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

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

Commission file number 0-7818

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

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

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

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

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

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

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

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

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

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

Common stock, no par value 9,493,399

Class	Outstanding at August 7, 2013

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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

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

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

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all inclusive. The risk factors disclosed in Part I – Item A of our Annual Report on Form 10-K for the year ended December 31, 2012, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks that our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us, that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

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Part I - Item 1.

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Financial Condition

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

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

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

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

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

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Comprehensive Income

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

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

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

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

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

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

See notes to interim condensed consolidated financial statements (unaudited)

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Preparation of Financial Statements

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

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

2. New Accounting Standards

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

3. Securities

Securities available for sale consist of the following:

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

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

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

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

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

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

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

	June 30, 2013		December 31, 2012	
	Fair Value	Net Unrealized Gain (Loss)	Fair Value	Net Unrealized Gain (Loss)
	(In thousands)			
Private label residential mortgage-backed				
Jumbo	$5,299	$ (483)	$6,041	$ (594)
Alt-A	2,183	(140)	2,153	(282)

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

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

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

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

	Senior Security	Super Senior Security	Senior Support Security	Total
	(In thousands)			
As of June 30, 2013				
Fair value	$2,903	$ 1,838	$ 57	$4,798
Amortized cost	3,231	1,801	-	5,032
Non-credit unrealized loss	328	-	-	328
Unrealized gain	-	37	57	94
Cumulative credit related OTTI	748	457	380	1,585
Credit related OTTI recognized in our Condensed Consolidated Statements of Operations				
For the three months ended June 30,				
2013	$26	$ -	$ -	$26
2012	85	-	-	85
For the six months ended June 30,				
2013	26	-	-	26
2012	170	32	60	262

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

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

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

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

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

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

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

	June 30, 2013		December 31, 2012	
	Fair Value	Net Unrealized Loss	Fair Value	Net Unrealized Loss
	(In thousands)			
Trust preferred securities				
Rated issues	$1,615	$ (284)	$1,581	$ (316)
Unrated issues	780	(220)	1,508	(1,299)

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

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

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

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

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

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

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

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

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

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

4. Loans

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

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

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

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

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

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

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

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

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

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

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An aging analysis of loans by class follows:

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

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

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

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

Impaired loans are as follows :

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

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Impaired loans by class are as follows (1):

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

1-4 family	60,956	64,392	7,957	64,160	68,418	8,518
Resort lending	21,685	22,710	3,593	23,763	24,160	4,321
Home equity line of credit - 1st lien	155	166	83	62	77	30
Home equity line of credit - 2nd lien	42	118	4	43	118	-
Installment						
Home equity installment - 1st lien	3,026	3,255	520	3,242	3,459	610
Home equity installment - 2nd lien	3,321	3,321	816	3,439	3,452	930
Loans not secured by real estate	819	925	62	804	875	42
Other	18	18	-	20	20	-
Total	$137,581	$147,457	$ 17,481	$151,167	$165,922	$ 21,009
Accrued interest included in recorded investment	$522			$506		

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

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

	2013		2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:	(In thousands)			
Commercial				
Income producing - real estate	$4,856	$ 42	$2,211	$ 13
Land, land development & construction-real estate	3,212	42	2,877	36
Commercial and industrial	4,400	76	3,896	44
Mortgage				
1-4 family	4	-	-	-
Resort lending	35	-	936	-
Home equity line of credit - 1st lien	-	-	-	-
Home equity line of credit - 2nd lien	-	-	-	-
Installment				
Home equity installment - 1st lien	2,020	28	1,827	32
Home equity installment - 2nd lien	2,313	33	1,987	30
Loans not secured by real estate	599	7	473	7
Other	19	-	23	-
	17,458	228	14,230	162
With an allowance recorded:				
Commercial				
Income producing - real estate	20,745	176	24,300	120
Land, land development & construction-real estate	6,837	55	10,495	52
Commercial and industrial	11,886	88	18,954	156
Mortgage				
1-4 family	62,011	682	66,900	725
Resort lending	21,916	222	23,697	252
Home equity line of credit - 1st lien	156	-	70	-
Home equity line of credit - 2nd lien	42	-	93	1
Installment				
Home equity installment - 1st lien	1,023	8		