12,843
Total interest income	53,951	51,148	54,076	50,418
Total interest expense	9,970	9,970	11,021	11,021
Net interest income	43,981	41,178	43,055	39,397
Provision for loan losses	(668	) (668	) 1,111	1,111
Net interest income after provision for loan losses	44,649	41,846	41,944	38,286
Total noninterest income	9,325	9,325	10,175	10,175
Noninterest expenses				
Compensation and benefits	21,305	18,502	21,465	17,807
All other noninterest expenses	16,601	16,601	15,948	15,948
Total noninterest expenses	37,906	35,103	37,413	33,755
Federal income tax expense	2,344	2,344	2,196	2,196
Net income	\$13,724	\$13,724	\$12,510	\$12,510

As demonstrated above, loan interest and fee income and compensation and benefits were reduced by \$2,803 and \$3,658 during the years ended December 31, 2014 and 2013, respectively.

All amounts in this Annual Report on Form 10-K affected by the restatement adjustments reflect such amounts as restated.

Table of Contents

PART I

Item 1. Business. (Dollars in thousands)

General

Isabella Bank Corporation is a registered financial services holding company that was incorporated in September 1988 under Michigan law. The Corporation's sole subsidiary, Isabella Bank, has 29 banking offices located throughout Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties. The area includes significant agricultural production, manufacturing, retail, gaming and tourism, and five colleges and universities.

As used in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations as well as in Item 8. Financial Statements and Supplementary Data, references to "the Corporation," "Isabella," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiary. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank or the "Bank" refer to Isabella Bank Corporation's subsidiary, Isabella Bank.

Our reportable segments are based on legal entities that account for at least 10% of net operating results. Retail banking operations for 2015, 2014, and 2013 represent approximately 90% or greater of total assets and operating results. As such, we have only one reportable segment.

We are a community bank with a focus on providing high quality, personalized service at a fair price. We offer a broad array of banking services to businesses, institutions, and individuals. We compete with other commercial banks, savings and loan associations, mortgage brokers, finance companies, credit unions, and retail brokerage firms.

Lending activities include loans for commercial and agricultural operating and real estate purposes, residential real estate loans, and consumer loans. We limit lending activities primarily to local markets and have not purchased any loans from the secondary market. We do not make loans to fund leveraged buyouts, have no foreign corporate or government loans, and have limited holdings of corporate debt securities. Our general lending philosophy is to limit concentrations to individuals and business segments. For additional information related to our lending strategies and policies, see "Note 5 – Loans and ALLL" of the "Notes to Consolidated Financial Statements" in Item 8. Financial Statements and Supplementary Data.

Deposit services offered include checking accounts, savings accounts, certificates of deposit, direct deposits, cash management services, mobile and internet banking, electronic bill pay services, and automated teller machines. We also offer full service trust and brokerage services.

As of December 31, 2015, we had 374 full-time equivalent employees. We provide group life, health, accident, disability, and other insurance programs as well as a number of other employee benefit programs. None of our workforce is subject to collective bargaining agreements.

Available Information

Our SEC filings (including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Definitive Proxy Statements, Current Reports on Form 8-K and amendments to those reports) are available through our website (www.isabellabank.com). We will provide paper copies of our SEC reports free of charge upon request of a shareholder.

The SEC maintains a website (www.sec.gov) that contains reports, proxy and information statements and other information regarding Isabella Bank Corporation (CIK #0000842517) and other issuers.

Supervision and Regulation

The earnings and growth of the banking industry and, therefore, our earnings are affected by the credit policies of monetary authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to combat recessions and curb inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Treasury and U.S. Government Agency securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements against member bank deposits. These methods are used in varying combinations to influence overall growth of bank loans, investments and deposits and also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks and related financial service providers in the past and are expected to continue to do so in the future. The effect of such policies upon our future business and earnings cannot be predicted.

We, as a financial holding company, are regulated under the BHC Act, and are subject to the supervision of the FRB. We are registered as a financial services holding company with the FRB and are subject to annual reporting requirements and

6

Table of Contents

inspections and audits. Under FRB policy, we are expected to act as a source of financial strength to the Bank and to commit resources to support its subsidiaries. This support may be required at times when, in the absence of such FRB policy, it would not otherwise be required to provide support.

Under Michigan law, if the capital of a Michigan state chartered bank has become impaired by losses or otherwise, the Commissioner of the DIFS may require that the deficiency in capital be met by assessment upon the bank's shareholders pro rata on the amount of capital stock held by each, and if any such assessment is not paid by any shareholder within 30 days of the date of mailing of notice thereof to such shareholder, cause the sale of the stock of such shareholder to pay such assessment and the costs of sale of such stock.

Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to a priority of payment. This priority would apply to guarantees of capital plans under the FDIC Improvement Act of 1991.

SOX contains important requirements for public companies in the area of financial disclosure and corporate governance. In accordance with Section 302(a) of SOX, written certifications by our principal executive, financial, and accounting officers are required. These certifications attest that our quarterly and annual reports filed with the SEC do not contain any untrue statement of a material fact (see the certifications filed as Exhibits 31 (a) and (b) to this Form 10-K for such certification of consolidated financial statements and other information for this 2015 Form 10-K). We have also implemented a program designed to comply with Section 404 of SOX, which included the identification of significant processes and accounts, documentation of the design of control effectiveness over process and entity level controls, and testing of the operating effectiveness of key controls. See Item 9A. Controls and Procedures for our evaluation of disclosure controls and procedures and internal control over financial reporting.

Certain additional information concerning regulatory guidelines for capital adequacy and other regulatory matters is presented herein under the caption "Capital" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and in "Note 15 – Commitments and Other Matters" and "Note 16 – Minimum Regulatory Capital Requirements" of the Notes to Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data.

Isabella Bank

The Bank is supervised and regulated by DIFS and the FRB. The agencies and federal and state laws extensively regulate various aspects of the banking business including, among other things, permissible types and amounts of loans, investments and other activities, capital adequacy, branching, interest rates on loans and deposits, and the safety and soundness of banking practices.

Our deposits are insured up to applicable limits by the DIF of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that assesses insurance premiums based upon a risk matrix that takes into account assets and capital levels and supervisory ratings.

Banking laws and regulations restrict transactions by insured banks owned by a bank holding company, including loans to and certain purchases from the parent holding company, non-bank and bank subsidiaries of the parent holding company, principal shareholders, officers, directors and their affiliates, and investments by the subsidiary bank in the shares or securities of the parent holding company (or any of the other non-bank or bank affiliates), or acceptance of such shares or securities as collateral security for loans to any borrower.

The Bank is subject to legal limitations on the frequency and amount of dividends that can be paid to Isabella Bank Corporation. For example, a Michigan state chartered bank may not declare a cash dividend or a dividend in kind except out of net profits then on hand after deducting all losses and bad debts, and then only if it will have a surplus amounting to not less than 20% of its capital after the payment of the dividend. Moreover, a Michigan state chartered bank may not declare or pay any cash dividend or dividend in kind until the cumulative dividends on its preferred stock, if any, have been paid in full. Further, if the surplus of a Michigan state chartered bank is at any time less than the amount of its capital, before the declaration of a cash dividend or dividend in kind, it must transfer to surplus not less than 10% of its net profits for the preceding six months (in the case of quarterly or semi-annual dividends) or the preceding two consecutive six month periods (in the case of annual dividends).

The payment of dividends by Isabella Bank Corporation and the Bank is also affected by various regulatory requirements and policies, such as the requirement to keep adequate capital in compliance with regulatory guidelines. Federal laws impose further restrictions on the payment of dividends by insured banks that fail to meet specified capital levels. The FDIC may

7

Table of Contents

prevent an insured bank from paying dividends if the bank is in default of payment of any assessment due to the FDIC. In addition, payment of dividends by a bank may be prevented by the applicable federal regulatory authority if such payment is determined, by reason of the financial condition of such bank, to be an unsafe and unsound banking practice. The FRB and the FDIC have issued policy statements providing that bank holding companies and insured banks should generally pay dividends only out of current operating earnings. Additionally, the FRB Board of Governors requires a bank holding company to notify the FRB prior to increasing its cash dividend by more than 10% over the prior year.

The aforementioned regulations and restrictions may limit our ability to obtain funds from the Bank for our cash needs, including payment of dividends and operating expenses.

The activities and operations of the Bank are also subject to various federal and state laws and regulations.

Item 1A. Risk Factors.

In the normal course of business we are exposed to various risks. These risks, if not managed correctly, could have a significant impact on our earnings, capital, share price, and ability to pay dividends. In order to effectively monitor and control the following risks, we utilize an enterprise risk model. We balance our strategic goals, including revenue and profitability objectives, with associated risks through the use of policies, systems, and procedures which have been adopted to identify, assess, control, monitor, and manage each risk area. We continually review the adequacy and effectiveness of these policies, systems, and procedures.

Our enterprise risk process covers each of the following areas.

Changes in credit quality and required allowance for loan and lease losses

To manage the credit risk arising from lending activities, our most significant source of credit risk, we maintain what we believe are sound underwriting policies and procedures. We continuously monitor asset quality in order to manage our credit risk to determine the appropriateness of valuation allowances. These valuation allowances take into consideration various factors including, but not limited to, local, regional, and national economic conditions.

We maintain an ALLL to reserve for estimated incurred loan losses and risks within our loan portfolio. The level of the ALLL reflects our evaluation of industry concentrations; specific credit risks; loan loss experience; loan portfolio quality; and economic, political and regulatory conditions. The determination of the appropriate level of the ALLL inherently involves a high degree of subjectivity and requires us to make significant estimates, all of which may undergo material changes.

Changes in economic conditions

An economic downturn within our local markets, as well as downturns in the state or national markets, could negatively impact household and corporate incomes. This could lead to decreased demand for both loan and deposit products and lead to an increase of customers who fail to pay interest or principal on their loans. We continually monitor key economic indicators in an effort to anticipate the possible effects of downturns in the local, regional, and national economies.

Our success depends primarily on the general economic conditions of the State of Michigan and the specific local markets in which we operate. Unlike larger national or other regional banks that are more geographically diversified, we provide banking and financial services to customers located primarily in the Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The local economic conditions in these areas have a significant impact on the demand for our products and services, as well as the ability of our customers to repay loans, the value of the collateral securing loans, and the stability of our deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on our financial condition and results of operations.

Interest rate risk

IRR results from the timing differences in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. We monitor the potential effects of changes in interest rates through simulations and gap analyses. To help mitigate the effects of changes in interest rates, we make significant efforts to stagger projected cash flows and maturities of interest sensitive assets and liabilities.

Table of Contents

Liquidity risk

Liquidity risk is the risk to earnings or capital arising from our inability to meet our obligations when they come due without incurring unacceptable costs. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources, or failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value. We have significant borrowing capacity through correspondent banks and the ability to sell certain investments to fund potential cash shortages, which we may use to help mitigate this risk. The value of investment securities may be negatively impacted by fluctuations in the market

A volatile, illiquid market or decline in credit quality could require us to recognize an OTTI loss related to the investment securities held in our portfolio. We consider many factors in determining whether an OTTI exists including the length of time and extent to which fair value has been less than cost, the investment credit rating, and the probability that the issuer will be unable to pay the amount when due. The presence of these factors could lead to impairment charges. These risks are mitigated by the fact that we assert that we do not intend to sell the security in an unrealized loss position and it is more likely than not that we will not have to sell the security before recovery of its cost basis.

Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or external events and includes reputation risk and transaction risk. Reputation risk is developing and retaining marketplace confidence in handling customers' financial transactions in an appropriate manner and protecting our safety and soundness. Transaction risk includes losses from fraud, error, the inability to deliver products or services, and loss or theft of information. Transaction risk also encompasses product development and delivery, transaction processing, information technology systems, and the internal control environment.

To minimize the potential losses due to operational risks, we have established a robust system of internal controls that is regularly tested by our internal audit department in conjunction with the services of certified public accounting firms who assists in performing such internal audit work. The focus of these internal audit procedures is to verify the validity and appropriateness of various transactions, processes, and controls. The results of these procedures are reported to our Audit Committee.

The adoption of, violations of, or nonconformance with laws, rules, regulations, or prescribed practices

The financial services industry and public companies are extensively regulated and must meet regulatory standards set by the FDIC, DIFS, FRB, FASB, SEC, PCAOB, the CFPB, and other regulatory bodies. Federal and state laws and regulations are designed primarily to protect the deposit insurance funds and consumers, and not necessarily to benefit our shareholders. The nature, extent, and timing of the adoption of significant new laws, changes in existing laws, or repeal of existing laws may have a material impact on our business, results of operations, and financial condition, the effect of which is impossible to predict at this time.

Our compliance department annually assesses the adequacy and effectiveness of our processes for controlling and managing our principal compliance risks.

We may not adjust to changes in the financial services industry

Our financial performance depends in part on our ability to maintain and grow our core deposit customer base and expand our financial services to our existing and new customers. The increasingly competitive environment is, in part, a result of changes in technology and product delivery systems and the accelerating pace of consolidation among financial service providers. New competitors may emerge to increase the degree of competition for our products and services. Financial services and products are also constantly changing. Our financial performance is also dependent upon customer demand for our products and services and our ability to develop and offer competitive financial products and services.

We may be required to recognize an impairment of goodwill

Goodwill represents the excess of the amounts paid to acquire subsidiaries over the fair value of their net assets at the date of acquisition. The majority of the recorded goodwill is related to acquisitions of other banks, which were subsequently merged into Isabella Bank. If it is determined that the goodwill has been impaired, we must write-down the goodwill by the amount of the impairment.

Table of Contents

We may face pressure from purchasers of our residential mortgage loans to repurchase loans sold or reimburse purchasers for losses related to such loans

We generally sell the fixed rate long term residential mortgage loans we originate to the secondary market. In response to the recent economic downturn, the purchasers of residential mortgage loans, such as government sponsored entities, increased their efforts to require sellers of residential mortgage loans to either repurchase loans previously sold, or reimburse the purchasers for losses incurred on foreclosed loans due to actual or alleged failure to strictly conform to the terms of the contract.

Consumers may decide not to use banks to complete their financial transactions

Technology and other changes are allowing customers to complete financial transactions without the involvement of banks. For example, consumers can now pay bills and transfer funds directly without banks. The process of eliminating banks as intermediaries in financial transactions could result in the loss of fee income, as well as the loss of customer deposits and income generated from those deposits.

Changes to the financial services industry as a result of regulatory changes or actions, or significant litigation

The financial services industry is extensively regulated by state and federal regulation that governs almost all aspects of our operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors, and the deposit insurance fund. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact us or our ability to increase the value of our business.

Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the appropriateness of an institution's ALLL. Future regulatory changes or accounting pronouncements may increase our regulatory capital requirements or adversely affect our regulatory capital levels. Additionally, actions by regulatory agencies or significant litigation against us could require the dedication of significant time and resources to defending our business and may lead to penalties.

Unauthorized disclosure of sensitive or confidential client or customer information, whether through cyber attacks, breach of computer systems or otherwise

As part of our business, we collect and retain sensitive and confidential client and customer information on our behalf and on behalf of other third parties. Despite the security measures we have in place for our facilities and systems, and the security measures of our third party service providers, we may be vulnerable to cyber attacks, security breaches, acts of vandalism, computer viruses, misplaced or lost data, human errors or other similar events. Risks related to cybersecurity continue to evolve within the industry. We continually review and monitor information and data related to cybersecurity to detect and mitigate attacks. A cyber attack could disrupt our operations and have a material adverse effect on our business. Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether by us or by our vendors, could severely damage our reputation, expose us to the risks of litigation and liability, disrupt our operations and have a material adverse effect on our business.

Our estimates and assumptions may be incorrect

Our consolidated financial statements conform with GAAP, which require us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. These estimates are based on information available to us at the time the estimates are made. Actual results could differ from those estimates. For further discussion regarding significant accounting estimates, see "Note 1 – Nature of Operations and Summary of Significant Accounting Policies" of the Notes to Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data.

Disruption of infrastructure

Our operations depend upon our technological and physical infrastructure, including our equipment and facilities. Extended disruption of our vital infrastructure by fire, power loss, natural disaster, telecommunications failure, computer hacking and viruses, or other events outside of our control, could have a significant impact on our operations. We have developed and tested disaster recovery plans, which provide detailed instructions covering all significant aspects of our operations.

Anti-takeover provisions

Our articles of incorporation include anti-takeover provisions that require a two-thirds majority vote to approve a sale of the Corporation. Additionally, changes to our articles of incorporation must be approved by a two-thirds majority vote of our shareholders. These provisions may make our stock less attractive to potential shareholders.

Table of Contents

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Our executive offices are located at 401 North Main Street in Mount Pleasant, Michigan. In addition to this location, we own 29 branches, an operations center, a mortgage operations center, and a previous main office building. Our facilities current, planned, and best use is for conducting our current activities, with the exception of approximately 75% of our previous main office location and approximately 25% of the building that houses our mortgage processing operations which are leased to non-related parties. We continually monitor and assess the need for expansion and/or improvement for all facilities. In our opinion, each facility has sufficient capacity and is in good condition.

Item 3. Legal Proceedings.

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

Item 4. Mine Safety Disclosures.

Not applicable.

Table of Contents

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Common Stock and Dividend Information

Our authorized common stock consists of 15,000,000 shares, of which 7,799,867 shares are issued and outstanding as of December 31, 2015. As of that date, there were 3,044 shareholders of record.

Our common stock is traded in the over-the-counter market. Our common stock is quoted on the OTCQX market tier of the OTC Markets Group Inc.'s ("OTC Markets") electronic quotation system (www.otcm Markets.com) under the symbol "ISBA". Other trades in our common stock occur in privately negotiated transactions from time-to-time of which we may have little or no information.

We have reviewed the information available as to the range of reported high and low bid quotations, including high and low bid information as reported by OTC Markets. The following table sets forth our compilation of that information for the periods indicated. Price information obtained from OTC Markets reflects inter-dealer prices, without retail mark-up, mark-down, or commissions and may not necessarily represent actual transactions. The following compiled data is provided for information purposes only and should not be viewed as indicative of the actual or market value of our common stock.

	Number of Common Shares	Sale Price Low	High
2015			
First Quarter	81,754	\$22.00	\$23.50
Second Quarter	94,019	22.70	23.80
Third Quarter	143,183	22.75	23.85
Fourth Quarter	109,276	23.50	29.90
	428,232		
2014			
First Quarter	79,719	\$22.25	\$23.94
Second Quarter	72,142	22.44	23.50
Third Quarter	94,422	21.73	24.00
Fourth Quarter	67,771	22.10	23.99
	314,054		

The following table sets forth the cash dividends paid for the following quarters:

	Per Share	
	2015	2014
First Quarter	\$0.23	\$0.22
Second Quarter	0.23	0.22
Third Quarter	0.24	0.22
Fourth Quarter	0.24	0.23
Total	\$0.94	\$0.89

We have adopted and publicly announced a common stock repurchase plan. The plan was last amended on September 23, 2015, to allow for the repurchase of an additional 200,000 shares of common stock after that date. These authorizations do not have expiration dates. As shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued shares.

Table of Contents

The following table provides information for the unaudited three month period ended December 31, 2015, with respect to our common stock repurchase plan:

	Common Shares Repurchased	Average Price	Total Number of	Maximum Number of
	Number	Per Common	Common Shares	Common
		Share	Purchased	Shares That May Yet Be
			as Part of Publicly	Purchased Under the
			Announced Plan	Plans or Programs
			or Program	
Balance, September 30				198,436
October 1 - 31	22,923	\$24.21	22,923	175,513
November 1 - 30	12,362	25.89	12,362	163,151
December 1 - 31	4,493	26.93	4,493	158,658
Balance, December 31	39,778	\$25.04	39,778	158,658

Information concerning securities authorized for issuance under equity compensation plans appears under Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Stock Performance

The following graph compares the cumulative total shareholder return on our common stock for the last five years with the cumulative total return on (1) NASDAQ, which is comprised of all United States common shares traded on the NASDAQ and (2) the NASDAQ Banks, which is comprised of bank and bank holding company common shares traded on the NASDAQ over the same period. The graph assumes the value of an investment in the Corporation's common stock and each index was \$100 at December 31, 2010 and all dividends are reinvested.

Year	ISBA	NASDAQ	NASDAQ Banks
12/31/2010	\$100.00	\$100.00	\$100.00
12/31/2011	142.50	99.23	89.54
12/31/2012	135.30	116.79	106.15
12/31/2013	153.50	163.38	150.00
12/31/2014	150.50	187.43	157.22
12/31/2015	207.70	200.70	170.99

Table of Contents

Item 6. Selected Financial Data.

Results of Operations (Dollars in thousands except per share amounts)

The following table outlines the results of operations and provides certain key performance measures as of, and for the years ended, December 31:

	2015	2014	2013	2012	2011	
INCOME STATEMENT DATA						
Interest income	\$51,502	\$51,148	\$50,418	\$53,123	\$55,590	
Interest expense	10,163	9,970	11,021	13,423	16,203	
Net interest income	41,339	41,178	39,397	39,700	39,387	
Provision for loan losses	(2,771)	(668)	1,111	2,300	3,826	
Noninterest income	10,359	9,325	10,175	11,530	8,218	
Noninterest expenses	36,051	35,103	33,755	34,361	32,215	
Federal income tax expense	3,288	2,344	2,196	2,363	1,354	
Net Income	\$15,130	\$13,724	\$12,510	\$12,206	\$10,210	
PER SHARE						
Basic earnings	\$1.95	\$1.77	\$1.63	\$1.61	\$1.35	
Diluted earnings	\$1.90	\$1.74	\$1.59	\$1.56	\$1.31	
Dividends	\$0.94	\$0.89	\$0.84	\$0.80	\$0.76	
Tangible book value*	\$17.30	\$16.59	\$15.62	\$14.72	\$13.90	
Quoted market value						
High	\$29.90	\$24.00	\$26.00	\$24.98	\$24.45	
Low	\$22.00	\$21.73	\$21.12	\$21.75	\$17.10	
Close*	\$29.90	\$22.50	\$23.85	\$21.75	\$23.70	
Common shares outstanding*	7,799,867	7,776,274	7,723,023	7,671,846	7,589,226	
PERFORMANCE RATIOS						
Return on average total assets	0.95	% 0.90	% 0.86	% 0.88	% 0.79	%
Return on average shareholders' equity	8.33	% 8.06	% 7.67	% 7.60	% 6.74	%
Return on average tangible shareholders' equity	11.46	% 10.80	% 10.71	% 11.41	% 10.30	%
Net interest margin yield (FTE)	3.10	% 3.24	% 3.22	% 3.43	% 3.67	%
BALANCE SHEET DATA*						
Gross loans	\$850,492	\$836,550	\$810,777	\$774,627	\$751,610	
AFS securities	\$660,136	\$567,534	\$512,062	\$504,010	\$425,120	
Total assets	\$1,668,112	\$1,549,543	\$1,493,137	\$1,430,639	\$1,337,925	
Deposits	\$1,164,563	\$1,074,484	\$1,043,766	\$1,017,667	\$958,164	
Borrowed funds	\$309,732	\$289,709	\$279,326	\$241,001	\$216,136	
Shareholders' equity	\$183,971	\$174,594	\$160,609	\$164,489	\$154,783	
Gross loans to deposits	73.03	% 77.86	% 77.68	% 76.12	% 78.44	%
ASSETS UNDER MANAGEMENT*						
Loans sold with servicing retained	\$287,029	\$288,639	\$293,665	\$303,425	\$302,636	
Assets managed by our Investment and Trust Services Department	\$405,109	\$383,878	\$351,420	\$319,301	\$297,393	
Total assets under management	\$2,360,250	\$2,222,060	\$2,138,222	\$2,053,365	\$1,937,954	
ASSET QUALITY*						
Nonperforming loans to gross loans	0.09	% 0.50	% 0.42	% 1.00	% 0.95	%
Nonperforming assets to total assets	0.07	% 0.33	% 0.32	% 0.68	% 0.67	%
ALLL to gross loans	0.87	% 1.21	% 1.42	% 1.54	% 1.65	%

Edgar Filing: ISABELLA BANK CORP - Form 10-K

CAPITAL RATIOS*

Shareholders' equity to assets	11.03	% 11.27	% 10.76	% 11.50	% 11.57	%
Tier 1 leverage	8.52	% 8.59	% 8.46	% 8.29	% 8.18	%
Common equity tier 1 capital	13.24	% N/A	N/A	N/A	N/A	
Tier 1 risk-based capital	13.24	% 14.08	% 13.68	% 13.24	% 12.93	%
Total risk-based capital	13.96	% 15.19	% 14.93	% 14.49	% 14.18	%

* At end of year

Table of Contents

The following table outlines our interim results of operations and key performance measures as of, and for the unaudited periods ended:

	Quarter to Date							
	December 31 2015	September 30 2015	June 30 2015	March 31 2015	December 31 2014	September 30 2014	June 30 2014	March 31 2014
Total interest income	\$ 13,023	\$ 12,967	\$ 12,759	\$ 12,753	\$ 13,030	\$ 12,800	\$ 12,625	\$ 12,693
Total interest expense	2,577	2,580	2,518	2,488	2,504	2,498	2,468	2,500
Net interest income	10,446	10,387	10,241	10,265	10,526	10,302	10,157	10,193
Provision for loan losses	(772)	(738)	(535)	(726)	(64)	(162)	(200)	(242)
Noninterest income	2,501	3,101	2,629	2,128	2,426	2,216	2,434	2,249
Noninterest expenses	9,885	9,161	8,330	8,675	8,923	8,831	8,534	8,815
Federal income tax expense	538	1,002	977	771	648	444	692	560
Net income	\$ 3,296	\$ 4,063	\$ 4,098	\$ 3,673	\$ 3,445	\$ 3,405	\$ 3,565	\$ 3,309
PER SHARE								
Basic earnings	\$ 0.43	\$ 0.52	\$ 0.53	\$ 0.47	\$ 0.44	\$ 0.44	\$ 0.46	\$ 0.43
Diluted earnings	0.41	0.51	0.52	0.46	0.44	0.43	0.45	0.42
Dividends	0.24	0.24	0.23	0.23	0.23	0.22	0.22	0.22
Quoted Market value*	29.90	23.69	23.75	22.90	22.50	23.60	22.95	23.00
Tangible book value*	17.30	17.06	17.17	16.84	16.59	16.33	16.08	15.82

* At end of period

Reclassifications and Restatements: Certain amounts previously reported in the Results of Operations section of this report have been either reclassified or restated to conform with the 2015 presentation. For a complete overview on restatements impacting the Results of Operations, see pages 4 and 52 of this report.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(Dollars in thousands except per share amounts)

The following is management's discussion and analysis of the financial condition and results of our operations. This discussion and analysis is intended to provide a better understanding of the consolidated financial statements and statistical data included elsewhere in this Annual Report on Form 10-K.

Executive Summary

We reported record net income of \$15,130 and earnings per common share of \$1.95 for the year ended December 31, 2015. Our continued strong earnings have primarily been the result of increased interest income and continued improvement in credit quality. The improvement in credit quality resulted in a decline in the level of the ALLL in both amount and as a percentage of gross loans, resulting in a reversal of provision for loan losses of \$2,771 for the year ended December 31, 2015. Net loan recoveries during 2015 were \$71 as compared to net loan charge-offs \$732 in 2014. Additionally, we continue to see reductions in loans classified as less than satisfactory.

During the year, total assets grew by 7.65% to \$1,668,112, and assets under management increased to \$2,360,250 which includes loans sold and serviced and assets managed by our Investment and Trust Services Department of \$692,138. In 2015, we had total loan growth of \$13,942 which was driven by commercial and agricultural loan growth of \$26,301. This was partially offset by declines in both residential real estate and consumer loans of \$12,359 as new loan originations were less than principal payments by borrowers.

We increased our AFS securities portfolio by \$92,602 during 2015 to continue providing growth in our balance sheet to increase interest income. Our net yield on interest earning assets of 3.10% remains at historically low levels. While we expect the Federal Reserve Bank to increase short term interest rates in 2016, we do not anticipate any significant improvements in our net yield on interest earning assets as the rates paid on interest bearing liabilities will likely increase faster than those of interest earning assets. Net interest income will increase only through continued growth in loans, investments, and other income earning assets. We are committed to increasing earnings and dedicated to providing long term sustainable growth to enable us to increase shareholder value.

While we have been able to grow our commercial and agricultural loan portfolios, increasing our residential real estate and

consumer loan portfolios has been more challenging. To generate growth in these portfolios, we are implementing new

products, enhancing our marketing efforts, streamlining delivery channels for direct and indirect loans, and expanding our

service area. These initiatives are designed to attract new customers while expanding our relationships with current customers

to improve earnings.

Acquisitions

On July 31, 2015, we completed the acquisition of a branch from Flagstar Bank, FSB located in Saginaw, Michigan. In addition to real estate and equipment, we assumed deposit liabilities of \$44,290 and recorded \$156 of core deposit intangibles and \$2,061 of goodwill, which represented the excess of the purchase price over the fair value of identifiable net assets acquired.

On August 28, 2015, we completed the acquisition of a branch from Independent Bank located in Midland, Michigan. In addition to real estate and equipment, we assumed \$8,658 of deposit liabilities and recorded \$50 of core deposit intangibles and \$602 of goodwill, which represented the excess of the purchase price over the fair value of identifiable net assets acquired.

Recent Legislation

The Health Care and Education Act of 2010, the Patient Protection and Affordable Care Act, the Dodd-Frank Act, and the JOBS Act, have already had, and are expected to continue to have, a negative impact on our operating results. Of these four acts, the Dodd-Frank Act has had the most significant impact. The Dodd-Frank Act established the CFPB which has made significant changes in the regulation of financial institutions aimed at strengthening the oversight of

the federal government over the operation of the financial services sector and increasing the protection of consumers. New regulations issued by the CFPB regarding consumer lending, including residential mortgage lending, have increased our compensation and outside advisor costs and this trend is expected to continue.

On July 2, 2013, the FRB published revised BASEL III Capital standards for banks. The rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum

Table of Contents

required equity capital to be considered well capitalized, and introduces a capital cushion buffer. The rules, which will be gradually phased in between 2015 and 2019, are not expected to have a material impact on the Corporation but will require us to hold more capital than we have historically.

Reclassifications and Restatements: Certain amounts previously reported in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of this report have been either reclassified or restated to conform with the 2015 presentation. For a complete overview on restatements impacting Management's Discussion and Analysis of Financial Condition and Results of Operations, see pages 4 and 52 of this report.

Other

We have not received any notices of regulatory actions as of February 19, 2016.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are set forth in "Note 1 – Nature of Operations and Summary of Significant Accounting Policies" of the "Notes to Consolidated Financial Statements" in Item 8. Financial Statements and Supplementary Data. Of these significant accounting policies, we consider our policies regarding the ALLL, acquisition intangibles and goodwill, and the determination of the fair value and assessment of OTTI of investment securities to be our most critical accounting policies.

The ALLL requires our most subjective and complex judgment. Changes in economic conditions can have a significant impact on the ALLL and, therefore, the provision for loan losses and results of operations. We have developed policies and procedures for assessing the appropriateness of the ALLL, recognizing that this process requires a number of assumptions and estimates with respect to our loan portfolio. Our assessments may be impacted in future periods by changes in economic conditions, and the discovery of information with respect to borrowers which is not known to us at the time of the issuance of the consolidated financial statements. For additional discussion concerning our ALLL and related matters, see the detailed discussion to follow under the caption "Allowance for Loan and Lease Losses" and "Note 5 – Loans and ALLL" of the "Notes to Consolidated Financial Statements" in Item 8. Financial Statements and Supplementary Data.

U.S. generally accepted accounting principles require that we determine the fair value of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. We employ a variety of measures in the determination of the fair value, including the use of discounted cash flow analysis, market appraisals, and projected future revenue streams. For certain items that we believe we have the appropriate expertise to determine the fair value, we may choose to use our own calculations of the value. In other cases, where the value is not easily determined, we consult with outside parties to determine the fair value of the identified asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired entity and the net value of assets acquired on our balance sheet, including identifiable intangibles, is recorded as goodwill. Acquisition intangibles and goodwill are qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired on at least an annual basis.

AFS securities are carried at fair value with changes in the fair value included as a component of other comprehensive income. Declines in the fair value of AFS securities below their cost that are other-than-temporary are reflected as realized losses in the consolidated statements of income. We evaluate AFS securities for indications of losses that are considered other-than-temporary, if any, on a regular basis. The market values for AFS investment securities are typically obtained from outside sources and applied to individual securities within the portfolio.

Table of Contents

Average Balances, Interest Rate, and Net Interest Income

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

	Year Ended December 31									
	2015			2014			2013			
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	
INTEREST EARNING ASSETS										
Loans	\$829,903	\$35,853	4.32 %	\$816,105	\$36,629	4.49 %	\$792,430	\$37,575	4.74 %	
Taxable investment securities	395,981	9,053	2.29 %	357,250	8,092	2.27 %	335,575	7,228	2.15 %	
Nontaxable investment securities	205,242	9,870	4.81 %	194,751	9,877	5.07 %	165,774	8,294	5.00 %	
Other	25,947	600	2.31 %	25,784	519	2.01 %	28,306	502	1.77 %	
Total earning assets	1,457,073	55,376	3.80 %	1,393,890	55,117	3.95 %	1,322,085	53,599	4.05 %	
NONEARNING ASSETS										
Allowance for loan losses	(9,275)			(10,973)			(11,877)			
Cash and demand deposits due from banks	17,925			18,552			18,162			
Premises and equipment	26,968			25,957			25,993			
Accrued income and other assets	98,805			94,754			94,077			
Total assets	\$1,591,496			\$1,522,180			\$1,448,440			
INTEREST BEARING LIABILITIES										
Interest bearing demand deposits	\$195,260	155	0.08 %	\$191,750	157	0.08 %	\$183,665	161	0.09 %	
Savings deposits	293,703	449	0.15 %	260,469	374	0.14 %	242,777	366	0.15 %	
Time deposits	433,409	5,246	1.21 %	448,971	5,764	1.28 %	456,774	6,613	1.45 %	
Borrowed funds	295,641	4,313	1.46 %	274,080	3,675	1.34 %	251,590	3,881	1.54 %	
Total interest bearing liabilities	1,218,013	10,163	0.83 %	1,175,270	9,970	0.85 %	1,134,806	11,021	0.97 %	
NONINTEREST BEARING										

Edgar Filing: ISABELLA BANK CORP - Form 10-K

LIABILITIES

Demand deposits	181,939	165,860	141,872
Other	10,001	10,773	8,752
Shareholders' equity	181,543	170,277	163,010
Total liabilities and shareholders' equity	\$1,591,496	\$1,522,180	\$1,448,440
Net interest income (FTE)	\$45,213	\$45,147	\$42,578
Net yield on interest earning assets (FTE)	3.10 %	3.24 %	3.22 %

18

Table of Contents

Net Interest Income

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

Volume and Rate Variance Analysis

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

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

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

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

	2015 Compared to 2014			Increase Net	2014 Compared to 2013			Increase Net
	(Decrease) Due to		Net		(Decrease) Due to		Net	
	Volume	Rate			Volume	Rate		
Changes in interest income								
Loans	\$612	\$(1,388)	) \$(776)	) \$1,101	\$(2,047)	) \$(946))	
Taxable investment securities	885	76	961	480	384	864		
Nontaxable investment securities	518	(525)	) (7)	) 1,468	115	1,583		
Other	3	78	81	(47)	) 64	17		
Total changes in interest income	2,018	(1,759)	) 259	3,002	(1,484)	) 1,518		
Changes in interest expense								
Interest bearing demand deposits	3	(5)	) (2)	) 7	(11)	) (4))	
Savings deposits	50	25	75	26	(18)	) 8		
Time deposits	(195)	) (323)	) (518)	) (111)	) (738)	) (849))	
Borrowed funds	301	337	638	329	(535)	) (206))	
Total changes in interest expense	159	34	193	251	(1,302)	) (1,051))	
Net change in interest margin (FTE)	\$1,859	\$(1,793)	) \$66	\$2,751	\$(182)	) \$2,569		

Our net yield on interest earning assets remains at historically low levels. The persistent low interest rate environment coupled with an increase in the concentration of AFS securities as a percentage of earning assets has also placed downward pressure on net interest margin yield. While we anticipate that the FRB will increase short term interest rates in 2016, we do not expect any significant change in our net yield on interest earning assets as the rates paid on interest bearing liabilities will likely increase as fast as those of interest earning assets. Net interest income will increase only through continued balance sheet growth.

Average Yield / Rate for the Three Month Periods Ended:

	December 31	September 30	June 30	March 31	December 31	
	2015	2015	2015	2015	2014	
Total earning assets	3.73	% 3.79	% 3.81	% 3.88	% 3.97	%
Total interest bearing liabilities	0.83	% 0.84	% 0.84	% 0.84	% 0.85	%
Net yield on interest earning assets (FTE)	3.04	% 3.09	% 3.11	% 3.18	% 3.26	%

Table of Contents

	Quarter to Date Net Interest Income (FTE)				
	December 31 2015	September 30 2015	June 30 2015	March 31 2015	December 31 2014
Total interest income (FTE)	\$13,970	\$13,919	\$13,748	\$13,742	\$14,019
Total interest expense	2,577	2,580	2,518	2,488	2,504
Net interest income (FTE)	\$11,393	\$11,339	\$11,230	\$11,254	\$11,515

Allowance for Loan and Lease Losses

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

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

	December 31 2015	September 30 2015	June 30 2015	March 31 2015	December 31 2014
Total charge-offs	\$238	\$210	\$296	\$160	\$351
Total recoveries	210	148	231	386	115
Net loan charge-offs	28	62	65	(226)	236
Net loan charge-offs to average loans outstanding	—	0.01	% 0.01	% (0.03)	% 0.03
Provision for loan losses	\$(772)	\$(738)	\$(535)	\$(726)	\$(64)
Provision for loan losses to average loans outstanding	(0.09)%	(0.09)%	(0.07)%	(0.09)%	(0.01)%
ALLL	\$7,400	\$8,200	\$9,000	\$9,600	\$10,100
ALLL as a % of loans at end of period	0.87%	0.98%	1.08%	1.17%	1.21%

The following table summarizes our charge-off and recovery activity for the years ended December 31:

	2015	2014	2013	2012	2011
ALLL at beginning of period	\$10,100	\$11,500	\$11,936	\$12,375	\$12,373
Charge-offs					
Commercial and agricultural	134	590	907	1,672	1,984
Residential real estate	397	722	1,004	1,142	2,240
Consumer	373	316	429	542	552
Total charge-offs	904	1,628	2,340	3,356	4,776
Recoveries					
Commercial and agricultural	549	550	363	240	461
Residential real estate	220	197	181	122	177
Consumer	206	149	249	255	314
Total recoveries	975	896	793	617	952
Provision for loan losses	(2,771)	(668)	1,111	2,300	3,826
ALLL at end of period	7,400	10,100	11,500	11,936	12,375
Net loan charge-offs	\$(71)	\$732	\$1,547	\$2,739	\$3,824
Net loan charge-offs to average loans outstanding	(0.01)%	0.09%	0.20%	0.36%	0.51%
ALLL as a % of loans at end of period	0.87%	1.21%	1.42%	1.54%	1.65%

Table of Contents

As the level of net loans charged-off decline and credit quality indicators continue to improve, we have reduced the ALLL in both amount and as a percentage of loans. While more volatile, loans individually evaluated for impairment have been relatively flat until the 4th quarter of 2015. The decline in loans collectively impaired illustrates the downward trend we are experiencing in our overall level of ALLL to gross loans. The following table illustrates our changes within the two main components of the ALLL.

	December 31 2015	September 30 2015	June 30 2015	March 31 2015	December 31 2014	
ALLL						
Individually evaluated for impairment	\$2,820	\$3,217	\$3,202	\$3,361	\$3,427	
Collectively evaluated for impairment	4,580	4,983	5,798	6,239	6,673	
Total	\$7,400	\$8,200	\$9,000	\$9,600	\$10,100	
ALLL to gross loans						
Individually evaluated for impairment	0.33	% 0.38	% 0.38	% 0.41	% 0.41	%
Collectively evaluated for impairment	0.54	% 0.60	% 0.70	% 0.76	% 0.80	%
Total	0.87	% 0.98	% 1.08	% 1.17	% 1.21	%

For further discussion of the allocation of the ALLL, see “Note 5 – Loans and ALLL” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data.

Loans Past Due and Loans in Nonaccrual Status

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

	Total Past Due and Nonaccrual Loans as of December 31					
	2015	2014	2013	2012	2011	
Commercial and agricultural	\$2,247	\$4,805	\$3,621	\$7,271	\$7,420	
Residential real estate	2,520	4,181	7,008	5,431	5,297	
Consumer	31	138	259	199	186	
Total	\$4,798	\$9,124	\$10,888	\$12,901	\$12,903	
Total past due and nonaccrual loans to gross loans	0.56	% 1.09	% 1.34	% 1.67	% 1.72	%

Declines in past due and nonaccrual status loans during 2015 are the result of improved loan performance. A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual status loans by type, is included in “Note 5 – Loans and ALLL” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data.

Troubled Debt Restructurings

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

We restructure debt with borrowers who due to temporary financial difficulties are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, forgive principal, forgive interest, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There were no TDRs that were Government sponsored as of December 31, 2015 or December 31, 2014.

Table of Contents

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

The following tables provide a roll-forward of TDRs for the years ended December 31, 2014 and 2015:

	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans		of Loans		of Loans	
January 1, 2014	165	\$24,423	15	\$1,442	180	\$25,865
New modifications	30	2,647	5	367	35	3,014
Principal advances (payments)	—	(1,501)	—	(254)	—	(1,755)
Loans paid-off	(32)	(2,964)	(3)	(90)	(35)	(3,054)
Partial charge-offs	—	(70)	—	(193)	—	(263)
Balances charged-off	(3)	(13)	(3)	(115)	(6)	(128)
Transfers to OREO	—	—	(5)	(338)	(5)	(338)
Transfers to accrual status	5	502	(5)	(502)	—	—
Transfers to nonaccrual status	(9)	(2,093)	9	2,093	—	—
December 31, 2014	156	20,931	13	2,410	169	23,341
New modifications	28	6,490	4	491	32	6,981
Principal advances (payments)	—	(1,205)	—	(1,002)	—	(2,207)
Loans paid-off	(26)	(5,227)	(7)	(597)	(33)	(5,824)
Partial charge-offs	—	—	—	(87)	—	(87)
Balances charged-off	(2)	(83)	—	—	(2)	(83)
Transfers to OREO	—	—	(6)	(796)	(6)	(796)
Transfers to accrual status	3	292	(3)	(292)	—	—
Transfers to nonaccrual status	(4)	(267)	4	267	—	—
December 31, 2015	155	\$20,931	5	\$394	160	\$21,325

The following table summarizes our TDRs as of December 31:

	2015			2014			2013		
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total
Current	\$20,550	\$146	\$20,696	\$20,012	\$272	\$20,284	\$21,690	\$1,189	\$22,879
Past due 30-59 days	357	—	357	804	592	1,396	2,158	37	2,195
Past due 60-89 days	24	—	24	115	3	118	575	—	575
Past due 90 days or more	—	248	248	—	1,543	1,543	—	216	216
Total	\$20,931	\$394	\$21,325	\$20,931	\$2,410	\$23,341	\$24,423	\$1,442	\$25,865
	2012			2011					
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total
Current	\$16,301	\$941	\$17,242	\$16,125	\$514	\$16,639			
Past due 30-59 days	158	561	719	1,564	344	1,908			
Past due 60-89 days	72	41	113	50	85	135			
Past due 90 days or more	—	1,281	1,281	—	74	74			
Total	\$16,531	\$2,824	\$19,355	\$17,739	\$1,017	\$18,756			

Additional disclosures about TDRs are included in “Note 5 – Loans and ALLL” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data.

Table of Contents

Impaired Loans

The following is a summary of information pertaining to impaired loans as of December 31:

	2015			2014		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
TDRs						
Commercial real estate	\$7,619	\$7,858	\$818	\$10,222	\$10,501	\$1,276
Commercial other	188	199	11	715	945	4
Agricultural real estate	3,549	3,549	—	1,423	1,423	—
Agricultural other	519	519	2	66	186	—
Residential real estate senior liens	9,155	9,457	1,851	10,462	11,019	1,847
Residential real estate junior liens	133	133	28	246	246	49
Home equity lines of credit	127	427	—	153	453	46
Consumer secured	35	35	—	54	54	1
Total TDRs	21,325	22,177	2,710	23,341	24,827	3,223
Other impaired loans						
Commercial real estate	162	175	—	1,009	1,195	3
Commercial other	—	—	—	83	95	—
Agricultural real estate	—	—	—	106	106	—
Agricultural other	—	—	—	—	—	—
Residential real estate senior liens	841	1,308	108	1,183	1,763	168
Residential real estate junior liens	10	30	2	19	29	4
Home equity lines of credit	—	7	—	97	197	29
Consumer secured	—	—	—	10	10	—
Total other impaired loans	1,013	1,520	110	2,507	3,395	204
Total impaired loans	\$22,338	\$23,697	\$2,820	\$25,848	\$28,222	\$3,427

Additional disclosure related to impaired loans is included in “Note 5 – Loans and ALLL” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data.

Nonperforming Assets

The following table summarizes our nonperforming assets as of December 31:

	2015	2014	2013	2012	2011	
Nonaccrual status loans	\$792	\$4,044	\$3,244	\$7,303	\$6,389	
Accruing loans past due 90 days or more	—	148	142	428	760	
Total nonperforming loans	792	4,192	3,386	7,731	7,149	
Foreclosed assets	421	885	1,412	2,018	1,876	
Total nonperforming assets	\$1,213	\$5,077	\$4,798	\$9,749	\$9,025	
Nonperforming loans as a % of total loans	0.09	% 0.50	% 0.42	% 1.00	% 0.95	%
Nonperforming assets as a % of total assets	0.07	% 0.33	% 0.32	% 0.68	% 0.67	%

After a loan is 90 days past due, it is placed on nonaccrual status unless it is well secured and in the process of collection. Upon transferring a loan to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Loans

may be placed back on accrual status after six months months of continued performance. Total nonperforming loans continue to improve with current levels reflecting historic lows.

Table of Contents

Included in the nonaccrual loan balances above were loans currently classified as TDRs as of December 31:

	2015	2014	2013	2012	2011
Commercial and agricultural	\$232	\$1,995	\$833	\$2,325	\$520
Residential real estate	162	262	609	499	497
Consumer	—	153	—	—	—
Total	\$394	\$2,410	\$1,442	\$2,824	\$1,017

Additional disclosures about nonaccrual status loans are included in “Note 5 – Loans and ALLL” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data.

We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge-off. We believe that we have identified all impaired loans as of December 31, 2015.

We believe that the level of the ALLL is appropriate as of December 31, 2015. We will continue to closely monitor overall credit quality indicators and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains at the appropriate level.

Table of Contents

Noninterest Income and Noninterest Expenses

Significant noninterest account balances are highlighted in the following table with additional descriptions of significant fluctuations for the years ended December 31:

	2015	2014	Change		2013	Change		
			\$	%		\$	%	
Service charges and fees								
ATM and debit card fees	\$2,411	\$2,084	\$327	15.69	% \$1,944	\$140	7.20	%
NSF and overdraft fees	1,855	2,156	(301)	(13.96)	% 2,243	(87)	(3.88)	%
Freddie Mac servicing fee	712	720	(8)	(1.11)	% 737	(17)	(2.31)	%
Service charges on deposit accounts	345	354	(9)	(2.54)	% 373	(19)	(5.09)	%
Net OMSR income (loss)	(14)	(36)	22	61.11	% 269	(305)	(113.38)	%
All other	128	133	(5)	(3.76)	% 116	17	14.66	%
Total service charges and fees	5,437	5,411	26	0.48	% 5,682	(271)	(4.77)	%
Net gain on sale of mortgage loans	573	514	59	11.48	% 962	(448)	(46.57)	%
Earnings on corporate owned life insurance policies	771	751	20	2.66	% 732	19	2.60	%
Net gains (losses) on sale of AFS securities	163	97	66	68.04	% 171	(74)	(43.27)	%
Other								
Trust and brokerage advisory fees	2,161	2,069	92	4.45	% 1,858	211	11.36	%
Corporate Settlement Solutions joint venture	463	76	387	509.21	% 143	(67)	(46.85)	%
Other	791	407	384	94.35	% 627	(220)	(35.09)	%
Total other	3,415	2,552	863	33.82	% 2,628	(76)	(2.89)	%
Total noninterest income	\$10,359	\$9,325	\$1,034	11.09	% \$10,175	\$(850)	(8.35)	%

Significant changes in noninterest income are detailed below:

ATM and debit card fees increased during 2015 as a result of marketing incentives. While we do not anticipate significant changes to our ATM and debit card fees, we do expect that fees will continue to increase in 2016 as the usage of ATM and debit cards continues to increase.

NSF and overdraft fees fluctuate from period-to-period based on customer activity as well as the number of business days in the period. We anticipate NSF and overdraft fees in 2016 to approximate 2015 levels.

Offering rates on residential mortgage loans, as well as the decline in loan demand, have been the most significant drivers behind fluctuations in the gain on sale of mortgage loans and net OMSR income (loss). Mortgage rates are expected to approximate current levels in the foreseeable future and purchase money mortgage activity is anticipated to increase as a result of our various initiatives to drive growth. As such, we anticipate increases in origination volumes and in turn, an increase in gains on sale of mortgage loans.

We are continually analyzing our AFS securities for potential sale opportunities. These analyses identified several securities that made economic sense to sell in 2015, 2014, and 2013.

In recent periods, we have invested considerable efforts to increase our market share in trust and brokerage advisory services. These efforts have translated into increases in trust fees and brokerage and advisory fees. We anticipate that these fees will continue to increase in 2016.

The increase in earnings from our Corporate Settlement Solutions joint venture during 2015 can be attributed to their expansion of national sales and maintaining consistent margins with the increased sales volume.

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

Table of Contents

Significant noninterest expense account balances are highlighted in the following table with additional descriptions of significant fluctuations for the years ended December 31:

	2015	2014	Change		2013	Change			
			\$	%		\$	%		
Compensation and benefits									
Employee salaries	\$13,760	\$13,311	\$449	3.37	% \$12,019	\$1,292	10.75	%	
Employee benefits	5,308	5,191	117	2.25	% 5,788	(597)	(10.31))%	
Total compensation and benefits	19,068	18,502	566	3.06	% 17,807	695	3.90	%	
Furniture and equipment									
Service contracts	2,932	2,542	390	15.34	% 2,277	265	11.64	%	
Depreciation	1,949	1,850	99	5.35	% 1,889	(39)	(2.06))%	
ATM and debit card fees	742	722	20	2.77	% 710	12	1.69	%	
All other	116	59	57	96.61	% 69	(10)	(14.49))%	
Total furniture and equipment	5,739	5,173	566	10.94	% 4,945	228	4.61	%	
Occupancy									
Depreciation	728	701	27	3.85	% 667	34	5.10	%	
Outside services	701	718	(17)	(2.37)	)% 671	47	7.00	%	
Utilities	528	524	4	0.76	% 502	22	4.38	%	
Property taxes	526	515	11	2.14	% 499	16	3.21	%	
All other	351	340	11	3.24	% 314	26	8.28	%	
Total occupancy	2,834	2,798	36	1.29	% 2,653	145	5.47	%	
Other									
Director fees	827	775	52	6.71	% 819	(44)	(5.37))%	
Audit and related fees	821	809	12	1.48	% 738	71	9.62	%	
FDIC insurance premiums	813	842	(29)	(3.44)	)% 1,082	(240)	(22.18))%	
Donations and community relations	808	1,004	(196)	(19.52)	)% 715	289	40.42	%	
Marketing costs	491	427	64	14.99	% 416	11	2.64	%	
Legal fees	464	320	144	45.00	% 359	(39)	(10.86))%	
Education and travel	442	625	(183)	(29.28)	)% 502	123	24.50	%	
Printing and supplies	405	367	38	10.35	% 396	(29)	(7.32))%	
Postage and freight	377	397	(20)	(5.04)	)% 387	10	2.58	%	
Consulting fees	364	349	15	4.30	% 315	34	10.79	%	
Loan underwriting fees	347	361	(14)	(3.88)	)% 423	(62)	(14.66))%	
State taxes	218	171	47	27.49	% 140	31	22.14	%	
Amortization of deposit premium	169	183	(14)	(7.65)	)% 221	(38)	(17.19))%	
Other losses	150	250	(100)	(40.00)	)% 109	141	129.36	%	
Foreclosed asset and collection	53	122	(69)	(56.56)	)% 211	(89)	(42.18))%	
All other	1,661	1,628	33	2.03	% 1,517	111	7.32	%	
Total other	8,410	8,630	(220)	(2.55)	)% 8,350	280	3.35	%	
Total noninterest expenses	\$36,051	\$35,103	\$948	2.70	% \$33,755	\$1,348	3.99	%	

Table of Contents

Significant changes in noninterest expenses are detailed below:

Employee salaries have increased as a result of normal merit increases and additional staffing required by our continued growth. The decline in employee benefits from 2013 to 2014, is related to health care costs as a result of lower than anticipated claims. Employee benefits are expected to increase moderately in future periods as a result of anticipated increases in health care costs.

Service contracts include approximately \$147 of conversion related costs incurred as a result of two branch acquisitions during the third quarter of 2015.

FDIC insurance premiums were elevated in 2013 due to us receiving less of a refund for prepaid FDIC insurance premiums than we had anticipated. FDIC insurance premiums have returned to normalized levels and are anticipated to approximate current levels in 2016.

We have consistently been a strong supporter of the various communities, schools, and charities in the markets we serve. We sponsor a foundation, which we established in 1996, that is funded by discretionary donations. The foundation provides centralized oversight for charitable donations to organizations that benefit our communities. Included in donations and community relations were discretionary donations to the foundation of \$258, \$500, and \$200 for the years ended December 31, 2015, 2014, and 2013, respectively.

- Legal fees include approximately \$133 of legal service expense incurred as a result of two branch acquisitions during the third quarter of 2015. Legal fees are expected to approximate 2014 levels in 2016.

We place a strong emphasis on employee development through continuous education. Education and travel expenses vary from year to year based on the timing of various programs that our employees attend.

- Other losses increased significantly in 2014 primarily as a result of losses related to fraudulent activities associated with debit cards. Also contributing to losses in 2014 were losses related to the repurchase of loans that we previously sold to a third party. While other losses fluctuate from period to period, they are expected to approximate 2015 levels in 2016.

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

Table of Contents

Analysis of Changes in Financial Condition

The following table shows the composition and changes in our balance sheet as of December 31:

	2015	2014	Change		
			\$	%	
ASSETS					
Cash and cash equivalents	\$21,569	\$19,906	\$1,663	8.35	%
AFS securities					
Amortized cost of AFS securities	654,348	561,893	92,455	16.45	%
Unrealized gains (losses) on AFS securities	5,788	5,641	147	2.61	%
AFS securities	660,136	567,534	92,602	16.32	%
Mortgage loans AFS	1,187	901	286	31.74	%
Loans					
Gross loans	850,492	836,550	13,942	1.67	%
Less allowance for loan and lease losses	7,400	10,100	(2,700)	(26.73))%
Net loans	843,092	826,450	16,642	2.01	%
Premises and equipment	28,331	25,881	2,450	9.47	%
Corporate owned life insurance policies	26,423	25,152	1,271	5.05	%
Accrued interest receivable	6,269	5,851	418	7.14	%
Equity securities without readily determinable fair values	22,286	20,076	2,210	11.01	%
Goodwill and other intangible assets	48,828	46,128	2,700	5.85	%
Other assets	9,991	11,664	(1,673)	(14.34))%
TOTAL ASSETS	\$1,668,112	\$1,549,543	\$118,569	7.65	%
LIABILITIES AND SHAREHOLDERS' EQUITY					
Liabilities					
Deposits	\$1,164,563	\$1,074,484	\$90,079	8.38	%
Borrowed funds	309,732	289,709	20,023	6.91	%
Accrued interest payable and other liabilities	9,846	10,756	(910)	(8.46))%
Total liabilities	1,484,141	1,374,949	109,192	7.94	%
Shareholders' equity	183,971	174,594	9,377	5.37	%
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,668,112	\$1,549,543	\$118,569	7.65	%

As shown above, total assets have increased \$118,569 since December 31, 2014. During 2015, we increased our cost basis of AFS securities by \$92,455 while loans grew by \$13,942. Included in the increase in our AFS securities portfolio was \$147 increase in unrealized gains. This balance sheet growth was funded by increases in both deposits (through branch acquisitions) and borrowed funds. While we do anticipate that generating quality loans will continue to be competitive, we expect that loans will continue to grow in 2016.

A discussion of changes in balance sheet amounts by major categories follows:

Cash and cash equivalents

Included in cash and cash equivalents are funds held with FRB which fluctuate from period-to-period.

AFS investment securities

The primary objective of our investing activities is to provide for safety of the principal invested. Secondary considerations include the need for earnings, liquidity, and our overall exposure to changes in interest rates. The current interest rate environment has made it almost impossible to increase net interest income without increasing earning assets. As deposit growth outpaced loan demand in recent periods, we deployed funds from deposit growth into purchases of AFS securities to provide additional interest income. We anticipate that future increases in our AFS securities will be in the form of mortgage-backed securities and collateralized mortgage obligations.

Table of Contents

The following is a schedule of the carrying value of AFS investment securities as of December 31:

	2015	2014	2013	2012	2011
Government sponsored enterprises	\$24,345	\$24,136	\$23,745	\$25,776	\$397
States and political subdivisions	232,217	215,345	201,988	182,743	174,938
Auction rate money market preferred	2,866	2,619	2,577	2,778	2,049
Preferred stocks	3,299	6,140	5,827	6,363	5,033
Mortgage-backed securities	263,384	166,926	144,115	155,345	143,602
Collateralized mortgage obligations	134,025	152,368	133,810	131,005	99,101
Total	\$660,136	\$567,534	\$512,062	\$504,010	\$425,120

Excluding those holdings in government sponsored enterprises and municipalities within the State of Michigan, there were no investments in securities of any one issuer that exceeded 10% of shareholders' equity. We have a policy prohibiting investments in securities that we deem are unsuitable due to their inherent credit or market risks.

Prohibited investments include stripped mortgage backed securities, zero coupon bonds, nongovernment agency asset backed securities, and structured notes. Our holdings in mortgage-backed securities and collateralized mortgage obligations include only government agencies and government sponsored agencies as we hold no investments in private label mortgage-backed securities or collateralized mortgage obligations.

The following is a schedule of maturities of AFS investment securities and their weighted average yield as of December 31, 2015. Weighted average yields have been computed on an FTE basis using a tax rate of 34%. Our auction rate money market preferred is a long term floating rate instrument for which the interest rate is set at periodic auctions. At each successful auction, we have the option to sell the security at par value. Additionally, the issuers of auction rate securities generally have the right to redeem or refinance the debt. Because of their lack of contractual maturities, auction rate money market preferred and preferred stocks are not reported by a specific maturity group. Mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group due to their variable monthly payments. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Maturing									
	Within One Year		After One Year But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Securities with Variable Monthly Payments or Noncontractual Maturities	
	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)
Government sponsored enterprises	\$—	—	\$23,963	1.45	\$382	2.05	\$—	—	\$—	—
States and political subdivisions	30,217	2.01	71,489	4.75	96,489	4.22	34,022	4.91	—	—
Mortgage-backed securities	—	—	—	—	—	—	—	—	263,384	2.28
Collateralized mortgage obligations	—	—	—	—	—	—	—	—	134,025	2.35
Auction rate money market preferred	—	—	—	—	—	—	—	—	2,866	6.35
Preferred stocks	—	—	—	—	—	—	—	—	3,299	5.44
Total	\$30,217	2.01	\$95,452	3.92	\$96,871	4.21	\$34,022	4.91	\$403,574	2.36

Table of Contents

Loans

Loans are the largest component of earning assets. The proper management of credit and market risk inherent in the loan portfolio is critical to our financial well-being. To control these risks, we have adopted strict underwriting standards. These standards include specific criteria against lending outside our defined market areas, lending limits to a single borrower, and strict loan to collateral value limits. We also monitor and limit loan concentrations to specific industries. We have no foreign loans and there were no concentrations greater than 10% of total loans that are not disclosed as a separate category in the following table.

The following table presents the composition of the loan portfolio for the years ended December 31:

	2015	2014	2013	2012	2011
Commercial	\$448,381	\$433,270	\$393,164	\$372,332	\$366,440
Agricultural	115,911	104,721	92,589	83,606	74,645
Residential real estate	251,501	266,155	291,499	285,070	278,803
Consumer	34,699	32,404	33,525	33,619	31,722
Total	\$850,492	\$836,550	\$810,777	\$774,627	\$751,610

The following table presents the change in the loan portfolio categories for the years ended December 31:

	2015		2014		2013		
	\$ Change	% Change	\$ Change	% Change	\$ Change	% Change	
Commercial	\$15,111	3.49	% \$40,106	10.20	% \$20,832	5.60	%
Agricultural	11,190	10.69	% 12,132	13.10	% 8,983	10.74	%
Residential real estate	(14,654)	(5.51)%	(25,344)	(8.69)%	6,429	2.26	%
Consumer	2,295	7.08	% (1,121)	(3.34)%	(94)	(0.28)%	%
Total	\$13,942	1.67	% \$25,773	3.18	% \$36,150	4.67	%

While competition for commercial loans continues to be strong, we experienced growth in this segment of the portfolio during 2015 and anticipate strong growth in 2016. Residential real estate loans declined during 2015; however, we anticipate growth in 2016 as a result of initiatives designed to increase both loan volume and the number of originations.

Equity securities without readily determinable fair values

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost and investments in unconsolidated entities accounted for under the equity method of accounting (see “Note 1 – Nature of Operations and Summary of Significant Accounting Policies” and “Note 20 – Fair Value” of the “Notes to Consolidated Financial Statements” in Item 8. Financial Statements and Supplementary Data).

Deposits

Deposits are our primary source of funding. The following table presents the composition of the deposit portfolio as of December 31:

	2015	2014	2013	2012	2011
Noninterest bearing demand deposits	\$191,376	\$181,826	\$158,428	\$143,735	\$119,072
Interest bearing demand deposits	212,666	190,984	192,089	181,259	163,653
Savings deposits	337,641	261,412	243,237	228,338	193,902
Certificates of deposit	324,101	339,824	362,473	376,790	395,777
Brokered certificates of deposit	73,815	72,134	56,329	55,348	54,326
Internet certificates of deposit	24,964	28,304	31,210	32,197	31,434
Total	\$1,164,563	\$1,074,484	\$1,043,766	\$1,017,667	\$958,164

Table of Contents

The following table presents the change in the deposit categories for the years ended December 31:

	2015		2014		2013			
	\$ Change	% Change	\$ Change	% Change	\$ Change	% Change		
Noninterest bearing demand deposits	\$9,550	5.25	% \$23,398	14.77	% \$14,693	10.22	%	
Interest bearing demand deposits	21,682	11.35	% (1,105)	(0.58)%	10,830	5.97	%	
Savings deposits	76,229	29.16	% 18,175	7.47	% 14,899	6.52	%	
Certificates of deposit	(15,723)	(4.63)%	(22,649)	(6.25)%	(14,317)	(3.80)%		
Brokered certificates of deposit	1,681	2.33	% 15,805	28.06	% 981	1.77	%	
Internet certificates of deposit	(3,340)	(11.80)%	(2,906)	(9.31)%	(987)	(3.07)%		
Total	\$90,079	8.38	% \$30,718	2.94	% \$26,099	2.56	%	

Deposit demand continues to be driven by non-contractual deposits while certificates of deposit gradually decline. Our significant growth in savings deposits during 2015 is the result of our recent branch acquisitions. In 2016, growth is anticipated to continue to come in the form of non-contractual deposits, while certificates of deposit are expected to continue to decline but at a sl