

INDEPENDENT BANK CORP /MI/  
Form 10-Q  
November 03, 2017

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2017

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)

4200 East Beltline, Grand Rapids, Michigan 49525  
(Address of principal executive offices)

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

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to section 13(a) of the Exchange Act. Yes No

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

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

|                            |                                 |
|----------------------------|---------------------------------|
| Common stock, no par value | 21,331,967                      |
| Class                      | Outstanding at November 2, 2017 |

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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FORWARD-LOOKING STATEMENTS

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

- economic, market, operational, liquidity, credit, and interest rate risks associated with our business;
- economic conditions generally and in the financial services industry, particularly economic conditions within Michigan and the regional and local real estate markets in which our bank operates;
- the failure of assumptions underlying the establishment of, and provisions made to, our allowance for loan losses;
- increased competition in the financial services industry, either nationally or regionally;
- our ability to achieve loan and deposit growth;
- volatility and direction of market interest rates;
- the continued services of our management team; and
- implementation of new legislation, which may have significant effects on us and the financial services industry.

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all-inclusive. The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2016, 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 our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

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

|  | September 30,<br>2017<br>(unaudited) | December 31,<br>2016 |
|--|--------------------------------------|----------------------|
|  | (In thousands, except share amounts) |                      |
| Assets   |                                      |                      |
| Cash and due from banks  | \$ 31,998                            | \$ 35,238            |
| Interest bearing deposits                                      | 15,605                               | 47,956               |
| Cash and Cash Equivalents                                      | 47,603                               | 83,194               |
| Interest bearing deposits - time                               | 3,489                                | 5,591                |
| Trading securities   | 347                                  | 410                  |
| Securities available for sale                                  | 548,865                              | 610,616              |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 15,543                               | 15,543               |
| Loans held for sale, carried at fair value                     | 47,611                               | 35,946               |
| Payment plan receivables and other assets held for sale        | -                                    | 33,360               |
| Loans  |                                      |                      |
| Commercial   | 837,250                              | 804,017              |
| Mortgage   | 781,346                              | 538,615              |
| Installment  | 318,498                              | 265,616              |
| Total Loans  | 1,937,094                            | 1,608,248            |
| Allowance for loan losses                                      | (21,478 )                            | (20,234 )            |
| Net Loans  | 1,915,616                            | 1,588,014            |
| Other real estate and repossessed assets                       | 2,150                                | 5,004                |
| Property and equipment, net                                    | 38,774                               | 40,175               |
| Bank-owned life insurance                                      | 54,286                               | 54,033               |
| Deferred tax assets, net                                       | 22,433                               | 32,818               |
| Capitalized mortgage loan servicing rights                     | 14,675                               | 13,671               |
| Other intangibles  | 1,673                                | 1,932                |
| Accrued income and other assets                                | 40,381                               | 28,643               |
| Total Assets   | \$ 2,753,446                         | \$ 2,548,950         |
| Liabilities and Shareholders' Equity                           |                                      |                      |
| Deposits   |                                      |                      |
| Non-interest bearing   | \$ 753,555                           | \$ 717,472           |
| Savings and interest-bearing checking                          | 1,040,974                            | 1,015,724            |
| Reciprocal   | 49,078                               | 38,657               |
| Time   | 412,601                              | 453,866              |
| Brokered time  | 87,553                               | -                    |
| Total Deposits   | 2,343,761                            | 2,225,719            |
| Federal funds purchased  | 3,000                                | -                    |
| Other borrowings   | 72,849                               | 9,433                |
| Subordinated debentures  | 35,569                               | 35,569               |
| Other liabilities held for sale                                | -                                    | 718                  |
| Accrued expenses and other liabilities                         | 30,557                               | 28,531               |
| Total Liabilities  | 2,485,736                            | 2,299,970            |
| Shareholders' Equity   | -                                    | -                    |

Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding

Common stock, no par value, 500,000,000 shares authorized; issued and outstanding: 21,332,317 shares at September 30, 2017 and 21,258,092 shares at December 31, 2016

|  |              |   |              |   |
|--|--------------|---|--------------|---|
|  | 324,607      |   | 323,745      |   |
| Accumulated deficit                        | (53,240      | ) | (65,657      | ) |
| Accumulated other comprehensive loss       | (3,657       | ) | (9,108       | ) |
| Total Shareholders' Equity                 | 267,710      |   | 248,980      |   |
| Total Liabilities and Shareholders' Equity | \$ 2,753,446 |   | \$ 2,548,950 |   |

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                       |                    | Nine months ended  |                    |
|---|--|--------------------|--------------------|--------------------|
|   | September 30, 2017                       | September 30, 2016 | September 30, 2017 | September 30, 2016 |
|   |  |                    | (unaudited)        |                    |
|   | (In thousands, except per share amounts) |                    |                    |                    |
| Interest Income                                     |  |                    |                    |                    |
| Interest and fees on loans                          | \$21,831                                 | \$18,597           | \$61,638           | \$55,361           |
| Interest on securities                              |  |                    |                    |                    |
| Taxable   | 2,765                                    | 2,537              | 8,300              | 7,261              |
| Tax-exempt  | 512                                      | 330                | 1,478              | 860                |
| Other investments                                   | 263                                      | 281                | 867                | 884                |
| Total Interest Income                               | 25,371                                   | 21,745             | 72,283             | 64,366             |
| Interest Expense                                    |  |                    |                    |                    |
| Deposits  | 1,833                                    | 1,254              | 4,754              | 3,520              |
| Other borrowings and subordinated debentures        | 626                                      | 493                | 1,659              | 1,455              |
| Total Interest Expense                              | 2,459                                    | 1,747              | 6,413              | 4,975              |
| Net Interest Income                                 | 22,912                                   | 19,998             | 65,870             | 59,391             |
| Provision for loan losses                           | 582                                      | (175 )             | 806                | (1,439 )           |
| Net Interest Income After Provision for Loan Losses | 22,330                                   | 20,173             | 65,064             | 60,830             |
| Non-interest Income                                 |  |                    |                    |                    |
| Service charges on deposit accounts                 | 3,281                                    | 3,281              | 9,465              | 9,164              |
| Interchange income                                  | 1,942                                    | 1,943              | 5,869              | 5,797              |
| Net gains (losses) on assets                        |  |                    |                    |                    |
| Mortgage loans                                      | 2,971                                    | 3,556              | 8,886              | 7,727              |
| Securities  | 69                                       | (45 )              | 62                 | 302                |
| Mortgage loan servicing, net                        | 1  | 858                | 668                | (454 )             |
| Other   | 2,040                                    | 2,115              | 6,139              | 6,561              |
| Total Non-interest Income                           | 10,304                                   | 11,708             | 31,089             | 29,097             |
| Non-interest Expense                                |  |                    |                    |                    |
| Compensation and employee benefits                  | 13,577                                   | 13,031             | 41,104             | 36,912             |
| Occupancy, net                                      | 1,970                                    | 1,919              | 6,032              | 5,982              |
| Data processing                                     | 1,796                                    | 1,971              | 5,670              | 6,008              |
| Furniture, fixtures and equipment                   | 961                                      | 990                | 2,943              | 2,939              |
| Communications                                      | 685                                      | 670                | 2,046              | 2,280              |
| Loan and collection                                 | 481                                      | 568                | 1,564              | 1,964              |
| Advertising   | 526                                      | 455                | 1,551              | 1,410              |
| Legal and professional                              | 550                                      | 420                | 1,376              | 1,178              |
| Interchange expense                                 | 294                                      | 276                | 869                | 809                |
| FDIC deposit insurance                              | 208                                      | 187                | 608                | 852                |
| Credit card and bank service fees                   | 105                                      | 203                | 432                | 588                |
| Other   | 1,463                                    | 1,839              | 4,751              | 4,547              |
| Total Non-interest Expense                          | 22,616                                   | 22,529             | 68,946             | 65,469             |
| Income Before Income Tax                            | 10,018                                   | 9,352              | 27,207             | 24,458             |
| Income tax expense                                  | 3,159                                    | 2,979              | 8,443              | 7,547              |
| Net Income  | \$6,859                                  | \$6,373            | \$18,764           | \$16,911           |

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|                             |        |        |        |        |
|-----------------------------|--------|--------|--------|--------|
| Net Income Per Common Share |        |        |        |        |
| Basic                       | \$0.32 | \$0.30 | \$0.88 | \$0.79 |
| Diluted                     | \$0.32 | \$0.30 | \$0.87 | \$0.78 |
| Dividends Per Common Share  |        |        |        |        |
| Declared                    | \$0.10 | \$0.08 | \$0.30 | \$0.24 |
| Paid                        | \$0.10 | \$0.08 | \$0.30 | \$0.24 |

See notes to interim condensed consolidated financial statements (unaudited)



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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

|  | Three months<br>ended<br>September 30,<br>2017 |         | 2016        |        | Nine months ended<br>September 30,<br>2017 |        | 2016        |  |
|--|--|---------|-------------|--------|--|--------|-------------|--|
|  | (unaudited)                                    |         | (unaudited) |        | (unaudited)                                |        | (unaudited) |  |
|  | (In thousands)                                 |         |             |        |  |        |             |  |
| Net income   | \$6,859  | \$6,373 | \$          | 18,764 | \$   | 16,911 |             |  |
| Other comprehensive income, before tax   |  |         |             |        |  |        |             |  |
| Securities available for sale  |  |         |             |        |  |        |             |  |
| Unrealized gains arising during period   | 20   | 451     | 7,738       |        | 4,899                                      |        |             |  |
| Change in unrealized gains for which a portion of other than<br>temporary impairment has been recognized in earnings | 126  | (24 )   | 211         |        | 47   |        |             |  |
| Reclassification adjustments for gains included in earnings  | (8 )   | (15 )   | (125 )      |        | (298 )                                     |        |             |  |
| Unrealized gains recognized in other comprehensive income on<br>securities available for sale                        | 138  | 412     | 7,824       |        | 4,648                                      |        |             |  |
| Income tax expense   | 48   | 144     | 2,738       |        | 1,627                                      |        |             |  |
| Unrealized gains recognized in other comprehensive income on<br>securities available for sale, net of tax            | 90   | 268     | 5,086       |        | 3,021                                      |        |             |  |
| Derivative instruments   |  |         |             |        |  |        |             |  |
| Unrealized gain arising during period  | 95   | -       | 95          |        | -  |        |             |  |
| Reclassification adjustment for expense recognized in earnings   | 5  | -       | 5           |        | -  |        |             |  |
| Unrealized gains recognized in other comprehensive income on<br>derivative instruments                               | 100  | -       | 100         |        | -  |        |             |  |
| Income tax expense   | 35   | -       | 35          |        | -  |        |             |  |
| Unrealized gains recognized in other comprehensive income on<br>derivative instruments, net of tax                   | 65   | -       | 65          |        | -  |        |             |  |
| Other comprehensive income   | 155  | 268     | 5,151       |        | 3,021                                      |        |             |  |
| Comprehensive income   | \$7,014  | \$6,641 | \$          | 23,915 | \$   | 19,932 |             |  |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

|   | Nine months ended September<br>30, |            |
|---|------------------------------------|------------|
|   | 2017                               | 2016       |
|   | (unaudited - In thousands)         |            |
| Net Income  | \$ 18,764                          | \$ 16,911  |
| Adjustments to Reconcile Net Income to Net Cash From Operating Activities   |                                    |            |
| Proceeds from sales of loans held for sale  | 313,559                            | 222,610    |
| Disbursements for loans held for sale   | (316,338 )                         | (225,025 ) |
| Provision for loan losses   | 806                                | (1,439 )   |
| Deferred income tax expense   | 7,422                              | 7,099      |
| Deferred loan fees  | (4,588 )                           | (1,634 )   |
| Net depreciation, amortization of intangible assets and premiums and accretion of discounts on securities, loans and interest bearing deposits - time | 5,079                              | 3,831      |
| Net gains on mortgage loans   | (8,886 )                           | (7,727 )   |
| Net gains on securities   | (62 )                              | (302 )     |
| Share based compensation  | 1,342                              | 1,200      |
| Increase in accrued income and other assets   | (13,159 )                          | (3,804 )   |
| Increase in accrued expenses and other liabilities  | 2,274                              | 1,150      |
| Total Adjustments   | (12,551 )                          | (4,041 )   |
| Net Cash From Operating Activities  | 6,213                              | 12,870     |
| Cash Flow Used in Investing Activities  |                                    |            |
| Proceeds from the sale of securities available for sale   | 8,834                              | 56,451     |
| Proceeds from maturities, prepayments and calls of securities available for sale  | 143,953                            | 150,103    |
| Purchases of securities available for sale  | (84,080 )                          | (213,839 ) |
| Proceeds from the maturity of interest bearing deposits - time  | 2,100                              | 4,613      |
| Purchase of Federal Reserve Bank stock  | -                                  | (407 )     |
| Redemption of Federal Reserve Bank stock  | -                                  | 371        |
| Net increase in portfolio loans (loans originated, net of principal payments)   | (326,089 )                         | (73,673 )  |
| Purchase of portfolio loans   | -                                  | (15,000 )  |
| Cash received from the sale of Mepco Finance Corporation assets, net  | 33,446                             | -          |
| Proceeds from bank-owned life insurance   | 523                                | 2,235      |
| Proceeds from the collection of vehicle service contract counterparty receivables   | 411                                | 4,671      |
| Proceeds from the sale of other real estate and repossessed assets  | 4,111                              | 3,854      |
| Capital expenditures  | (2,592 )                           | (1,717 )   |
| Net Cash Used in Investing Activities   | (219,383 )                         | (82,338 )  |
| Cash Flow From Financing Activities   |                                    |            |
| Net increase in total deposits  | 118,042                            | 120,997    |
| Net increase in other borrowings  | 3,003                              | 5          |
| Proceeds from Federal Home Loan Bank Advances   | 461,000                            | -          |
| Payments of Federal Home Loan Bank Advances   | (397,587 )                         | (432 )     |
| Dividends paid  | (6,400 )                           | (5,149 )   |
| Proceeds from issuance of common stock  | 57                                 | 61         |
| Repurchase of common stock  | -                                  | (16,854 )  |
| Share based compensation withholding obligation   | (536 )                             | (627 )     |
| Net Cash From Financing Activities  | 177,579                            | 98,001     |
| Net Increase (Decrease) in Cash and Cash Equivalents  | (35,591 )                          | 28,533     |
| Cash and Cash Equivalents at Beginning of Period  | 83,194                             | 85,783     |

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|   |           |            |
|---|-----------|------------|
| Cash and Cash Equivalents at End of Period                | \$ 47,603 | \$ 114,316 |
| Cash paid during the period for                           |           |            |
| Interest  | \$ 6,240  | \$ 4,811   |
| Income taxes  | 988       | 437        |
| Transfers to other real estate and repossessed assets     | 1,389     | 1,791      |
| Purchase of securities available for sale not yet settled | 1,765     | 7,440      |
| Sale of securities available for sale not yet settled     | 760       | -          |

See notes to interim condensed consolidated financial statements (unaudited)

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

|   | Nine months ended<br>September 30, |            |
|---|------------------------------------|------------|
|   | 2017                               | 2016       |
|   | (unaudited)                        |            |
|   | (In thousands)                     |            |
| Balance at beginning of period  | \$ 248,980                         | \$ 251,092 |
| Cumulative effect of change in accounting                                     | 352                                | 1,247      |
| Balance at beginning of period, as adjusted                                   | 249,332                            | 252,339    |
| Net income  | 18,764                             | 16,911     |
| Cash dividends declared   | (6,400 )                           | (5,149 )   |
| Issuance of common stock  | 57                                 | 61         |
| Share based compensation  | 1,342                              | 1,200      |
| Share based compensation withholding obligation                               | (536 )                             | (627 )     |
| Repurchase of common stock  | -                                  | (16,854 )  |
| Net change in accumulated other comprehensive loss, net of related tax effect | 5,151                              | 3,021      |
| Balance at end of period  | \$ 267,710                         | \$ 250,902 |

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, 2016 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 September 30, 2017 and December 31, 2016, and the results of operations for the three and nine-month periods ended September 30, 2017 and 2016. The results of operations for the three and nine-month periods ended September 30, 2017, 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 determination of the allowance for loan losses, the valuation of originated mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2016 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers (Topic 606)”. This ASU supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this ASU specifies the accounting for some costs to obtain or fulfill a contract with a customer. This amended guidance is effective for us on January 1, 2018, and is not expected to have a material impact on our consolidated operating results or financial condition. We expect to adopt this ASU using the modified retrospective approach. Financial instruments for the most part and related contractual rights and obligations which are the sources of the majority of our operating revenue are excluded from the scope of this amended guidance. In addition, for those operating revenue streams that are included in the scope of this amended guidance, based upon our review of these sources of income we do not believe they will be materially impacted by this amended guidance.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities”. This ASU amends existing guidance related to the accounting for certain financial assets and liabilities. These amendments, among other things, require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset and eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This amended guidance is effective for us on January 1, 2018. We have reviewed the types of financial instruments impacted by this amended guidance, including certain equity investments and liabilities measured under the fair value election, and have determined that we do not currently own any such instruments. The balance of this amended guidance is expected to impact certain disclosure items but is not expected to have any impact on our consolidated operating results or financial condition.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)”. This ASU amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the balance sheet while recognizing expense on the income statement in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. This amended guidance is effective for us on January 1, 2019 and is not expected to have a material impact on our consolidated operating results or financial condition. Based on a review of our operating leases that we currently have in place we do not expect a material change in the recognition, measurement and presentation of lease expense or impact on cash flow. While the primary impact will be the recognition of certain operating leases on our Condensed Consolidated Statements of Financial Condition this impact is not expected to be material.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments”. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU will replace today’s “incurred loss” approach with an “expected loss” model for instruments measured at amortized cost. For securities available for sale, allowances will be recorded rather than reducing the carrying amount as is done under the current other-than-temporary impairment model. This ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. This amended guidance is effective for us on January 1, 2020. We began evaluating this ASU in 2016 and have formed a committee that includes personnel from various areas of the Bank that meets regularly to discuss the implementation of the ASU. We are currently in the process of gathering data and reviewing loss methodologies and have engaged third party resources that will assist us in the implementation of this ASU. While we have not yet determined what the impact will be on our consolidated operating results or financial condition by the nature of the implementation of an expected loss model compared to an incurred loss approach, we would expect our allowance for loan losses (“AFL”) to increase under this ASU.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815), Targeted Improvements to Accounting for Hedging Activities”. This new ASU amends the hedge accounting model in Topic 815 to enable entities to better portray the economics of their risk management activities in the financial statements and enhance the transparency and understandability of hedge results. The amendments expand an entity’s ability to hedge nonfinancial and financial risk components and reduce complexity in fair value hedges of interest rate risk. The guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The guidance also eases certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. This amended guidance is effective for us on January 1, 2019, and given our current level of derivatives designated as hedges is not expected to have a material impact on our consolidated operating results or financial condition.

In March 2017, the FASB issued ASU 2017-08, “Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities” (“ASU 2017-08”). This ASU shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be accreted to maturity. This amended guidance is effective for us on January 1, 2019, with early adoption permitted. We adopted this amended guidance during the first quarter of 2017 using a modified retrospective approach. The impact of this adoption was to adjust our January 1, 2017 Condensed Consolidated Statement of Financial Position to reflect cumulative effect adjustments as summarized in the table below. The adjustments below reflect the recording of \$0.46 million (\$0.30 million, net of tax) of additional premium amortization on securities available for sale and a \$0.30 million decrease in accumulated other comprehensive loss to reflect the decrease in after tax unrealized losses on securities available for sale as of January 1, 2017 as a result of adopting this amended guidance. After January 1, 2017, premium amortization on certain callable debt securities is now amortized to the first call date. During the first quarter of 2017 the impact on the Condensed Consolidated Statements of Operations was an increase to premium amortization of \$0.03 million.

During the first quarter of 2017, we adopted the fair value method of accounting for our capitalized mortgage loan servicing rights pursuant to FASB Accounting Standards Codification topic 860 – “Transfers and Servicing”. Prior to January 1, 2017, we were accounting for our capitalized mortgage loan servicing rights under the amortization method. We adopted the fair value method using a modified retrospective adjustment to beginning accumulated deficit. The impact of the adoption of the fair value method is summarized in the table below. The adjustments below reflect the recording of a \$0.54 million increase in the fair value of our capitalized mortgage loan servicing rights with a \$0.19 million reduction in deferred tax assets, net for a net impact on accumulated deficit and total equity of \$0.35 million.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|  | January 1,<br>2017<br>Originally<br>Presented<br>(In thousands) | Cumulative<br>Retrospective<br>Adjustments | January 1,<br>2017<br>Adjusted |
|--|---|--|--------------------------------|
| Deferred tax assets, net                   | \$32,818  | \$ (190                                    | )(1) \$ 32,628                 |
| Capitalized mortgage loan servicing rights | \$13,671  | \$ 542                                     | (1) \$ 14,213                  |
| Total assets                               | \$2,548,950   | \$ 352                                     | \$ 2,549,302                   |
| Accumulated deficit                        | \$(65,657 )   | \$ 352                                     | (1)                            |
|  |   | \$ (300                                    | )(2) \$ (65,605 )              |
| Accumulated other comprehensive loss       | \$(9,108 )  | \$ 300                                     | (2) \$ (8,808 )                |
| Total Shareholders' Equity                 | \$248,980   | \$ 352                                     | \$ 249,332                     |
| Total Liabilities and Shareholders' Equity | \$2,548,950   | \$ 352                                     | \$ 2,549,302                   |

Represents adjustment to capitalized mortgage loan servicing rights, deferred tax assets, net, and accumulated (1) deficit to reflect the adoption of the fair value method of accounting for our capitalized mortgage loan servicing rights.

(2) Represents adjustment to accumulated deficit and accumulated other comprehensive loss to reflect the adoption of ASU 2017-08.

3. Securities

Securities available for sale consist of the following:

|  | Amortized Unrealized |         |         |            |
|--|----------------------|---------|---------|------------|
|  | Cost                 | Gains   | Losses  | Fair Value |
|  | (In thousands)       |         |         |            |
| September 30, 2017                               |                      |         |         |            |
| U.S. agency                                      | \$26,455             | \$210   | \$39    | \$26,626   |
| U.S. agency residential mortgage-backed          | 135,293              | 1,331   | 515     | 136,109    |
| U.S. agency commercial mortgage-backed           | 10,767               | 84      | 115     | 10,736     |
| Private label mortgage-backed                    | 26,703               | 518     | 231     | 26,990     |
| Other asset backed                               | 108,128              | 319     | 108     | 108,339    |
| Obligations of states and political subdivisions | 176,087              | 1,708   | 619     | 177,176    |
| Corporate  | 57,213               | 853     | 66      | 58,000     |
| Trust preferred                                  | 2,928                | -       | 128     | 2,800      |
| Foreign government                               | 2,098                | -       | 9       | 2,089      |
| Total  | \$545,672            | \$5,023 | \$1,830 | \$548,865  |
| December 31, 2016                                |                      |         |         |            |
| U.S. agency                                      | \$28,909             | \$159   | \$80    | \$28,988   |
| U.S. agency residential mortgage-backed          | 156,053              | 1,173   | 937     | 156,289    |
| U.S. agency commercial mortgage-backed           | 12,799               | 28      | 195     | 12,632     |



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|  |           |         |         |            |
|--|-----------|---------|---------|------------|
| Private label mortgage-backed                    | 35,035    | 216     | 524     | 34,727     |
| Other asset backed                               | 146,829   | 271     | 391     | 146,709    |
| Obligations of states and political subdivisions | 175,180   | 478     | 4,759   | 170,899    |
| Corporate  | 56,356    | 223     | 399     | 56,180     |
| Trust preferred                                  | 2,922     | -       | 343     | 2,579      |
| Foreign government                               | 1,626     | -       | 13      | 1,613      |
| Total  | \$615,709 | \$2,548 | \$7,641 | \$ 610,616 |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

We adopted ASU 2017-08 during the first quarter of 2017 using a modified retrospective approach. As a result, the amortized cost of securities as of January 1, 2017 was adjusted lower by \$0.46 million (see note #2).

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

|   | Less Than Twelve<br>Months |                      | Twelve Months or More |                      | Total         |                      |         |
|---|----------------------------|----------------------|-----------------------|----------------------|---------------|----------------------|---------|
|   | Fair<br>Value              | Unrealized<br>Losses | Fair Value            | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |         |
| (In thousands)                                      |                            |                      |                       |                      |               |                      |         |
| September 30, 2017                                  |                            |                      |                       |                      |               |                      |         |
| U.S. agency   | \$4,819                    | \$ 21                | \$ 4,947              | \$ 18                | \$9,766       | \$ 39                |         |
| U.S. agency residential<br>mortgage-backed          | 24,116                     | 215                  | 27,817                | 300                  | 51,933        | 515                  |         |
| U.S. agency commercial<br>mortgage-backed           | 1,815                      | 22                   | 3,933                 | 93                   | 5,748         | 115                  |         |
| Private label mortgage- backed                      | 3,423                      | 26                   | 3,163                 | 205                  | 6,586         | 231                  |         |
| Other asset backed                                  | 12,756                     | 18                   | 16,298                | 90                   | 29,054        | 108                  |         |
| Obligations of states and political<br>subdivisions | 42,186                     | 447                  | 13,787                | 172                  | 55,973        | 619                  |         |
| Corporate   | 8,654                      | 22                   | 2,458                 | 44                   | 11,112        | 66                   |         |
| Trust preferred                                     | -                          | -                    | 2,800                 | 128                  | 2,800         | 128                  |         |
| Foreign government                                  | 2,089                      | 9                    | -                     | -                    | 2,089         | 9                    |         |
| Total   | \$99,858                   | \$ 780               | \$ 75,203             | \$ 1,050             | \$175,061     | \$ 1,830             |         |
| December 31, 2016                                   |                            |                      |                       |                      |               |                      |         |
| U.S. agency   |                            | \$4,179              | \$41                  | \$8,217              | \$39          | \$12,396             | \$80    |
| U.S. agency residential mortgage-backed             |                            | 62,524               | 732                   | 20,857               | 205           | 83,381               | 937     |
| U.S. agency commercial mortgage-backed              |                            | 6,079                | 194                   | 143                  | 1             | 6,222                | 195     |
| Private label mortgage-backed                       |                            | 20,545               | 281                   | 1,413                | 243           | 21,958               | 524     |
| Other asset backed                                  |                            | 52,958               | 172                   | 17,763               | 219           | 70,721               | 391     |
| Obligations of states and political subdivisions    |                            | 113,078              | 4,014                 | 14,623               | 745           | 127,701              | 4,759   |
| Corporate   |                            | 25,546               | 292                   | 2,810                | 107           | 28,356               | 399     |
| Trust preferred                                     |                            | -                    | -                     | 2,579                | 343           | 2,579                | 343     |
| Foreign government                                  |                            | 1,613                | 13                    | -                    | -             | 1,613                | 13      |
| Total   |                            | \$286,522            | \$5,739               | \$68,405             | \$1,902       | \$354,927            | \$7,641 |

Our portfolio of securities available for sale 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.



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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at September 30, 2017, we had 33 U.S. agency, 109 U.S. agency residential mortgage-backed and 10 U.S. agency commercial mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to increases in interest rates since acquisition 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 mortgage backed securities — at September 30, 2017, we had 11 of this type of security whose fair value is less than amortized cost. The majority of unrealized losses are attributed to three securities purchased prior to 2016. Two of these three securities has an impairment in excess of 10% and all three of these holdings have been impaired for more than 12 months. The unrealized losses are largely attributable to credit spread widening on these three securities since their acquisition.

These three securities are receiving principal and interest payments. These transactions are pass-through structures, receiving pro rata principal and interest payments from a dedicated collateral pool. The nonreceipt of interest cash flows is not expected and thus not presently considered in our discounted cash flow methodology discussed below.

These three private label mortgage-backed securities are periodically reviewed for other than temporary impairment (“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. Our cash flow analysis forecasts complete recovery of our cost basis for all three of these securities whose fair value is less than amortized cost.

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

Other asset backed — at September 30, 2017, we had 51 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at September 30, 2017, we had 182 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to wider benchmark pricing spreads and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at September 30, 2017, we had 11 corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Trust preferred securities — at September 30, 2017, 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 has suffered from credit spread widening.

One of the three securities is rated by two major rating agencies as investment grade, while one (a Bank of America issuance) is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.9 million as of September 30, 2017, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of September 30, 2017 and December 31, 2016:

| September 30, 2017 |                     | December 31, 2016 |                     |
|--------------------|---------------------|-------------------|---------------------|
| Fair Value         | Net Unrealized Loss | Fair Value        | Net Unrealized Loss |
| (In thousands)     |                     |                   |                     |

## Trust preferred securities

|                |         |        |   |          |         |   |
|----------------|---------|--------|---|----------|---------|---|
| Rated issues   | \$1,880 | \$ (48 | ) | \$ 1,800 | \$ (123 | ) |
| Unrated issues | 920     | (80    | ) | 779      | (220    | ) |

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.

Foreign government — at September 30, 2017, we had two foreign government securities whose fair value is less than amortized cost. The unrealized loss is primarily due to increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

We recorded no credit related OTTI charges in our Condensed Consolidated Statements of Operations related to securities available for sale during the three and nine month periods ended September 30, 2017 and 2016, respectively.

At September 30, 2017, three private label 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 September 30, 2017   |                 |                       |                         |         |
| Fair value                 | \$1,076         | \$ 1,032              | \$ 65                   | \$2,173 |
| Amortized cost             | 937             | 842                   | -                       | 1,779   |
| Non-credit unrealized loss | -               | -                     | -                       | -       |

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|                                |     |     |     |       |
|--------------------------------|-----|-----|-----|-------|
| Unrealized gain                | 139 | 190 | 65  | 394   |
| Cumulative credit related OTTI | 757 | 457 | 380 | 1,594 |

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(unaudited)

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. All three of these securities have unrealized gains at September 30, 2017. The original amortized cost for each of these securities has been permanently adjusted downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for these securities is now less than previously recorded credit related OTTI amounts.

A roll forward of credit losses recognized in earnings on securities available for sale follows:

|  | Three months ended |         | Nine months ended  |          |
|--|--------------------|---------|--------------------|----------|
|  | September 30, 2017 | 2016    | September 30, 2017 | 2016     |
| Balance at beginning of period   | \$1,844            | \$1,844 | \$ 1,844           | \$ 1,844 |
| 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  | -                  | -       | -                  | -        |
| Balance at end of period   | \$1,844            | \$1,844 | \$ 1,844           | \$ 1,844 |

The amortized cost and fair value of securities available for sale at September 30, 2017, by contractual maturity, follow:

|  | Amortized Fair |            |
|--|----------------|------------|
|  | Cost           | Value      |
|  | (In thousands) |            |
| Maturing within one year                       | \$27,811       | \$ 27,865  |
| Maturing after one year but within five years  | 98,784         | 99,533     |
| Maturing after five years but within ten years | 82,590         | 83,671     |
| Maturing after ten years                       | 55,596         | 55,622     |
|  | 264,781        | 266,691    |
| U.S. agency residential mortgage-backed        | 135,293        | 136,109    |
| U.S. agency commercial mortgage-backed         | 10,767         | 10,736     |
| Private label mortgage-backed                  | 26,703         | 26,990     |
| Other asset backed                             | 108,128        | 108,339    |
| Total  | \$545,672      | \$ 548,865 |

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

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

|          | Realized |        |
|----------|----------|--------|
| Proceeds | Gains    | Losses |
| (1)      |          |        |

(In thousands)

|      |         |       |      |
|------|---------|-------|------|
| 2017 | \$9,594 | \$125 | \$ - |
| 2016 | 56,451  | 350   | 52   |

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(1)2017 includes \$0.760 million for trades that did not settle until after September 30, 2017.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During 2017 and 2016, our trading securities consisted of various preferred stocks. During the nine months ended September 30, 2017 and 2016, we recognized gains (losses) on trading securities of \$(0.063) million and \$0.004 million, respectively, that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. These amounts relate to 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 September 30, follows:

|  | Commercial     | Mortgage | Installment | Payment<br>Plan<br>Receivables(1) | Subjective<br>Allocation | Total    |
|--|----------------|----------|-------------|-----------------------------------|--------------------------|----------|
|  | (In thousands) |          |             |                                   |                          |          |
| 2017   |                |          |             |                                   |                          |          |
| Balance at beginning of period                   | \$5,100        | \$ 8,145 | \$ 900      | \$ -                              | \$ 6,441                 | \$20,586 |
| Additions (deductions) Provision for loan losses | (97 )          | 68       | (33 )       | -                                 | 644                      | 582      |
| Recoveries credited to the allowance             | 340            | 587      | 285         | -                                 | -                        | 1,212    |
| Loans charged against the allowance              | (92 )          | (471 )   | (339 )      | -                                 | -                        | (902 )   |
| Balance at end of period                         | \$5,251        | \$ 8,329 | \$ 813      | \$ -                              | \$ 7,085                 | \$21,478 |
| 2016   |                |          |             |                                   |                          |          |
| Balance at beginning of period                   | \$6,039        | \$ 9,956 | \$ 1,139    | \$ 52                             | \$ 5,526                 | \$22,712 |
| Additions (deductions) Provision for loan losses | (153 )         | (247 )   | 208         | -                                 | 17                       | (175 )   |
| Recoveries credited to the allowance             | 474            | 195      | 236         | -                                 | -                        | 905      |
| Loans charged against the allowance              | (365 )         | (561 )   | (473 )      | -                                 | -                        | (1,399 ) |
| Balance at end of period                         | \$5,995        | \$ 9,343 | \$ 1,110    | \$ 52                             | \$ 5,543                 | \$22,043 |

(1) Payment plan receivables were reclassified to held for sale at December 31, 2016. See note #15.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Commercial     | Mortgage | Installment | Payment<br>Plan<br>Receivables(1) | Subjective<br>Allocation | Total    |
|--|----------------|----------|-------------|-----------------------------------|--------------------------|----------|
|  | (In thousands) |          |             |                                   |                          |          |
| 2017   |                |          |             |                                   |                          |          |
| Balance at beginning of period                   | \$4,880        | \$8,681  | \$1,011     | \$-                               | \$5,662                  | \$20,234 |
| Additions (deductions) Provision for loan losses | (197 )         | (593 )   | 173         | -                                 | 1,423                    | 806      |
| Recoveries credited to the allowance             | 946            | 1,264    | 788         | -                                 | -                        | 2,998    |
| Loans charged against the allowance              | (378 )         | (1,023 ) | (1,159 )    | -                                 | -                        | (2,560 ) |
| Balance at end of period                         | \$5,251        | \$8,329  | \$813       | \$-                               | \$7,085                  | \$21,478 |
| 2016   |                |          |             |                                   |                          |          |
| Balance at beginning of period                   | \$5,670        | \$10,391 | \$1,181     | \$56                              | \$5,272                  | \$22,570 |
| Additions (deductions) Provision for loan losses | (1,220)        | (885 )   | 399         | (4 )                              | 271                      | (1,439 ) |
| Recoveries credited to the allowance             | 1,944          | 871      | 808         | -                                 | -                        | 3,623    |
| Loans charged against the allowance              | (399 )         | (1,034 ) | (1,278 )    | -                                 | -                        | (2,711 ) |
| Balance at end of period                         | \$5,995        | \$9,343  | \$1,110     | \$52                              | \$5,543                  | \$22,043 |

(1) Payment plan receivables were reclassified to held for sale at December 31, 2016. See note #15.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Commercial     | Mortgage  | Installment | Subjective<br>Allocation | Total       |
|--|----------------|-----------|-------------|--------------------------|-------------|
|  | (In thousands) |           |             |                          |             |
| September 30, 2017                               |                |           |             |                          |             |
| Allowance for loan losses                        |                |           |             |                          |             |
| Individually evaluated for impairment            | \$967          | \$5,823   | \$271       | \$ -                     | \$7,061     |
| Collectively evaluated for impairment            | 4,284          | 2,506     | 542         | 7,085                    | 14,417      |
| Total ending allowance balance                   | \$5,251        | \$8,329   | \$813       | \$ 7,085                 | \$21,478    |
| Loans  |                |           |             |                          |             |
| Individually evaluated for impairment            | \$10,257       | \$54,322  | \$4,215     |                          | \$68,794    |
| Collectively evaluated for impairment            | 829,073        | 730,050   | 315,146     |                          | 1,874,269   |
| Total loans recorded investment                  | 839,330        | 784,372   | 319,361     |                          | 1,943,063   |
| Accrued interest included in recorded investment | 2,080          | 3,026     | 863         |                          | 5,969       |
| Total loans                                      | \$837,250      | \$781,346 | \$318,498   |                          | \$1,937,094 |
| December 31, 2016                                |                |           |             |                          |             |
| Allowance for loan losses                        |                |           |             |                          |             |
| Individually evaluated for impairment            | \$2,244        | \$6,579   | \$329       | \$ -                     | \$9,152     |
| Collectively evaluated for impairment            | 2,636          | 2,102     | 682         | 5,662                    | 11,082      |
| Total ending allowance balance                   | \$4,880        | \$8,681   | \$1,011     | \$ 5,662                 | \$20,234    |
| Loans  |                |           |             |                          |             |
| Individually evaluated for impairment            | \$15,767       | \$59,151  | \$4,913     |                          | \$79,831    |
| Collectively evaluated for impairment            | 790,228        | 481,828   | 261,474     |                          | 1,533,530   |
| Total loans recorded investment                  | 805,995        | 540,979   | 266,387     |                          | 1,613,361   |
| Accrued interest included in recorded investment | 1,978          | 2,364     | 771         |                          | 5,113       |
| Total loans                                      | \$804,017      | \$538,615 | \$265,616   |                          | \$1,608,248 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 90+<br>and<br>Still Non-<br>Accrual<br>(In thousands) | Total Non-<br>Performing<br>Loans |
|---|---|-----------------------------------|
| September 30, 2017                                    |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$ 72   | \$ 72                             |
| Land, land development and construction - real estate | - 10  | 10                                |
| Commercial and industrial                             | - 706   | 706                               |
| Mortgage  |   |                                   |
| 1-4 family  | - 5,207   | 5,207                             |
| Resort lending  | - 1,411   | 1,411                             |
| Home equity - 1st lien                                | - 258   | 258                               |
| Home equity - 2nd lien                                | - 221   | 221                               |
| Purchased loans                                       | - -   | -                                 |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 97  | 97                                |
| Home equity - 2nd lien                                | - 224   | 224                               |
| Boat lending  | - 69  | 69                                |
| Recreational vehicle lending                          | - 25  | 25                                |
| Other   | - 110   | 110                               |
| Total recorded investment                             | \$- \$ 8,410  | \$ 8,410                          |
| Accrued interest included in recorded investment      | \$- \$ -  | \$ -                              |
| December 31, 2016                                     |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$ 628  | \$ 628                            |
| Land, land development and construction - real estate | - 105   | 105                               |
| Commercial and industrial                             | - 4,430   | 4,430                             |
| Mortgage  |   |                                   |
| 1-4 family  | - 5,248   | 5,248                             |
| Resort lending  | - 1,507   | 1,507                             |
| Home equity - 1st lien                                | - 222   | 222                               |
| Home equity - 2nd lien                                | - 317   | 317                               |
| Purchased loans                                       | - -   | -                                 |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 266   | 266                               |
| Home equity - 2nd lien                                | - 289   | 289                               |
| Boat lending  | - 219   | 219                               |
| Recreational vehicle lending                          | - 21  | 21                                |
| Other   | - 112   | 112                               |
| Total recorded investment                             | \$- \$ 13,364   | \$ 13,364                         |
| Accrued interest included in recorded investment      | \$- \$ -  | \$ -                              |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An aging analysis of loans by class follows:

|   | Loans Past Due |               |          | Total    | Loans not<br>Past Due | Total<br>Loans |
|---|----------------|---------------|----------|----------|-----------------------|----------------|
|   | 30-59<br>days  | 60-89<br>days | 90+ days |          |                       |                |
| September 30, 2017                                    |                |               |          |          |                       |                |
| Commercial  |                |               |          |          |                       |                |
| Income producing - real estate                        | \$425          | \$ -          | \$ 30    | \$455    | \$271,747             | \$272,202      |
| Land, land development and construction - real estate | 10             | -             | -        | 10       | 67,793                | 67,803         |
| Commercial and industrial                             | 120            | 149           | 65       | 334      | 498,991               | 499,325        |
| Mortgage  |                |               |          |          |                       |                |
| 1-4 family  | 1,929          | 919           | 5,207    | 8,055    | 553,928               | 561,983        |
| Resort lending  | 363            | 135           | 1,411    | 1,909    | 91,370                | 93,279         |
| Home equity - 1st lien                                | 460            | -             | 258      | 718      | 35,826                | 36,544         |
| Home equity - 2nd lien                                | 597            | 195           | 221      | 1,013    | 56,677                | 57,690         |
| Purchased loans                                       | 3              | 1             | -        | 4        | 34,872                | 34,876         |
| Installment   |                |               |          |          |                       |                |
| Home equity - 1st lien                                | 115            | 86            | 97       | 298      | 9,925                 | 10,223         |
| Home equity - 2nd lien                                | 161            | 23            | 224      | 408      | 10,103                | 10,511         |
| Boat lending  | 112            | 69            | 69       | 250      | 131,153               | 131,403        |
| Recreational vehicle lending                          | 52             | 4             | 25       | 81       | 93,687                | 93,768         |
| Other   | 108            | 50            | 110      | 268      | 73,188                | 73,456         |
| Total recorded investment                             | \$4,455        | \$ 1,631      | \$ 7,717 | \$13,803 | \$1,929,260           | \$1,943,063    |
| Accrued interest included in recorded investment      | \$53           | \$ 24         | \$ -     | \$77     | \$5,892               | \$5,969        |
| December 31, 2016                                     |                |               |          |          |                       |                |
| Commercial  |                |               |          |          |                       |                |
| Income producing - real estate                        | \$-            | \$-           | \$383    | \$383    | \$287,255             | \$287,638      |
| Land, land development and construction - real estate | 74             | -             | 31       | 105      | 51,670                | 51,775         |
| Commercial and industrial                             | 100            | 1,385         | 66       | 1,551    | 465,031               | 466,582        |
| Mortgage  |                |               |          |          |                       |                |
| 1-4 family  | 2,361          | 869           | 5,248    | 8,478    | 306,063               | 314,541        |
| Resort lending  | -              | -             | 1,507    | 1,507    | 101,541               | 103,048        |
| Home equity - 1st lien                                | 149            | -             | 222      | 371      | 28,645                | 29,016         |
| Home equity - 2nd lien                                | 470            | 218           | 317      | 1,005    | 54,232                | 55,237         |
| Purchased loans                                       | 13             | 2             | -        | 15       | 39,122                | 39,137         |
| Installment   |                |               |          |          |                       |                |
| Home equity - 1st lien                                | 311            | 48            | 266      | 625      | 12,025                | 12,650         |
| Home equity - 2nd lien                                | 238            | 41            | 289      | 568      | 13,390                | 13,958         |
| Boat lending  | 184            | 33            | 219      | 436      | 102,489               | 102,925        |
| Recreational vehicle lending                          | 68             | 33            | 21       | 122      | 74,413                | 74,535         |
| Other   | 289            | 30            | 112      | 431      | 61,888                | 62,319         |
| Total recorded investment                             | \$4,257        | \$2,659       | \$8,681  | \$15,597 | \$1,597,764           | \$1,613,361    |

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|  |      |      |     |      |         |         |
|--|------|------|-----|------|---------|---------|
| Accrued interest included in recorded investment | \$45 | \$19 | \$- | \$64 | \$5,049 | \$5,113 |
|--|------|------|-----|------|---------|---------|

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans are as follows:

|   | September<br>30,<br>2017 | December 31,<br>2016 |
|---|--------------------------|----------------------|
|   | (In thousands)           |                      |
| Impaired loans with no allocated allowance          |                          |                      |
| TDR   | \$ 349                   | \$ 1,782             |
| Non - TDR   | 186                      | 1,107                |
| Impaired loans with an allocated allowance          |                          |                      |
| TDR - allowance based on collateral                 | 2,320                    | 3,527                |
| TDR - allowance based on present value cash flow    | 65,449                   | 72,613               |
| Non - TDR - allowance based on collateral           | 202                      | 491                  |
| Total impaired loans                                | \$ 68,506                | \$ 79,520            |
| Amount of allowance for loan losses allocated       |                          |                      |
| TDR - allowance based on collateral                 | \$ 641                   | \$ 1,868             |
| TDR - allowance based on present value cash flow    | 6,329                    | 7,146                |
| Non - TDR - allowance based on collateral           | 91                       | 138                  |
| Total amount of allowance for loan losses allocated | \$ 7,061                 | \$ 9,152             |

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows (1):

|   | September 30, 2017 |                                    |                      | December 31, 2016 |                                    |                      |
|---|--------------------|------------------------------------|----------------------|-------------------|------------------------------------|----------------------|
|   | Unpaid             |                                    | Related<br>Allowance | Unpaid            |                                    | Related<br>Allowance |
|   | Recorded           | Principal<br>Investment<br>Balance |                      | Recorded          | Principal<br>Investment<br>Balance |                      |
|   | (In thousands)     |                                    |                      |                   |                                    |                      |
| With no related allowance recorded:               |                    |                                    |                      |                   |                                    |                      |
| Commercial  |                    |                                    |                      |                   |                                    |                      |
| Income producing - real estate                    | \$-                | \$-                                | \$ -                 | \$517             | \$768                              | \$ -                 |
| Land, land development & construction-real estate | -                  | -                                  | -                    | 31                | 709                                | -                    |
| Commercial and industrial                         | 535                | 557                                | -                    | 2,341             | 3,261                              | -                    |
| Mortgage  |                    |                                    |                      |                   |                                    |                      |
| 1-4 family  | 2                  | 472                                | -                    | 2                 | 387                                | -                    |
| Resort lending                                    | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Home equity - 1st lien                            | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Home equity - 2nd lien                            | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Installment                                       |                    |                                    |                      |                   |                                    |                      |
| Home equity - 1st lien                            | 1                  | 71                                 | -                    | -                 | 66                                 | -                    |
| Home equity - 2nd lien                            | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Boat lending                                      | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Recreational vehicle lending                      | -                  | -                                  | -                    | -                 | -                                  | -                    |
| Other   | -                  | -                                  | -                    | -                 | -                                  | -                    |
|   | 538                | 1,100                              | -                    | 2,891             | 5,191                              | -                    |
| With an allowance recorded:                       |                    |                                    |                      |                   |                                    |                      |
| Commercial  |                    |                                    |                      |                   |                                    |                      |
| Income producing - real estate                    | 6,975              | 7,121                              | 482                  | 7,737             | 7,880                              | 554                  |
| Land, land development & construction-real estate | 169                | 197                                | 10                   | 239               | 244                                | 36                   |
| Commercial and industrial                         | 2,578              | 2,612                              | 475                  | 4,902             | 5,246                              | 1,654                |
| Mortgage  |                    |                                    |                      |                   |                                    |                      |
| 1-4 family  | 37,872             | 39,393                             | 3,517                | 41,701            | 43,479                             | 4,100                |
| Resort lending                                    | 16,098             | 16,169                             | 2,264                | 16,898            | 16,931                             | 2,453                |
| Home equity - 1st lien                            | 171                | 238                                | 30                   | 235               | 242                                | 10                   |
| Home equity - 2nd lien                            | 179                | 213                                | 12                   | 315               | 398                                | 16                   |
| Installment                                       |                    |                                    |                      |                   |                                    |                      |
| Home equity - 1st lien                            | 1,791              | 1,921                              | 85                   | 1,994             | 2,117                              | 118                  |
| Home equity - 2nd lien                            | 1,969              | 1,994                              | 161                  | 2,415             | 2,443                              | 182                  |
| Boat lending                                      | 1                  | 6                                  | 1                    | 1                 | 6                                  | -                    |
| Recreational vehicle lending                      | 93                 | 93                                 | 5                    | 109               | 108                                | 6                    |
| Other   | 360                | 377                                | 19                   | 394               | 426                                | 23                   |
|   | 68,256             | 70,334                             | 7,061                | 76,940            | 79,520                             | 9,152                |
| Total   |                    |                                    |                      |                   |                                    |                      |
| Commercial  |                    |                                    |                      |                   |                                    |                      |
| Income producing - real estate                    | 6,975              | 7,121                              | 482                  | 8,254             | 8,648                              | 554                  |
| Land, land development & construction-real estate | 169                | 197                                | 10                   | 270               | 953                                | 36                   |

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|                              |          |          |          |          |          |          |
|------------------------------|----------|----------|----------|----------|----------|----------|
| Commercial and industrial    | 3,113    | 3,169    | 475      | 7,243    | 8,507    | 1,654    |
| Mortgage                     |          |          |          |          |          |          |
| 1-4 family                   | 37,874   | 39,865   | 3,517    | 41,703   | 43,866   | 4,100    |
| Resort lending               | 16,098   | 16,169   | 2,264    | 16,898   | 16,931   | 2,453    |
| Home equity - 1st lien       | 171      | 238      | 30       | 235      | 242      | 10       |
| Home equity - 2nd lien       | 179      | 213      | 12       | 315      | 398      | 16       |
| Installment                  |          |          |          |          |          |          |
| Home equity - 1st lien       | 1,792    | 1,992    | 85       | 1,994    | 2,183    | 118      |
| Home equity - 2nd lien       | 1,969    | 1,994    | 161      | 2,415    | 2,443    | 182      |
| Boat lending                 | 1        | 6        | 1        | 1        | 6        | -        |
| Recreational vehicle lending | 93       | 93       | 5        | 109      | 108      | 6        |
| Other                        | 360      | 377      | 19       | 394      | 426      | 23       |
| Total                        | \$68,794 | \$71,434 | \$ 7,061 | \$79,831 | \$84,711 | \$ 9,152 |

|  |       |       |
|--|-------|-------|
| Accrued interest included in recorded investment | \$288 | \$311 |
|--|-------|-------|

(1) There were no impaired purchased mortgage loans at September 30, 2017 or December 31, 2016.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2017           |            | 2016       |            |
|---|----------------|------------|------------|------------|
|   | Average        | Interest   | Average    | Interest   |
|   | Recorded       | Recognized | Recorded   | Recognized |
|   | Investment     | Income     | Investment | Income     |
|   | (In thousands) |            |            |            |
| With no related allowance recorded                |                |            |            |            |
| Commercial  |                |            |            |            |
| Income producing - real estate                    | \$-            | \$ -       | \$ 551     | \$ -       |
| Land, land development & construction-real estate | -              | -          | 133        | -          |
| Commercial and industrial                         | 445            | 8          | -          | -          |
| Mortgage  |                |            |            |            |
| 1-4 family  | 127            | 7          | 12         | 3          |
| Resort lending                                    | -              | -          | -          | -          |
| Home equity - 1st lien                            | -              | -          | -          | -          |
| Home equity - 2nd lien                            | -              | -          | -          | -          |
| Installment                                       |                |            |            |            |
| Home equity - 1st lien                            | 1              | 1          | -          | 3          |
| Home equity - 2nd lien                            | -              | -          | -          | -          |
| Boat lending                                      | -              | -          | -          | -          |
| Recreational vehicle lending                      | -              | -          | -          | -          |
| Other   | -              | 1          | -          | -          |
|   | 573            | 17         | 696        | 6          |
| With an allowance recorded                        |                |            |            |            |
| Commercial  |                |            |            |            |
| Income producing - real estate                    | 7,311          | 91         | 8,000      | 111        |
| Land, land development & construction-real estate | 171            | 2          | 1,117      | 3          |
| Commercial and industrial                         | 2,878          | 26         | 7,145      | 69         |
| Mortgage  |                |            |            |            |
| 1-4 family  | 38,533         | 462        | 44,256     | 470        |
| Resort lending                                    | 16,175         | 153        | 17,372     | 161        |
| Home equity - 1st lien                            | 201            | 1          | 241        | 2          |
| Home equity - 2nd lien                            | 180            | 2          | 280        | 6          |
| Installment                                       |                |            |            |            |
| Home equity - 1st lien                            | 1,808          | 40         | 2,140      | 34         |
| Home equity - 2nd lien                            | 2,058          | 26         | 2,585      | 37         |
| Boat lending                                      | 1              | -          | 2          | -          |
| Recreational vehicle lending                      | 98             | 1          | 114        | 2          |
| Other   | 361            | 6          | 424        | 7          |
|   | 69,775         | 810        | 83,676     | 902        |
| Total   |                |            |            |            |
| Commercial  |                |            |            |            |
| Income producing - real estate                    | 7,311          | 91         | 8,551      | 111        |
| Land, land development & construction-real estate | 171            | 2          | 1,250      | 3          |
| Commercial and industrial                         | 3,323          | 34         | 7,145      | 69         |
| Mortgage  |                |            |            |            |
| 1-4 family  | 38,660         | 469        | 44,268     | 473        |
| Resort lending                                    | 16,175         | 153        | 17,372     | 161        |

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|                              |          |        |           |        |
|------------------------------|----------|--------|-----------|--------|
| Home equity - 1st lien       | 201      | 1      | 241       | 2      |
| Home equity - 2nd lien       | 180      | 2      | 280       | 6      |
| Installment                  |          |        |           |        |
| Home equity - 1st lien       | 1,809    | 41     | 2,140     | 37     |
| Home equity - 2nd lien       | 2,058    | 26     | 2,585     | 37     |
| Boat lending                 | 1        | -      | 2         | -      |
| Recreational vehicle lending | 98       | 1      | 114       | 2      |
| Other                        | 361      | 7      | 424       | 7      |
| Total                        | \$70,348 | \$ 827 | \$ 84,372 | \$ 908 |

(1) There were no impaired purchased mortgage loans during the three month periods ended September 30, 2017 and 2016, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2017                              |                                  | 2016                              |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|   | (In thousands)                    |                                  |                                   |                                  |
| With no related allowance recorded:               |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | \$222                             | \$ -                             | \$ 632                            | \$ 2                             |
| Land, land development & construction-real estate | 8                                 | -                                | 405                               | 7                                |
| Commercial and industrial                         | 808                               | 16                               | 616                               | 21                               |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 64                                | 16                               | 12                                | 9                                |
| Resort lending                                    | -                                 | -                                | -                                 | -                                |
| Home equity - 1st lien                            | -                                 | -                                | -                                 | -                                |
| Home equity - 2nd lien                            | -                                 | -                                | -                                 | -                                |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | 1                                 | 4                                | -                                 | 4                                |
| Home equity - 2nd lien                            | -                                 | -                                | 4                                 | -                                |
| Boat lending                                      | -                                 | -                                | -                                 | -                                |
| Recreational vehicle lending                      | -                                 | -                                | -                                 | -                                |
| Other   | -                                 | 1                                | -                                 | -                                |
|   | 1,103                             | 37                               | 1,669                             | 43                               |
| With an allowance recorded:                       |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 7,525                             | 300                              | 8,153                             | 318                              |
| Land, land development & construction-real estate | 187                               | 6                                | 1,352                             | 29                               |
| Commercial and industrial                         | 3,488                             | 98                               | 5,929                             | 151                              |
| Mortgage  |                                   |                                  |                                   |                                  |
| 1-4 family  | 39,716                            | 1,420                            | 45,728                            | 1,447                            |
| Resort lending                                    | 16,485                            | 464                              | 17,705                            | 480                              |
| Home equity - 1st lien                            | 218                               | 5                                | 223                               | 6                                |
| Home equity - 2nd lien                            | 217                               | 5                                | 231                               | 11                               |
| Installment                                       |                                   |                                  |                                   |                                  |
| Home equity - 1st lien                            | 1,874                             | 107                              | 2,233                             | 118                              |
| Home equity - 2nd lien                            | 2,210                             | 96                               | 2,723                             | 122                              |
| Boat lending                                      | 1                                 | -                                | 2                                 | -                                |
| Recreational vehicle lending                      | 103                               | 4                                | 117                               | 5                                |
| Other   | 373                               | 19                               | 443                               | 23                               |
|   | 72,397                            | 2,524                            | 84,839                            | 2,710                            |
| Total   |                                   |                                  |                                   |                                  |
| Commercial  |                                   |                                  |                                   |                                  |
| Income producing - real estate                    | 7,747                             | 300                              | 8,785                             | 320                              |
|   | 195                               | 6                                | 1,757                             | 36                               |

## Land, land development &amp; construction-real estate

|                              |          |          |           |          |
|------------------------------|----------|----------|-----------|----------|
| Commercial and industrial    | 4,296    | 114      | 6,545     | 172      |
| Mortgage                     |          |          |           |          |
| 1-4 family                   | 39,780   | 1,436    | 45,740    | 1,456    |
| Resort lending               | 16,485   | 464      | 17,705    | 480      |
| Home equity - 1st lien       | 218      | 5        | 223       | 6        |
| Home equity - 2nd lien       | 217      | 5        | 231       | 11       |
| Installment                  |          |          |           |          |
| Home equity - 1st lien       | 1,875    | 111      | 2,233     | 122      |
| Home equity - 2nd lien       | 2,210    | 96       | 2,727     | 122      |
| Boat lending                 | 1        | -        | 2         | -        |
| Recreational vehicle lending | 103      | 4        | 117       | 5        |
| Other                        | 373      | 20       | 443       | 23       |
| Total                        | \$73,500 | \$ 2,561 | \$ 86,508 | \$ 2,753 |

(1) There were no impaired purchased mortgage loans during the nine month periods ended September 30, 2017 and 2016, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Cash receipts on impaired loans on non-accrual status are generally applied to the principal balance.

Troubled debt restructurings follow:

|                        | September 30, 2017 |                      | Total    |
|------------------------|--------------------|----------------------|----------|
|                        | Commercial         | Retail (1)           |          |
|                        | (In thousands)     |                      |          |
| Performing TDRs        | \$9,431            | \$ 53,755            | \$63,186 |
| Non-performing TDRs(2) | 401                | 4,531 <sup>(3)</sup> | 4,932    |
| Total                  | \$9,832            | \$ 58,286            | \$68,118 |

|                        | December 31, 2016 |                      | Total    |
|------------------------|-------------------|----------------------|----------|
|                        | Commercial        | Retail (1)           |          |
|                        | (In thousands)    |                      |          |
| Performing TDRs        | \$10,560          | \$ 59,726            | \$70,286 |
| Non-performing TDRs(2) | 3,565             | 4,071 <sup>(3)</sup> | 7,636    |
| Total                  | \$14,125          | \$ 63,797            | \$77,922 |

(1) Retail loans include mortgage and installment portfolio segments.

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

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

We allocated \$7.0 million and \$9.0 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2017 and December 31, 2016, respectively.

During the nine months ended September 30, 2017 and 2016, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan have generally been for periods ranging from 9 months to 36 months but have extended to as much as 480 months in certain circumstances. Modifications involving an extension of the maturity date have generally been for periods ranging from 1 month to 60 months but have extended to as much as 230 months in certain circumstances.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the three-month periods ended September 30 follow(1):

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance<br>(Dollars in thousands) | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
| 2017  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -  | \$ -                                     |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | -                         | -   | -  |
| Mortgage  |                           |   |  |
| 1-4 family  | 1                         | 93  | 95                                       |
| Resort lending                                    | -                         | -   | -  |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | -                         | -   | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | 2                         | 51  | 50                                       |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | 1                         | 10  | 10                                       |
| Total   | 4                         | \$ 154  | \$ 155                                   |
| 2016  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | 2                         | \$ 180  | \$ 180                                   |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | 2                         | 175   | 158                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 2                         | 204   | 207                                      |
| Resort lending                                    | -                         | -   | -  |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | 2                         | 77  | 78                                       |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 2                         | 82  | 85                                       |
| Home equity - 2nd lien                            | 1                         | 7   | 7  |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | 1                         | 34  | 34                                       |
| Total   | 12                        | \$ 759  | \$ 749                                   |

(1) There were no purchased mortgage loans classified as troubled debt restructurings during the three month periods ended September 30, 2017 and 2016, respectively.





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Loans that have been classified as troubled debt restructurings during the nine-month periods ended September 30 follow(1):

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance<br>(Dollars in thousands) | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
| 2017  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -  | \$ -                                     |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | 12                        | 786   | 786                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 3                         | 142   | 144                                      |
| Resort lending                                    | 1                         | 189   | 189                                      |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | -                         | -   | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 2                         | 34  | 37                                       |
| Home equity - 2nd lien                            | 7                         | 300   | 301                                      |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | 1                         | 10  | 10                                       |
| Total   | 26                        | \$ 1,461  | \$ 1,467                                 |
| 2016  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | 4                         | \$ 290  | \$ 290                                   |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | 6                         | 1,933   | 1,916                                    |
| Mortgage  |                           |   |  |
| 1-4 family  | 5                         | 396   | 470                                      |
| Resort lending                                    | 1                         | 116   | 117                                      |
| Home equity - 1st lien                            | 1                         | 107   | 78                                       |
| Home equity - 2nd lien                            | 2                         | 77  | 78                                       |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 6                         | 141   | 145                                      |
| Home equity - 2nd lien                            | 5                         | 133   | 136                                      |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | 2                         | 46  | 46                                       |
| Total   | 32                        | \$ 3,239  | \$ 3,276                                 |

(1) There were no purchased mortgage loans classified as troubled debt restructurings during the nine month periods ended September 30, 2017 and 2016, respectively.

The troubled debt restructurings described above for 2017 increased the allowance for loan losses by \$0.02 million and resulted in zero charge offs during the three months ended September 30, 2017, and increased the allowance by \$0.08 million and resulted in zero charge offs during the nine months ended September 30, 2017.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The troubled debt restructurings described above for 2016 increased the allowance for loan losses by \$0.34 million and resulted in charge offs of \$0.02 million during the three months ended September 30, 2016, and increased the allowance by \$0.69 million and resulted in charge offs of \$0.02 million during the nine months ended September 30, 2016.

Six commercial and industrial loans with a recorded balance of \$0.16 million that have been classified as troubled debt restructurings during the past twelve months subsequently defaulted during the three and nine month periods ended September 30, 2017. These subsequent defaults resulted in an increase in the allowance of \$0.02 million and \$0.04 million during the three and nine month periods ended September 30, 2017, respectively and resulted in charge-offs of \$0.05 million during both the three and nine month periods ended September 30, 2017. There were no troubled debt restructurings that subsequently defaulted within twelve months following the modification during the three and nine months ended September 30, 2017 for any other loan class.

There were no troubled debt restructurings that subsequently defaulted within twelve months following the modification during the three and nine months ended September 30, 2016.

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

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

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

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

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

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

|  | Commercial       |              | Substandard<br>Accrual<br>9 | Non-<br>Accrual<br>10-11 | Total     |
|--|------------------|--------------|-----------------------------|--------------------------|-----------|
|  | Non-watch<br>1-6 | Watch<br>7-8 |                             |                          |           |
|  | (In thousands)   |              |                             |                          |           |
| September 30, 2017                                       |                  |              |                             |                          |           |
| Income producing - real estate                           | \$268,781        | \$ 3,037     | \$ 312                      | \$ 72                    | \$272,202 |
| Land, land development and construction -<br>real estate | 67,730           | 63           | -                           | 10                       | 67,803    |
| Commercial and industrial                                | 474,022          | 22,217       | 2,380                       | 706                      | 499,325   |
| Total  | \$810,533        | \$ 25,317    | \$ 2,692                    | \$ 788                   | \$839,330 |
| Accrued interest included in total                       | \$1,991          | \$ 80        | \$ 9                        | \$ -                     | \$2,080   |
| December 31, 2016  |                  |              |                             |                          |           |
| Income producing - real estate                           | \$282,886        | \$ 3,787     | \$ 337                      | \$ 628                   | \$287,638 |
| Land, land development and construction -<br>real estate | 51,603           | 67           | -                           | 105                      | 51,775    |
| Commercial and industrial                                | 449,365          | 9,788        | 2,998                       | 4,431                    | 466,582   |
| Total  | \$783,854        | \$ 13,642    | \$ 3,335                    | \$ 5,164                 | \$805,995 |
| Accrued interest included in total                       | \$1,915          | \$ 52        | \$ 11                       | \$ -                     | \$1,978   |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables summarize credit scores by loan class for our mortgage and installment loan segments:

|                                    | Mortgage (1)  |                   | Home               | Home               | Purchased | Total     |
|------------------------------------|---------------|-------------------|--------------------|--------------------|-----------|-----------|
|                                    | 1-4<br>Family | Resort<br>Lending | Equity<br>1st Lien | Equity<br>2nd Lien |           |           |
| (In thousands)                     |               |                   |                    |                    |           |           |
| September 30, 2017                 |               |                   |                    |                    |           |           |
| 800 and above                      | \$62,145      | \$ 11,336         | \$ 8,491           | \$ 8,896           | \$ 7,790  | \$98,658  |
| 750-799                            | 227,676       | 33,287            | 15,619             | 21,092             | 18,559    | 316,233   |
| 700-749                            | 130,480       | 25,629            | 6,583              | 13,819             | 7,978     | 184,489   |
| 650-699                            | 77,357        | 12,441            | 3,304              | 7,970              | 429       | 101,501   |
| 600-649                            | 26,947        | 4,648             | 1,090              | 2,439              | -         | 35,124    |
| 550-599                            | 15,547        | 2,777             | 365                | 1,507              | -         | 20,196    |
| 500-549                            | 8,766         | 1,404             | 540                | 1,319              | -         | 12,029    |
| Under 500                          | 3,692         | 89                | 253                | 169                | -         | 4,203     |
| Unknown                            | 9,373         | 1,668             | 299                | 479                | 120       | 11,939    |
| Total                              | \$561,983     | \$ 93,279         | \$ 36,544          | \$ 57,690          | \$ 34,876 | \$784,372 |
| Accrued interest included in total | \$2,134       | \$ 374            | \$ 165             | \$ 260             | \$ 93     | \$3,026   |
| December 31, 2016                  |               |                   |                    |                    |           |           |
| 800 and above                      | \$36,534      | \$ 10,484         | \$ 6,048           | \$ 8,392           | \$ 8,462  | \$69,920  |
| 750-799                            | 102,382       | 41,999            | 10,006             | 20,113             | 20,984    | 195,484   |
| 700-749                            | 69,337        | 24,727            | 5,706              | 12,360             | 9,115     | 121,245   |
| 650-699                            | 50,621        | 13,798            | 4,106              | 8,167              | 437       | 77,129    |
| 600-649                            | 25,270        | 5,769             | 1,674              | 3,067              | -         | 35,780    |
| 550-599                            | 13,747        | 3,030             | 455                | 1,699              | -         | 18,931    |
| 500-549                            | 9,215         | 1,438             | 486                | 981                | -         | 12,120    |
| Under 500                          | 5,145         | 92                | 255                | 279                | -         | 5,771     |
| Unknown                            | 2,290         | 1,711             | 280                | 179                | 139       | 4,599     |
| Total                              | \$314,541     | \$ 103,048        | \$ 29,016          | \$ 55,237          | \$ 39,137 | \$540,979 |
| Accrued interest included in total | \$1,466       | \$ 450            | \$ 111             | \$ 226             | \$ 111    | \$2,364   |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|                                    | Installment(1)             |                            | Boat<br>Lending | Recreational<br>Vehicle<br>Lending | Other     | Total      |
|------------------------------------|----------------------------|----------------------------|-----------------|------------------------------------|-----------|------------|
|                                    | Home<br>Equity<br>1st Lien | Home<br>Equity<br>2nd Lien |                 |                                    |           |            |
| (In thousands)                     |                            |                            |                 |                                    |           |            |
| September 30, 2017                 |                            |                            |                 |                                    |           |            |
| 800 and above                      | \$ 1,085                   | \$ 869                     | \$ 26,168       | \$ 26,312                          | \$ 10,655 | \$ 65,089  |
| 750-799                            | 1,938                      | 2,721                      | 67,402          | 48,183                             | 26,546    | 146,790    |
| 700-749                            | 1,601                      | 2,236                      | 25,945          | 14,261                             | 16,433    | 60,476     |
| 650-699                            | 2,193                      | 1,864                      | 9,164           | 3,627                              | 8,990     | 25,838     |
| 600-649                            | 1,429                      | 1,429                      | 1,730           | 838                                | 2,334     | 7,760      |
| 550-599                            | 1,252                      | 919                        | 468             | 244                                | 894       | 3,777      |
| 500-549                            | 616                        | 398                        | 243             | 125                                | 434       | 1,816      |
| Under 500                          | 92                         | 56                         | 64              | 11                                 | 130       | 353        |
| Unknown                            | 17                         | 19                         | 219             | 167                                | 7,040     | 7,462      |
| Total                              | \$ 10,223                  | \$ 10,511                  | \$ 131,403      | \$ 93,768                          | \$ 73,456 | \$ 319,361 |
| Accrued interest included in total | \$ 42                      | \$ 44                      | \$ 322          | \$ 236                             | \$ 219    | \$ 863     |
| December 31, 2016                  |                            |                            |                 |                                    |           |            |
| 800 and above                      | \$ 1,354                   | \$ 1,626                   | \$ 21,422       | \$ 23,034                          | \$ 8,911  | \$ 56,347  |
| 750-799                            | 2,478                      | 3,334                      | 50,508          | 35,827                             | 21,918    | 114,065    |
| 700-749                            | 1,920                      | 2,686                      | 20,045          | 11,049                             | 13,183    | 48,883     |
| 650-699                            | 2,852                      | 2,541                      | 7,559           | 3,205                              | 8,913     | 25,070     |
| 600-649                            | 1,691                      | 1,775                      | 1,846           | 821                                | 2,269     | 8,402      |
| 550-599                            | 1,231                      | 1,063                      | 882             | 280                                | 833       | 4,289      |
| 500-549                            | 981                        | 692                        | 440             | 189                                | 511       | 2,813      |
| Under 500                          | 114                        | 220                        | 73              | 16                                 | 211       | 634        |
| Unknown                            | 29                         | 21                         | 150             | 114                                | 5,570     | 5,884      |
| Total                              | \$ 12,650                  | \$ 13,958                  | \$ 102,925      | \$ 74,535                          | \$ 62,319 | \$ 266,387 |
| Accrued interest included in total | \$ 54                      | \$ 59                      | \$ 264          | \$ 203                             | \$ 191    | \$ 771     |

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

Foreclosed residential real estate properties included in other real estate and repossessed assets on our Condensed Consolidated Statements of Financial Condition totaled \$1.7 million and \$1.9 million at September 30, 2017 and December 31, 2016, respectively. Retail mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements totaled \$1.2 million and \$1.0 million at September 30, 2017 and December 31, 2016, respectively.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

5. Shareholders' Equity and Earnings Per Common Share

On January 23, 2017, our Board of Directors authorized a share repurchase plan (the "Repurchase Plan") to buy back up to 5% of our outstanding common stock through December 31, 2017. We expect to accomplish the repurchases through open market transactions, though we could affect repurchases through other means, such as privately negotiated transactions. The timing and amount of any share repurchases will depend on a variety of factors, including, among others, securities law restrictions, the trading price of our common stock, regulatory requirements, potential alternative uses for capital, and our financial performance. The Repurchase Plan does not obligate us to acquire any particular amount of common stock, and it may be modified or suspended at any time at our discretion. We expect to fund any repurchases from cash on hand. We did not repurchase any shares of common stock during the nine months ended September 30, 2017.

A reconciliation of basic and diluted net income per common share follows:

|   | Three Months<br>Ended<br>September 30,   |         | Nine Months Ended<br>September 30, |           |
|---|--|---------|------------------------------------|-----------|
|   | 2017                                     | 2016    | 2017                               | 2016      |
|   | (In thousands, except per share amounts) |         |                                    |           |
| Net income  | \$6,859                                  | \$6,373 | \$ 18,764                          | \$ 16,911 |
| Weighted average shares outstanding (1)   | 21,334                                   | 21,232  | 21,325                             | 21,421    |
| Effect of stock options   | 138                                      | 149     | 144                                | 150       |
| Stock units for deferred compensation plan for non-employee directors             | 121                                      | 116     | 120                                | 115       |
| Performance share units   | 59                                       | 52      | 57                                 | 42        |
| Restricted stock units  | -  | -       | -                                  | 46        |
| Weighted average shares outstanding for calculation of diluted earnings per share | 21,652                                   | 21,549  | 21,646                             | 21,774    |
| Net income per common share   |  |         |                                    |           |
| Basic (1)   | \$0.32                                   | \$0.30  | \$ 0.88                            | \$ 0.79   |
| Diluted   | \$0.32                                   | \$0.30  | \$ 0.87                            | \$ 0.78   |

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

Weighted average stock options outstanding that were not considered in computing diluted net income per share because they were anti-dilutive were zero for both the three and nine month periods ended September 30, 2017, and totaled 0.03 million for both the three and nine month periods ended September 30, 2016.

6. Derivative Financial Instruments

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





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | September 30, 2017     |                          | Fair Value |
|--|------------------------|--------------------------|------------|
|  | Notional Amount        | Average Maturity (years) |            |
|  | (Dollars in thousands) |                          |            |
| Cash flow hedge - pay-fixed interest rate swap agreement | \$ 15,000              | 3.9                      | \$ 105     |
| No hedge designation                                     |                        |                          |            |
| Rate-lock mortgage loan commitments                      | \$ 36,580              | 0.1                      | \$ 769     |
| Mandatory commitments to sell mortgage loans             | 74,750                 | 0.1                      | 26         |
| Pay-fixed interest rate swap agreements                  | 52,586                 | 7.1                      | 52         |
| Pay-variable interest rate swap agreements               | 52,586                 | 7.1                      | (52 )      |
| Purchased options  | 3,119                  | 3.8                      | 277        |
| Written options  | 3,119                  | 3.8                      | (277 )     |
| Total  | \$ 222,740             | 3.5                      | \$ 795     |

|  | December 31, 2016      |                          | Fair Value |
|--|------------------------|--------------------------|------------|
|  | Notional Amount        | Average Maturity (years) |            |
|  | (Dollars in thousands) |                          |            |
| No hedge designation                         |                        |                          |            |
| Rate-lock mortgage loan commitments          | \$ 26,658              | 0.1                      | \$ 646     |
| Mandatory commitments to sell mortgage loans | 61,954                 | 0.1                      | 630        |
| Pay-fixed interest rate swap agreements      | 46,121                 | 8.6                      | 249        |
| Pay-variable interest rate swap agreements   | 46,121                 | 8.6                      | (249 )     |
| Purchased options                            | 3,119                  | 4.5                      | 238        |
| Written options                              | 3,119                  | 4.5                      | (238 )     |
| Total  | \$ 187,092             | 4.4                      | \$ 1,276   |

We use variable-rate and short-term fixed-rate (less than 12 months) debt obligations to fund a portion of our balance sheet, which exposes us to variability in interest rates. To meet our asset/liability management objectives, we may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates ("Cash Flow Hedges"). The Cash Flow Hedge is a pay-fixed interest-rate swap that converts variable-rate cash flows on debt obligations to fixed-rates.

We record the fair value of Cash Flow Hedges in accrued income and other assets and accrued expenses and other liabilities on our Condensed Consolidated Statements of Financial Condition. On an ongoing basis, we adjust our Condensed Consolidated Statements of Financial Condition to reflect the then current fair value of Cash Flow Hedges. The related gains or losses are reported in other comprehensive income or loss and are subsequently reclassified into earnings, as a yield adjustment in the same period in which the related interest on the hedged items (variable-rate debt obligations) affect earnings. It is anticipated that approximately \$0.03 million, of unrealized losses on Cash Flow Hedges at September 30, 2017 will be reclassified to earnings over the next twelve months. To the extent that the Cash Flow Hedges are not effective, the ineffective portion of the Cash Flow Hedges is immediately

recognized in interest expense. The maximum term of the Cash Flow Hedge at September 30, 2017 is 3.9 years.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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

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

We currently offer to our deposit customers an equity linked time deposit product (“Altitude CD”). The Altitude CD is a time deposit that provides the customer a guaranteed return of principal at maturity plus a potential equity return (a written option), while we receive a like stream of funds based on the equity return (a purchased option). The written and purchased options will generally move in opposite directions resulting in little or no net impact on our Condensed Consolidated Statements of Operations. All of the written and purchased options in the table above relate to this Altitude CD product.

We have a program that allows commercial loan customers to lock in a fixed rate for a longer period of time than we would normally offer for interest rate risk reasons. We will enter into a variable rate commercial loan and an interest rate swap agreement with a customer and then enter into an offsetting interest rate swap agreement with an unrelated party. The interest rate swap agreement fair values will generally move in opposite directions resulting in little or no net impact on our Condensed Consolidated Statements of Operations. All of the interest rate swap agreements in the table above with no hedge designation relate to this program.

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Fair Values of Derivative Instruments

|   | Asset Derivatives            |                      | Liability Derivatives        |                      |                              |                      |                              |                      |
|---|------------------------------|----------------------|------------------------------|----------------------|------------------------------|----------------------|------------------------------|----------------------|
|   | September 30,<br>2017        | December 31,<br>2016 | September 30,<br>2017        | December 31,<br>2016 | September 30,<br>2017        | December 31,<br>2016 | September 30,<br>2017        | December 31,<br>2016 |
|   | Balance<br>Sheet<br>Location | Fair<br>Value        | Balance<br>Sheet<br>Location | Fair<br>Value        | Balance<br>Sheet<br>Location | Fair<br>Value        | Balance<br>Sheet<br>Location | Fair<br>Value        |
|   | (In thousands)               |                      |                              |                      |                              |                      |                              |                      |
| Derivatives designated as hedging instruments     |                              |                      |                              |                      |                              |                      |                              |                      |
| Pay-fixed interest rate swap agreements           | Other assets                 | \$ 105               | Other assets                 | \$-                  | Other liabilities            | \$-                  | Other liabilities            | \$-                  |
| Derivatives not designated as hedging instruments |                              |                      |                              |                      |                              |                      |                              |                      |
| Rate-lock mortgage loan commitments               | Other assets                 | 769                  | Other assets                 | 646                  | Other liabilities            | -                    | Other liabilities            | -                    |
| Mandatory commitments to sell mortgage loans      | Other assets                 | 26                   | Other assets                 | 630                  | Other liabilities            | -                    | Other liabilities            | -                    |
| Pay-fixed interest rate swap agreements           | Other assets                 | 424                  | Other assets                 | 493                  | Other liabilities            | 372                  | Other liabilities            | 244                  |
| Pay-variable interest rate swap agreements        | Other assets                 | 372                  | Other assets                 | 244                  | Other liabilities            | 424                  | Other liabilities            | 493                  |
| Purchased options                                 | Other assets                 | 277                  | Other assets                 | 238                  | Other liabilities            | -                    | Other liabilities            | -                    |
| Written options                                   | Other assets                 | -                    | Other assets                 | -                    | Other liabilities            | 277                  | Other liabilities            | 238                  |
| Total   |                              | 1,868                |                              | 2,251                |                              | 1,073                |                              | 975                  |
| Total derivatives                                 |                              | \$1,973              |                              | \$2,251              |                              | \$1,073              |                              | \$975                |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Three Month Periods Ended September 30,

|  | Gain Recognized in Other Comprehensive Income (Effective Portion) 2017 | Loss into Comprehensive Income (Effective Portion) 2016 | Location of Reclassified Gain (Loss) from Accumulated Other Comprehensive Income | Loss from Other Comprehensive Income (Effective Portion) 2017 | Loss from Other Comprehensive Income (Effective Portion) 2016 | Location of Reclassified Gain (Loss) from Accumulated Other Comprehensive Income | Gain (Loss) Recognized in Income (1) 2017 | Gain (Loss) Recognized in Income (1) 2016 |
|--|--|---|--|---|---|--|---|---|
| Cash Flow Hedges                             |  |   |  |   |   |  |   |   |
| Pay-fixed interest rate swap agreements      | \$95   | \$-   | Interest expense   | \$(5)   | \$-   |  | \$5                                       | \$-                                       |
| Total  | \$95   | \$-   |  | \$(5)   | \$-   |  | \$5                                       | \$-                                       |
| No hedge designation                         |  |   |  |   |   |  |   |   |
| Rate-lock mortgage loan commitments          |  |   |  |   |   | Net gains on mortgage loans  | \$(313)                                   | \$264                                     |
| Mandatory commitments to sell mortgage loans |  |   |  |   |   | Net gains on mortgage loans  | 2   | 94  |
| Pay-fixed interest rate swap agreements      |  |   |  |   |   | Interest income  | 52  | 196                                       |
| Pay-variable interest rate swap agreements   |  |   |  |   |   | Interest income  | (52 )                                     | (196)                                     |
| Purchased options                            |  |   |  |   |   | Interest expense   | 5   | 13  |
| Written options                              |  |   |  |   |   | Interest expense   | (5 )                                      | (13 )                                     |
| Total  |  |   |  |   |   |  | \$(311)                                   | \$358                                     |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Nine Month Periods Ended September 30,

|  | Gain Recognized in Other Comprehensive Income (Effective Portion) 2017 | Loss into (Effective Portion) 2016 | Location of Reclassified Gain (Loss) from Accumulated Other Comprehensive Income | Loss Reclassified from Accumulated Other Comprehensive Income Location of Gain (Loss) Recognized in Income (1) 2017 | 2016 | Gain (Loss) Recognized in Income (1) 2017 | 2016          |
|--|--|------------------------------------|--|---|------|---|---------------|
| Cash Flow Hedges                             |  |                                    |  |   |      |   |               |
|  |  |                                    | Interest   |   |      |   |               |
| Pay-fixed interest rate swap agreements      | \$95   | \$-                                | expense  | \$(5)   | \$-  | \$5                                       | \$-           |
| Total  | \$95   | \$-                                |  | \$(5)   | \$-  | \$5                                       | \$-           |
| No hedge designation                         |  |                                    |  |   |      |   |               |
|  |  |                                    |  |   |      | Net gains on                              |               |
| Rate-lock mortgage loan commitments          |  |                                    |  |   |      | on mortgage loans                         | \$123 \$613   |
|  |  |                                    |  |   |      | Net gains on                              |               |
| Mandatory commitments to sell mortgage loans |  |                                    |  |   |      | on mortgage loans                         | (604) (352 )  |
| Pay-fixed interest rate swap agreements      |  |                                    |  |   |      | Interest income                           | (197) (1,512) |
| Pay-variable interest rate swap agreements   |  |                                    |  |   |      | Interest income                           | 197 1,512     |
|  |  |                                    |  |   |      | Interest                                  |               |
| Purchased options                            |  |                                    |  |   |      | expense                                   | 39 94         |
|  |  |                                    |  |   |      | Interest                                  |               |
| Written options                              |  |                                    |  |   |      | expense                                   | (39 ) (94 )   |
| Total  |  |                                    |  |   |      |   | \$(481) \$261 |

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

7. Intangible Assets

The following table summarizes intangible assets, net of amortization:

|   | September 30, 2017 |              | December 31, 2016 |              |
|---|--------------------|--------------|-------------------|--------------|
|   | Gross              | Accumulated  | Gross             | Accumulated  |
|   | Carrying Amount    | Amortization | Carrying Amount   | Amortization |
| Amortized intangible assets - core deposits | \$6,118            | \$ 4,445     | \$ 6,118          | \$ 4,186     |





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization of other intangibles has been estimated through 2022 in the following table.

(In thousands)

|                                       |          |
|---------------------------------------|----------|
| Three months ending December 31, 2017 | \$ 87    |
| 2018                                  | 346      |
| 2019                                  | 346      |
| 2020                                  | 346      |
| 2021                                  | 346      |
| 2022                                  | 202      |
| Total                                 | \$ 1,673 |

8. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.5 million shares of common stock as of September 30, 2017. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of September 30, 2017. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

During the three month periods ended March 31, 2017 and 2016, pursuant to our long-term incentive plan, we granted 0.05 million and 0.07 million shares of restricted stock, respectively and 0.02 million and 0.03 million performance stock units (“PSU”), respectively to certain officers. The shares of restricted stock and PSUs cliff vest after a period of three years. The performance feature of the PSUs is based on a comparison of our total shareholder return over the three year period starting on the grant date to the total shareholder return over that period for a banking index of our peers. No long term incentive grants were made during the second or third quarters of 2017 or 2016.

Our directors may elect to receive a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis pursuant to the non-employee director stock purchase plan referenced above). Shares equal in value to that portion of each director’s fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.006 million shares during each nine month period ended September 30, of 2017 and 2016 and expensed their value during those same periods.

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$0.4 million and \$1.2 million during the three and nine month periods ended September 30, 2017, respectively, and was \$0.3 million and \$1.1 million during the same periods in 2016, respectively. The corresponding tax benefit relating to this expense was \$0.1 million and \$0.4 million for the three and nine month periods ended September 30, 2017, respectively and \$0.1 million and \$0.4 million for the same periods in 2016. Total expense recognized for non-employee director share based payments was \$0.05 million and \$0.12 million during the three and nine month periods ended September 30, 2017, respectively, and was \$0.03 million and \$0.09 million during the same periods in 2016, respectively. The corresponding tax benefit relating to this expense was \$0.02 million and \$0.04 million for the three and nine month periods ended September 30, 2017, respectively and \$0.01 million and \$0.03 million during the same periods in 2016.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

At September 30, 2017, the total expected compensation cost related to non-vested restricted stock and PSUs not yet recognized was \$2.3 million. The weighted-average period over which this amount will be recognized is 2.2 years.

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

|  | Number of<br>Shares | Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (Years) | Aggregated<br>Intrinsic<br>Value<br>(In thousands) |
|--|---------------------|------------------------------|--|--|
| Outstanding at January 1, 2017                       | 211,018             | \$ 5.05                      |  |  |
| Granted  | -                   |                              |  |  |
| Exercised  | (28,963 )           | 4.03                         |  |  |
| Forfeited  | -                   |                              |  |  |
| Expired  | -                   |                              |  |  |
| Outstanding at September 30,<br>2017                 | 182,055             | \$ 5.21                      | 4.4  | \$ 3,175   |
| Vested and expected to vest at<br>September 30, 2017 | 182,055             | \$ 5.21                      | 4.4  | \$ 3,175   |
| Exercisable at September 30,<br>2017                 | 182,055             | \$ 5.21                      | 4.4  | \$ 3,175   |

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

|                                   | Number<br>of Shares | Weighted-<br>Average<br>Grant Date<br>Fair Value |
|-----------------------------------|---------------------|--|
| Outstanding at January 1, 2017    | 296,422             | \$ 14.52   |
| Granted                           | 68,473              | 21.07  |
| Vested                            | (63,799 )           | 14.91  |
| Forfeited                         | (8,510 )            | 15.59  |
| Outstanding at September 30, 2017 | 292,586             | \$ 15.88   |

Certain information regarding options exercised during the periods follows:

|                        | Three Months<br>Ended<br>September 30,<br>2017 |      | Nine Months Ended<br>September 30,<br>2017 |        |
|------------------------|--|------|--|--------|
|                        | 2016   | 2016 | 2016                                       | 2016   |
|                        | (In thousands)                                 |      |  |        |
| Intrinsic value        | \$ 39  | \$ 9 | \$ 513                                     | \$ 186 |
| Cash proceeds received | \$ 18  | \$ 5 | \$ 117                                     | \$ 64  |
| Tax benefit realized   | \$ 14  | \$ 3 | \$ 180                                     | \$ 65  |



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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

9. Income Tax

Income tax expense was \$3.2 million and \$3.0 million during the three month periods ended September 30, 2017 and 2016, respectively and \$8.4 million and \$7.5 million during the nine months ended September 30, 2017 and 2016, respectively.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at both September 30, 2017 and 2016, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

We had maintained a valuation allowance against our deferred tax assets of approximately \$1.1 million at December 31, 2016. This valuation allowance on our deferred tax assets related to state income taxes at Mepco. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. That conclusion was based on the pending sale of Mepco’s payment plan business. After accounting for the May 2017 sale of our payment plan business, all that remained of these deferred tax assets were loss carryforwards that we wrote off against the related valuation allowance during the second quarter of 2017 as we will no longer be doing business in those states.

At both September 30, 2017 and December 31, 2016, we had approximately \$0.8 million, of gross unrecognized tax benefits. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease during the balance of 2017.

10. Regulatory Matters

Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank’s current year net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of September 30, 2017, the Bank had positive undivided profits of \$13.0 million. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total, Tier 1, and common equity Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can result in certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of September 30, 2017 and December 31, 2016, categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation (“FDIC”) categorization.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

On July 2, 2013, the Federal Reserve approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The capital conservation buffer began to phase in on January 1, 2016 with 1.25% and 0.625% added to the minimum ratio for adequately capitalized institutions for 2017 and 2016, respectively and 0.625% will be added each subsequent year until fully phased in during 2019. This capital conservation buffer is not reflected in the table that follows. To avoid limits on capital distributions and certain discretionary bonus payments we must meet the minimum ratio for adequately capitalized institutions plus the phased in buffer. The rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity Tier 1 capital, the most loss-absorbing form of capital, and implement strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual capital amounts and ratios follow:

|  | Actual<br>Amount       | Ratio  | Minimum for<br>Adequately Capitalized<br>Institutions<br>Amount | Ratio | Minimum for<br>Well-Capitalized<br>Institutions<br>Amount | Ratio |   |
|--|------------------------|--------|---|-------|---|-------|---|
|  | (Dollars in thousands) |        |   |       |   |       |   |
| September 30, 2017                                   |                        |        |   |       |   |       |   |
| Total capital to risk-weighted assets                |                        |        |   |       |   |       |   |
| Consolidated   | \$307,278              | 15.14% | \$ 162,315  | 8.00  | % NA  | NA    |   |
| Independent Bank                                     | 281,228                | 13.87  | 162,210   | 8.00  | \$ 202,763  | 10.00 | % |
| Tier 1 capital to risk-weighted assets               |                        |        |   |       |   |       |   |
| Consolidated   | \$284,818              | 14.04% | \$ 121,737  | 6.00  | % NA  | NA    |   |
| Independent Bank                                     | 258,768                | 12.76  | 121,658   | 6.00  | \$ 162,210  | 8.00  | % |
| Common equity tier 1 capital to risk-weighted assets |                        |        |   |       |   |       |   |
| Consolidated   | \$253,101              | 12.47% | \$ 91,302   | 4.50  | % NA  | NA    |   |
| Independent Bank                                     | 258,768                | 12.76  | 91,243  | 4.50  | \$ 131,796  | 6.50  | % |
| Tier 1 capital to average assets                     |                        |        |   |       |   |       |   |
| Consolidated   | \$284,818              | 10.63% | \$ 107,154  | 4.00  | % NA  | NA    |   |
| Independent Bank                                     | 258,768                | 9.67   | 107,022   | 4.00  | \$ 133,778  | 5.00  | % |
| December 31, 2016                                    |                        |        |   |       |   |       |   |
| Total capital to risk-weighted assets                |                        |        |   |       |   |       |   |
| Consolidated   | \$286,289              | 15.86% | \$ 144,413  | 8.00  | % NA  | NA    |   |
| Independent Bank                                     | 270,855                | 15.02  | 144,223   | 8.00  | \$ 180,279  | 10.00 | % |
| Tier 1 capital to risk-weighted assets               |                        |        |   |       |   |       |   |
| Consolidated   | \$265,405              | 14.70% | \$ 108,309  | 6.00  | % NA  | NA    |   |
| Independent Bank                                     | 249,971                | 13.87  | 108,167   | 6.00  | \$ 144,223  | 8.00  | % |
| Common equity tier 1 capital to risk-weighted assets |                        |        |   |       |   |       |   |
| Consolidated   | \$238,996              | 13.24% | \$ 81,232   | 4.50  | % NA  | NA    |   |
| Independent Bank                                     | 249,971                | 13.87  | 81,126  | 4.50  | \$ 117,181  | 6.50  | % |
| Tier 1 capital to average assets                     |                        |        |   |       |   |       |   |
| Consolidated   | \$265,405              | 10.50% | \$ 101,112  | 4.00  | % NA  | NA    |   |
| Independent Bank                                     | 249,971                | 9.90   | 101,019   | 4.00  | \$ 126,274  | 5.00  | % |



NA - Not applicable

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The components of our regulatory capital are as follows:

|   | Consolidated             |                      | Independent Bank         |                      |
|---|--------------------------|----------------------|--------------------------|----------------------|
|   | September<br>30,<br>2017 | December 31,<br>2016 | September<br>30,<br>2017 | December 31,<br>2016 |
|   | (In thousands)           |                      |                          |                      |
| Total shareholders' equity  | \$267,710                | \$ 248,980           | \$267,406                | \$ 258,814           |
| Add (deduct)  |                          |                      |                          |                      |
| Accumulated other comprehensive (gain) loss for regulatory purposes   | (2,140 )                 | 3,310                | (2,140 )                 | 3,310                |
| Intangible assets   | (1,338 )                 | (1,159 )             | (1,338 )                 | (1,159 )             |
| Disallowed deferred tax assets  | (11,131 )                | (12,135 )            | (5,160 )                 | (10,994 )            |
| Common equity tier 1 capital  | 253,101                  | 238,996              | 258,768                  | 249,971              |
| Qualifying trust preferred securities   | 34,500                   | 34,500               | -                        | -                    |
| Disallowed deferred tax assets  | (2,783 )                 | (8,091 )             | -                        | -                    |
| Tier 1 capital  | 284,818                  | 265,405              | 258,768                  | 249,971              |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 22,460                   | 20,884               | 22,460                   | 20,884               |
| Total risk-based capital  | \$307,278                | \$ 286,289           | \$281,228                | \$ 270,855           |

11. Fair Value Disclosures

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

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

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

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

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



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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

Loans held for sale: The fair value of mortgage loans held for sale is based on mortgage backed security pricing for comparable assets (recurring Level 2).

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2017 and December 31, 2016, all of our impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Capitalized mortgage loan servicing rights: The fair value of capitalized mortgage loan servicing rights is based on a valuation model used by an independent third party that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Certain model assumptions are generally unobservable and are based upon the best information available including data relating to our own servicing portfolio, reviews of mortgage servicing assumption and valuation surveys and input from various mortgage servicers and, therefore, are recorded as Level 3. Management evaluates the third party valuation for reasonableness each quarter as part of our financial reporting control processes. Prior to January 1, 2017, capitalized mortgage loan servicing rights were accounted for using the amortization method of accounting and were measured at fair value on a non-recurring basis. During the first quarter of 2017, we adopted the fair value method of accounting for our capitalized mortgage loan servicing rights (see note #2) and are now measured at fair value on a recurring basis.

Derivatives: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets (recurring Level 2). The fair value of interest rate swap agreements is based on a discounted cash flow analysis whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management (recurring Level 2). The fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management (recurring Level 2).

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Fair Value Measurements | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Un-observable Inputs (Level 3) |
|--|-------------------------|--|---|--|
| September 30, 2017:                              |                         |  |   |  |
| Measured at Fair Value on a Recurring Basis      |                         |  |   |  |
| Assets   |                         |  |   |  |
| Trading securities                               | \$347                   | \$ 347   | \$ -  | \$ -                                       |
| Securities available for sale                    |                         |  |   |  |
| U.S. agency                                      | 26,626                  | -  | 26,626  | -  |
| U.S. agency residential mortgage-backed          | 136,109                 | -  | 136,109                                       | -  |
| U.S. agency commercial mortgage-backed           | 10,736                  | -  | 10,736  | -  |
| Private label mortgage-backed                    | 26,990                  | -  | 26,990  | -  |
| Other asset backed                               | 108,339                 | -  | 108,339                                       | -  |
| Obligations of states and political subdivisions | 177,176                 | -  | 177,176                                       | -  |
| Corporate  | 58,000                  | -  | 58,000  | -  |
| Trust preferred                                  | 2,800                   | -  | 2,800   | -  |
| Foreign government                               | 2,089                   | -  | 2,089   | -  |
| Loans held for sale                              | 47,611                  | -  | 47,611  | -  |
| Capitalized mortgage loan servicing rights       | 14,675                  | -  | -   | 14,675                                     |
| Derivatives (1)                                  | 1,973                   | -  | 1,973   | -  |
| Liabilities                                      |                         |  |   |  |
| Derivatives (2)                                  | 1,073                   | -  | 1,073   | -  |
| Measured at Fair Value on a Non-recurring basis: |                         |  |   |  |
| Assets   |                         |  |   |  |
| Impaired loans (3)                               |                         |  |   |  |
| Commercial                                       |                         |  |   |  |
| Income producing - real estate                   | 185                     | -  | -   | 185  |
|  | 11                      | -  | -   | 11   |

|   |     |   |   |     |
|---|-----|---|---|-----|
| Land, land development & construction-real estate |     |   |   |     |
| Commercial and industrial                         | 878 | - | - | 878 |
| Mortgage 1-4 family                               | 509 | - | - | 509 |
| Resort lending                                    | 207 | - | - | 207 |
| Other real estate (4)                             |     |   |   |     |
| Mortgage 1-4 family                               | 44  | - | - | 44  |
| Resort lending                                    | 5   | - | - | 5   |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|   | Fair Value Measurements Using |             |               |       |
|---|-------------------------------|-------------|---------------|-------|
|   | Quoted                        |             |               |       |
|   | Prices                        |             |               |       |
|   | in                            |             |               |       |
|   | Active                        |             |               |       |
|   | Markets                       |             |               |       |
|   | for                           | Significant |               |       |
|   | Identical                     | Other       | Significant   |       |
|   | Assets                        | Observable  | Un-observable |       |
|   | (Level                        | Inputs      | Inputs        |       |
|   | 1)                            | (Level 2)   | (Level 3)     |       |
|   | Measurements                  |             |               |       |
|   | (In thousands)                |             |               |       |
| December 31, 2016:                                |                               |             |               |       |
| Measured at Fair Value on a Recurring Basis       |                               |             |               |       |
| Assets  |                               |             |               |       |
| Trading securities                                | \$410                         | \$ 410      | \$ -          | \$ -  |
| Securities available for sale                     |                               |             |               |       |
| U.S. agency                                       | 28,988                        | -           | 28,988        | -     |
| U.S. agency residential mortgage-backed           | 156,289                       | -           | 156,289       | -     |
| U.S. agency commercial mortgage-backed            | 12,632                        | -           | 12,632        | -     |
| Private label mortgage-backed                     | 34,727                        | -           | 34,727        | -     |
| Other asset backed                                | 146,709                       | -           | 146,709       | -     |
| Obligations of states and political subdivisions  | 170,899                       | -           | 170,899       | -     |
| Corporate   | 56,180                        | -           | 56,180        | -     |
| Trust preferred                                   | 2,579                         | -           | 2,579         | -     |
| Foreign government                                | 1,613                         | -           | 1,613         | -     |
| Loans held for sale                               | 35,946                        | -           | 35,946        | -     |
| Derivatives (1)                                   | 2,251                         | -           | 2,251         | -     |
| Liabilities                                       |                               |             |               |       |
| Derivatives (2)                                   | 975                           | -           | 975           | -     |
| Measured at Fair Value on a Non-recurring basis:  |                               |             |               |       |
| Assets  |                               |             |               |       |
| Capitalized mortgage loan servicing rights (3)    | 8,163                         | -           | -             | 8,163 |
| Impaired loans (4)                                |                               |             |               |       |
| Commercial  |                               |             |               |       |
| Income producing - real estate                    | 255                           | -           | -             | 255   |
| Land, land development & construction-real estate | 54                            | -           | -             | 54    |
| Commercial and industrial                         | 1,342                         | -           | -             | 1,342 |
| Mortgage 1-4 family                               | 361                           | -           | -             | 361   |
| Other real estate (5)                             |                               |             |               |       |
| Commercial  |                               |             |               |       |
| Income producing - real estate (6)                | 2,863                         | -           | 2,863         | -     |
| Land, land development & construction-real estate | 176                           | -           | -             | 176   |
| Mortgage 1-4 family                               | 98                            | -           | -             | 98    |
| Resort lending                                    | 133                           | -           | -             | 133   |



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

There were no transfers between Level 1 and Level 2 during the nine months ended September 30, 2017 and 2016.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   |          | Changes in Fair Values for the Nine-Month<br>Periods Ended September 30 for Items Measured at<br>Fair Value Pursuant to Election of the Fair Value Option<br>2017 |          |                                    | 2016   |                                       |      |
|---|----------|---|----------|------------------------------------|--|---------------------------------------|------|
|   |          | Total<br>Change<br>in Fair<br>Values<br>Included<br>in Current<br>Period<br>Earnings  |          |                                    | Total<br>Change<br>in Fair<br>Values<br>Included<br>in Current<br>Period<br>Earnings |                                       |      |
| Net Gains<br>(Losses)<br>on Assets            |          | Mortgage<br>Loan<br>Servicing,<br>net   |          | Net Gains<br>(Losses)<br>on Assets |  | Mortgage<br>Loan<br>Servicing,<br>net |      |
| Securities<br>(In thousands)                  |          | Loans   |          | Securities                         |  | Loans                                 |      |
| Trading securities                            | \$ (63 ) | \$ -  | \$ -     | \$ (63 )                           | \$ 4   | \$ -                                  | \$ 4 |
| Loans held for sale                           | -        | 713   | -        | 713                                | -  | 612                                   | 612  |
| Capitalized mortgage<br>loan servicing rights | -        | -   | (2,585 ) | (2,585 )                           | -  | -                                     | -    |

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

The following represent impairment charges recognized during the three and nine month periods ended September 30, 2017 and 2016 relating to assets measured at fair value on a non-recurring basis:

Capitalized mortgage loan servicing rights, whose individual strata are measured at fair value, had a carrying amount of \$8.2 million, which is net of a valuation allowance of \$2.3 million, at December 31, 2016. A recovery (charge) of \$0.6 million and \$(1.5) million was included in our results of operations for the three and nine month periods ending September 30, 2016.

Loans which are measured for impairment using the fair value of collateral for collateral dependent loans had a carrying amount of \$2.5 million, with a valuation allowance of \$0.7 million at September 30, 2017, and had a carrying amount of \$4.0 million, with a valuation allowance of \$2.0 million at December 31, 2016. The provision for loan losses included in our results of operations relating to impaired loans was a net expense of \$0.3 million and \$0.1 million for the three month periods ending September 30, 2017 and 2016, respectively, and a net expense of \$0.5 million and \$0.3 million for the nine month periods ending September 30, 2017 and 2016, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$0.05 million which is net of a valuation allowance of \$0.08 million at September 30, 2017, and a carrying amount of \$3.2 million, which is net of a valuation allowance of \$0.8 million, at December 31, 2016. An additional charge relating to other real estate measured at fair value of \$0.03 million and \$0.04 million was included in our results of operations during the three and nine month periods ended September 30, 2017, respectively and \$0.37 million and \$0.41 million during the same periods in 2016.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A reconciliation for all assets and (liabilities) measured at fair value on a recurring basis using significant unobservable inputs (Level 3) follows:

|   | Capitalized Mortgage Loan Servicing Rights |      |                    |      |
|---|--|------|--------------------|------|
|   | Three Months Ended                         |      | Nine Months Ended  |      |
|   | September 30, 2017                         | 2016 | September 30, 2017 | 2016 |
| Beginning balance                                       | \$ 14,515                                  | \$ - | \$ -               | \$ - |
| Change in accounting                                    | -  | -    | 14,213             | -    |
| Beginning balance, as adjusted                          | 14,515                                     | -    | 14,213             | -    |
| Total losses realized and unrealized:                   |  |      |                    |      |
| Included in results of operations                       | (1,090 )                                   | -    | (2,585 )           | -    |
| Included in other comprehensive income                  | -  | -    | -                  | -    |
| Purchases, issuances, settlements, maturities and calls | 1,250                                      | -    | 3,047              | -    |
| Transfers in and/or out of Level 3                      | -  | -    | -                  | -    |
| Ending balance  | \$ 14,675                                  | \$ - | \$ 14,675          | \$ - |

Amount of total losses for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at September 30

\$ (1,090 ) \$ - \$ (2,585 ) \$ -

As discussed above we changed the accounting for capitalized mortgage loan servicing rights during the first quarter of 2017 (see note #2) and are now measuring valuation on a recurring basis. The fair value of our capitalized mortgage loan servicing rights has been determined based on a valuation model used by an independent third party as discussed above. The significant unobservable inputs used in the fair value measurement of the capitalized mortgage loan servicing rights are discount rate, cost to service, ancillary income and float rate. Significant changes in all four of these assumptions in isolation would result in significant changes to the value of our capitalized mortgage loan servicing rights. Quantitative information about our Level 3 fair value measurements measured on a recurring basis follows:

|  | Asset Fair Value | Valuation Technique                    | Unobservable Inputs | Weighted Average |   |
|--|------------------|--|---------------------|------------------|---|
| (In thousands)                             |                  |  |                     |                  |   |
| September 30, 2017                         |                  |  |                     |                  |   |
| Capitalized mortgage loan servicing rights | \$ 14,675        | Present value of net servicing revenue | Discount rate       | 10.10            | % |
|  |                  |  | Cost to service     | \$ 81            |   |
|  |                  |  | Ancillary income    | 23               |   |
|  |                  |  | Float rate          | 2.00             | % |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Asset<br>Fair Value<br>Value<br>(In thousands) | Valuation<br>Technique                    | Unobservable<br>Inputs                              | Weighted<br>Average |    |
|---|--|---|---|---------------------|----|
| September 30, 2017                            |  |   |   |                     |    |
| Impaired loans                                |  |   |   |                     |    |
| Commercial                                    | \$1,074  | Sales comparison approach                 | Adjustment for differences between comparable sales | (2.3                | )% |
| Mortgage<br>Other real estate                 | 716  | Sales comparison approach                 | Adjustment for differences between comparable sales | 0.3                 |    |
| Mortgage                                      | 49   | Sales comparison approach                 | Adjustment for differences between comparable sales | 5.8                 |    |
| December 31, 2016                             |  |   |   |                     |    |
| Capitalized mortgage<br>loan servicing rights | \$8,163  | Present value of net servicing<br>revenue | Discount rate                                       | 10.07               | %  |
|   |  |   | Cost to service                                     | \$ 83               |    |
|   |  |   | Ancillary income                                    | 24                  |    |
|   |  |   | Float rate  | 1.97                | %  |
| Impaired loans                                |  |   |   |                     |    |
| Commercial (1)                                | 1,446  | Sales comparison approach                 | Adjustment for differences between comparable sales | (1.5                | )% |
| Mortgage<br>Other real estate                 | 361  | Sales comparison approach                 | Adjustment for differences between comparable sales | (4.7                | )  |
| Commercial                                    | 176  | Sales comparison approach                 | Adjustment for differences between comparable sales | (22.5               | )  |
| Mortgage                                      | 231  | Sales comparison approach                 | Adjustment for differences between comparable sales | (5.1                | )  |

In addition to the valuation techniques and unobservable inputs discussed above, at December 31, 2016, we had an impaired collateral dependent commercial relationship that totaled \$0.2 million that was primarily secured by collateral other than real estate. Collateral securing this relationship primarily included machinery and equipment and inventory. Valuation techniques included appraisals and discounting restructuring firm valuations based on estimates of value recovery of each particular asset type. Discount rates used ranged from 0% to 100% of stated values.

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

presented.

|                     | Aggregate<br>Fair<br>Value      Difference |          | Contractual<br>Principal |
|---------------------|--|----------|--------------------------|
|                     | (In thousands)                             |          |                          |
| Loans held for sale |  |          |                          |
| September 30, 2017  | \$47,611                                   | \$ 1,150 | \$ 46,461                |
| December 31, 2016   | 35,946                                     | 437      | 35,509                   |

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

12. Fair Values of Financial Instruments

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

Estimated fair values have been determined using available data and methodologies that are considered suitable for each category of financial instrument. For instruments with adjustable interest rates which reprice frequently and without significant credit risk, it is presumed that estimated fair values approximate the recorded book balances. Fair value methodologies discussed below do not necessarily represent an exit price in the determination of the fair value of these financial instruments.

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

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

Securities: Financial instrument assets actively traded in a secondary market have been valued using quoted market prices. Trading securities are classified as Level 1 while securities available for sale are classified as Level 2 as described in note #11.

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

Net loans and loans held for sale: The fair value of loans is calculated by discounting estimated future cash flows using estimated market discount rates that reflect credit and interest-rate risk inherent in the loans and do not necessarily represent an exit price. Loans are classified as Level 3. Impaired loans are valued at the lower of cost or fair value as described in note #11. Loans held for sale are classified as Level 2 as described in note #11. Payment plan receivables held for sale are also classified as Level 2 based on a signed purchase agreement as described in note #15.

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

Derivative financial instruments: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets, the fair value of interest rate swap agreements is based on a discounted cash flow analysis whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management and the fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management. Each of these instruments has been classified as Level 2 as described in note #11.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Federal funds purchased: The recorded book balance of federal funds purchased, which mature in one day, approximates fair value and is classified as Level 2.

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The estimated recorded book balances and fair values follow:

|   | Recorded<br>Book<br>Balance<br>(In thousands) | Fair Value  | Fair Value Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
|---|---|-------------|---|---|---|
| September 30, 2017  |   |             |   |   |   |
| Assets  |   |             |   |   |   |
| Cash and due from<br>banks                                  | \$31,998                                      | \$31,998    | \$ 31,998   | \$ -  | \$ -  |
| Interest bearing<br>deposits                                | 15,605  | 15,605      | 15,605  | -   | -   |
| Interest bearing<br>deposits - time                         | 3,489   | 3,493       | -   | 3,493   | -   |
| Trading securities  | 347   | 347         | 347   | -   | -   |
| Securities available for<br>sale                            | 548,865                                       | 548,865     | -   | 548,865   | -   |
| Federal Home Loan<br>Bank and Federal<br>Reserve Bank Stock | 15,543  | NA          | NA  | NA  | NA  |
| Net loans and loans<br>held for sale                        | 1,963,227                                     | 1,909,662   | -   | 47,611  | 1,862,051   |
| Accrued interest<br>receivable                              | 8,740   | 8,740       | -   | 2,850   | 5,890   |
| Derivative financial<br>instruments                         | 1,973   | 1,973       | -   | 1,973   | -   |
| Liabilities   |   |             |   |   |   |
| Deposits with no<br>stated maturity (1)                     | \$1,808,071                                   | \$1,808,071 | \$ 1,808,071  | \$ -  | \$ -  |
| Deposits with stated<br>maturity (1)                        | 535,690                                       | 533,045     | -   | 533,045   | -   |
| Federal funds<br>purchased                                  | 3,000   | 3,000       | -   | 3,000   | -   |
| Other borrowings  | 72,849  | 73,405      | -   | 73,405  | -   |
| Subordinated<br>debentures                                  | 35,569  | 28,634      | -   | 28,634  | -   |
| Accrued interest<br>payable                                 | 1,105   | 1,105       | 40  | 1,065   | -   |
| Derivative financial<br>instruments                         | 1,073   | 1,073       | -   | 1,073   | -   |



December 31, 2016

## Assets

|   |           |           |           |         |           |
|---|-----------|-----------|-----------|---------|-----------|
| Cash and due from banks                               | \$35,238  | \$35,238  | \$ 35,238 | \$ -    | \$ -      |
| Interest bearing deposits                             | 47,956    | 47,956    | 47,956    | -       | -         |
| Interest bearing deposits - time                      | 5,591     | 5,611     | -         | 5,611   | -         |
| Trading securities                                    | 410       | 410       | 410       | -       | -         |
| Securities available for sale                         | 610,616   | 610,616   | -         | 610,616 | -         |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 15,543    | NA        | NA        | NA      | NA        |
| Net loans and loans held for sale (2)                 | 1,655,335 | 1,629,587 | -         | 67,321  | 1,562,266 |
| Accrued interest receivable                           | 7,316     | 7,316     | 5         | 2,364   | 4,947     |
| Derivative financial instruments                      | 2,251     | 2,251     | -         | 2,251   | -         |

## Liabilities

|                                      |             |             |              |         |      |
|--------------------------------------|-------------|-------------|--------------|---------|------|
| Deposits with no stated maturity (1) | \$1,740,601 | \$1,740,601 | \$ 1,740,601 | \$ -    | \$ - |
| Deposits with stated maturity (1)    | 485,118     | 483,469     | -            | 483,469 | -    |
| Other borrowings                     | 9,433       | 10,371      | -            | 10,371  | -    |
| Subordinated debentures              | 35,569      | 25,017      | -            | 25,017  | -    |
| Accrued interest payable             | 932         | 932         | 21           | 911     | -    |
| Derivative financial instruments     | 975         | 975         | -            | 975     | -    |

Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$13.5 million and \$7.4 million at September 30, 2017 and December 31, 2016, respectively. Deposits with a stated maturity include (1) reciprocal deposits with a recorded book balance of \$35.5 million and \$31.3 million September 30, 2017 and December 31, 2016, respectively.

(2) Net loans and loans held for sale include \$31.4 million of payment plan receivables and commercial loans held for sale at December 31, 2016.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

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

13. Contingent Liabilities

In December 2016, we reached a tentative settlement regarding litigation initiated against us in Wayne County, Michigan Circuit Court. The Court issued a preliminary approval of this settlement in the first quarter of 2017. This litigation concerned checking account transaction sequencing during a period from February 2009 to June 2011. Under the terms of the settlement, we have agreed to pay \$2.2 million and are also responsible for class notification costs and certain other expenses which are estimated to total approximately \$0.1 million (these amounts were accrued for and expensed in the fourth quarter of 2016). We expect the settlement payment to occur in the fourth quarter of 2017 or first quarter of 2018. Although, we deny any liability associated with this matter and believe we have meritorious defenses to the allegations in the complaint, given the costs and uncertainty of litigation, it was determined that this settlement was in the best interests of the organization.

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In connection with the sale of Mepco (see note #15), we agreed to contractually indemnify the purchaser from certain losses it may incur, including as a result of its failure to collect certain receivables it purchased as part of the business as well as breaches of representations and warranties we made in the sale agreement, subject to various limitations. We have not accrued any liability related to these indemnification requirements in our September 30, 2017 Condensed Consolidated Statement of Financial Condition because we believe the likelihood of having to pay any amount as a result of these indemnification obligations is remote. However, if the purchaser is unable to collect the receivables it purchased from Mepco or otherwise encounters difficulties in operating the business, it is possible it could make one or more claims against us pursuant to the sale agreement. In that event, we may incur expenses in defending any such claims and/or amounts paid to such purchaser to resolve such claims. As of September 30, 2017 these receivables balances had declined to \$22.5 million and to date the purchaser has made no claims for indemnification.

The provision for loss reimbursement on sold loans was an expense of \$0.02 million and \$0.07 million in the third quarter and first nine months of 2017, respectively, compared to an expense of \$0.05 million and \$0.03 million in the third quarter and first nine months of 2016, respectively. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank of Indianapolis). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The reserve for loss reimbursements on sold mortgage loans totaled \$0.6 million at both September 30, 2017 and December 31, 2016, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition.

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(unaudited)

14. Accumulated Other Comprehensive Loss (“AOCL”)

A summary of changes in AOCL follows:

|   | Unrealized<br>Gains<br>(Losses) on<br>Securities<br>Available<br>for Sale | Dispropor-<br>tionate<br>Tax Effects<br>from<br>Securities<br>Available<br>for Sale | Unrealized<br>Gains on<br>Cash Flow<br>Hedges | Total     |
|---|---|---|---|-----------|
|   | (In thousands)  |   |   |           |
| For the three months ended September 30,<br>2017    |   |   |   |           |
| Balances at beginning of period                     | \$ 1,986  | \$ (5,798 )   | \$ -  | \$(3,812) |
| Other comprehensive income before reclassifications | 95  | -   | 62  | 157       |
| Amounts reclassified from AOCL                      | (5 )  | -   | 3   | (2 )      |
| Net current period other comprehensive income       | 90  | -   | 65  | 155       |
| Balances at end of period                           | \$ 2,076  | \$ (5,798 )   | \$ 65   | \$(3,657) |
| 2016  |   |   |   |           |
| Balances at beginning of period                     | \$ 2,515  | \$ (5,798 )   | \$ -  | \$(3,283) |
| Other comprehensive income before reclassifications | 278   | -   | -   | 278       |
| Amounts reclassified from AOCL                      | (10 )   | -   | -   | (10 )     |
| Net current period other comprehensive income       | 268   | -   | -   | 268       |
| Balances at end of period                           | \$ 2,783  | \$ (5,798 )   | \$ -  | \$(3,015) |
| For the Nine months ended September 30,<br>2017     |   |   |   |           |
| Balances at beginning of period                     | \$ (3,310 )   | \$ (5,798 )   | \$ -  | \$(9,108) |
| Cumulative effect of change in accounting           | 300   | -   | -   | 300       |
| Balances at beginning of period, as adjusted        | (3,010 )  | (5,798 )  | -   | (8,808)   |
| Other comprehensive income before reclassifications | 5,167   | -   | 62  | 5,229     |
| Amounts reclassified from AOCL                      | (81 )   | -   | 3   | (78 )     |
| Net current period other comprehensive income       | 5,086   | -   | 65  | 5,151     |
| Balances at end of period                           | \$ 2,076  | \$ (5,798 )   | \$ 65   | \$(3,657) |
| 2016  |   |   |   |           |
| Balances at beginning of period                     | \$ (238 )   | \$ (5,798 )   | \$ -  | \$(6,036) |
| Other comprehensive income before reclassifications | 3,215   | -   | -   | 3,215     |
| Amounts reclassified from AOCL                      | (194 )  | -   | -   | (194 )    |
| Net current period other comprehensive income       | 3,021   | -   | -   | 3,021     |
| Balances at end of period                           | \$ 2,783  | \$ (5,798 )   | \$ -  | \$(3,015) |

We adopted ASU 2017-08 during the first quarter of 2017 using a modified retrospective approach. As a result, accumulated other comprehensive loss as of January 1, 2017 was adjusted by \$0.30 million (see note #2).



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The disproportionate tax effects from securities available for sale arose due to tax effects of other comprehensive income (“OCI”) in the presence of a valuation allowance against our deferred tax assets and a pretax loss from operations. Generally, the amount of income tax expense or benefit allocated to operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided when, in the presence of a valuation allowance against deferred tax assets, there is a pretax loss from operations and pretax income from other categories in the current period. In such instances, income from other categories must offset the current loss from operations, the tax benefit of such offset being reflected in operations.

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

| AOCL Component                                    | Amount<br>Reclassified<br>From<br>AOCL<br>(In thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|---|--|--|
| 2017  |  |  |
| Unrealized gains on securities available for sale | \$ 8   | Net gains on securities  |
|   | -  | Net impairment loss recognized in earnings                               |
|   | 8  | Total reclassifications before tax                                       |
|   | 3  | Income tax expense   |
|   | \$ 5   | Reclassifications, net of tax  |
| Unrealized gains on cash flow hedges              | \$ (5  | ) Interest expense   |
|   | (2   | ) Income tax expense   |
|   | \$ (3  | ) Reclassification, net of tax   |
|   | \$ 2   | Total reclassifications for the period, net of tax                       |
| 2016  |  |  |
| Unrealized gains on securities available for sale | \$ 15  | Net gains on securities  |
|   | -  | Net impairment loss recognized in earnings                               |
|   | 15   | Total reclassifications before tax                                       |
|   | 5  | Income tax expense   |
|   | \$ 10  | Reclassifications, net of tax  |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

A summary of reclassifications out of each component of AOCL for the nine months ended September 30 follows:

| AOCL Component                                    | Amount<br>Reclassified<br>From<br>AOCL<br>(In thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|---|--|--|
| 2017  |  |  |
| Unrealized gains on securities available for sale | \$ 125   | Net gains on securities  |
|   | -  | Net impairment loss recognized in earnings                               |
|   | 125  | Total reclassifications before tax                                       |
|   | 44   | Income tax expense   |
|   | \$ 81  | Reclassifications, net of tax  |
| Unrealized gains on cash flow hedges              | \$ (5  | ) Interest expense   |
|   | (2   | ) Income tax expense   |
|   | \$ (3  | ) Reclassification, net of tax   |
|   | \$ 78  | Total reclassifications for the period, net of tax                       |
| 2016  |  |  |
| Unrealized gains on securities available for sale | \$ 298   | Net gains on securities  |
|   | -  | Net impairment loss recognized in earnings                               |
|   | 298  | Total reclassifications before tax                                       |
|   | 104  | Income tax expense   |
|   | \$ 194   | Reclassifications, net of tax  |

#### 15. Payment Plan Receivables and Other Assets Held for Sale

On December 30, 2016 Mepco executed an Asset Purchase Agreement (the “APA”) with Seabury Asset Management LLC (“Seabury”). Pursuant to the terms of the APA, Mepco sold its payment plan processing business to Seabury effective May 1, 2017. We received cash totaling \$33.4 million and recorded no gain or loss in 2017 as the assets were sold and the liabilities were assumed at book value.

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

Assets sold and liabilities assumed were as follows:

|                          | May 1,<br>2017 | December 31,<br>2016 |
|--------------------------|----------------|----------------------|
|                          | (In thousands) |                      |
| Assets sold              |                |                      |
| Payment plan receivables | \$33,128       | \$ 30,582            |
| Commerical loans         | 525            | 794                  |
| Other assets             | 1,765          | 1,984                |
| Total assets             | \$35,418       | \$ 33,360            |
| Liabilities assumed      | \$1,972        | \$ 718               |

These assets and liabilities were categorized as “held for sale” in our December 31, 2016 Condensed Consolidated Statement of Financial Condition. These assets and corresponding liabilities held for sale were carried at the lower of cost or fair value on an aggregate basis. Fair value adjustments, if any, were recorded in current earnings.



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ITEM 2.

Management's Discussion and Analysis  
of Financial Condition and Results of Operations

**Introduction.** The following section presents additional information to assess the financial condition and results of operations of Independent Bank Corporation, its wholly-owned bank, Independent Bank (the "Bank"), and their subsidiaries. This section should be read in conjunction with the Condensed Consolidated Financial Statements. We also encourage you to read our 2016 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC"). That report includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

**Overview.** We provide banking services to customers located primarily in Michigan's Lower Peninsula. As a result, our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula. At times, we have experienced a difficult economy in Michigan. Economic conditions in Michigan began to show signs of improvement during 2010. Generally, these improvements have continued into 2017, albeit at an uneven pace. There has been an overall decline in the unemployment rate as well as generally improving housing prices and other related statistics (such as home sales and new building permits). In addition, since early- to mid-2009, we have seen an improvement in our asset quality metrics. In particular, since early 2012, we have generally experienced a decline in non-performing assets, reduced levels of new loan defaults, and reduced levels of loan net charge-offs.

**Recent Developments.** Effective on January 1, 2017, we adopted the fair value accounting method for capitalized mortgage loan servicing rights. The adoption of this accounting method resulted in the following changes to the January 1, 2017 beginning balances: an increase in capitalized mortgage loan servicing rights of \$0.54 million; a decrease in deferred income taxes of \$0.19 million and a decrease in our accumulated deficit of \$0.35 million. See note 2 to the Condensed Consolidated Financial Statements.

On December 30, 2016, the Bank and its wholly-owned subsidiary, Mepco Finance Corporation ("Mepco"), entered into an Asset Purchase Agreement ("APA") with Seabury Asset Management LLC ("Seabury"). Pursuant to the terms of the APA, we sold our payment plan processing business, payment plan receivables, and certain other assets to Seabury, who also assumed certain liabilities of Mepco. These assets and liabilities were categorized as "held for sale" in the December 31, 2016 Condensed Consolidated Statements of Financial Condition. We also recorded a \$0.32 million loss related to the sale of these assets in the fourth quarter of 2016. This transaction closed on May 18, 2017, with an effective date of May 1, 2017. As a result of the closing, Mepco sold \$33.1 million of net payment plan receivables, \$0.5 million of commercial loans, \$0.2 million of furniture and equipment and \$1.6 million of other assets to Seabury, who also assumed \$2.0 million of specified liabilities. Mepco was renamed IB Holding Company in May 2017 and was liquidated on June 30, 2017, with the remaining assets and liabilities transferred to the Bank. We do not believe that the sale of the Mepco business and assets will have a significant impact on our future overall financial condition or results of operations.

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In the fourth quarter of 2016, we reached a tentative settlement regarding litigation initiated against the Bank in Wayne County, Michigan Circuit Court. The Court issued a preliminary approval of this settlement in the first quarter of 2017. This litigation concerned the Bank's checking account transaction sequencing during a period from February 2009 to June 2011. Under the terms of the settlement, we have agreed to pay \$2.2 million and we are also responsible for class notification costs and certain other expenses which are estimated to total approximately \$0.1 million. We recorded a \$2.3 million expense in the fourth quarter of 2016 for this settlement. We expect the settlement payment to occur in the fourth quarter of 2017 or first quarter of 2018. Although, we deny any liability associated with this matter and believe we have meritorious defenses to the allegations in the complaint, given the costs and uncertainty of litigation, we determined that this settlement was in the best interests of the organization.

Regulation. On July 2, 2013, the Federal Reserve Board approved a final rule that establishes an integrated regulatory capital framework (the "New Capital Rules"). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The 2.5% capital conservation buffer is being phased in ratably over a four-year period that began in 2016. In 2017, 1.25% is being added to the minimum ratio for adequately capitalized institutions. To avoid limits on capital distributions and certain discretionary bonus payments we must meet the minimum ratio for adequately capitalized institutions plus the phased in buffer (now 5.75% in 2017). The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. Under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital. As of September 30, 2017 and December 31, 2016 we exceeded all of the capital ratio requirements of the New Capital Rules.

It is against this backdrop that we discuss our results of operations and financial condition in the third quarter and first nine months of 2017 as compared to 2016.

Results of Operations

Summary. We recorded net income of \$6.9 million and \$6.4 million, respectively, during the three months ended September 30, 2017 and 2016. The increase in 2017 results as compared to 2016 primarily reflects an increase in net interest income that was partially offset by increases in the provision for loan losses and in non-interest and income tax expenses and a decrease in non-interest income.

We recorded net income of \$18.8 million and \$16.9 million, respectively, during the nine months ended September 30, 2017 and 2016. The increase in 2017 year-to-date results as compared to 2016 is primarily due to increases in net interest income and non-interest income that were partially offset by increases in the provision for loan losses, non-interest expense and income tax expense.

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## Key performance ratios

|                                     | Three months ended |         | Nine months ended |         |
|-------------------------------------|--------------------|---------|-------------------|---------|
|                                     | September 30,      |         | September 30,     |         |
|                                     | 2017               | 2016    | 2017              | 2016    |
| Net income (annualized) to          |                    |         |                   |         |
| Average assets                      | 1.01               | %       | 1.02              | %       |
| Average common shareholders' equity | 10.27              |         | 10.20             |         |
|                                     |                    |         | 9.69              | 9.19    |
| Net income per common share         |                    |         |                   |         |
| Basic                               | \$ 0.32            | \$ 0.30 | \$ 0.88           | \$ 0.79 |
| Diluted                             | 0.32               | 0.30    | 0.87              | 0.78    |

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

Our net interest income totaled \$22.9 million during the third quarter of 2017, an increase of \$2.9 million, or 14.6% from the year-ago period. This increase primarily reflects a \$227.4 million increase in average interest-earning assets as well as a 15 basis point increase in our tax equivalent net interest income as a percent of average interest-earning assets (the "net interest margin").

For the first nine months of 2017, net interest income totaled \$65.9 million, an increase of \$6.5 million, or 10.9% from 2016. This increase primarily reflects a \$184.9 million increase in average interest-earning assets as well as an 10 basis point increase in our net interest margin.

The increase in average interest-earning assets primarily reflects loan growth utilizing funds from increases in deposits and borrowed funds. The increase in the net interest margin reflects a change in the mix of average-interest earning assets (higher percentage of loans) as well as increases in short-term market interest rates.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the third quarter and first nine months of 2017 non-accrual loans averaged \$8.6 million and \$9.7 million, respectively compared to \$10.7 million and \$10.6 million, respectively for the same periods in 2016. In addition, in the third quarter and first nine months of 2017 we had net recoveries of \$0.28 million and \$0.90 million, respectively, of previously unpaid interest on loans placed on or taken off non-accrual during each period or on loans previously charged-off compared to net recoveries of \$0.07 million and \$0.75 million, respectively, during the same periods in 2016.

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## Average Balances and Tax Equivalent Rates

|  | Three Months Ended<br>September 30,<br>2017 |           |                     |              | 2016               |          |                     |
|--|---|-----------|---------------------|--------------|--------------------|----------|---------------------|
|  | Average<br>Balance                          | Interest  | Rate <sup>(2)</sup> |              | Average<br>Balance | Interest | Rate <sup>(2)</sup> |
| (Dollars in thousands)   |   |           |                     |              |                    |          |                     |
| <b>Assets</b>  |   |           |                     |              |                    |          |                     |
| Taxable loans  | \$ 1,908,497                                | \$ 21,801 | 4.55 %              | \$ 1,613,189 | \$ 18,562          | 4.59 %   |                     |
| Tax-exempt loans <sup>(1)</sup>  | 3,138                                       | 47        | 5.94                | 3,492        | 53                 | 6.04     |                     |
| Taxable securities   | 474,901                                     | 2,765     | 2.33                | 534,319      | 2,537              | 1.90     |                     |
| Tax-exempt securities <sup>(1)</sup>                                   | 90,645                                      | 783       | 3.46                | 58,694       | 507                | 3.46     |                     |
| Interest bearing cash  | 29,336                                      | 63        | 0.85                | 69,603       | 86                 | 0.49     |                     |
| Other investments  | 15,543                                      | 200       | 5.11                | 15,347       | 195                | 5.05     |                     |
| Interest Earning Assets  | 2,522,060                                   | 25,659    | 4.05                | 2,294,644    | 21,940             | 3.81     |                     |
| Cash and due from banks  | 33,019                                      |           |                     | 34,565       |                    |          |                     |
| Other assets, net  | 142,283                                     |           |                     | 152,793      |                    |          |                     |
| Total Assets   | \$ 2,697,362                                |           |                     | \$ 2,482,002 |                    |          |                     |
| <b>Liabilities</b>   |   |           |                     |              |                    |          |                     |
| Savings and interest-bearing checking                                  | \$ 1,048,289                                | 408       | 0.15                | \$ 1,014,201 | 284                | 0.11     |                     |
| Time deposits  | 531,226                                     | 1,425     | 1.06                | 438,504      | 970                | 0.88     |                     |
| Other borrowings   | 85,219                                      | 626       | 2.91                | 47,227       | 493                | 4.15     |                     |
| Interest Bearing Liabilities   | 1,664,734                                   | 2,459     | 0.59                | 1,499,932    | 1,747              | 0.46     |                     |
| Non-interest bearing deposits  | 736,291                                     |           |                     | 706,282      |                    |          |                     |
| Other liabilities  | 31,263                                      |           |                     | 27,110       |                    |          |                     |
| Shareholders' equity   | 265,074                                     |           |                     | 248,678      |                    |          |                     |
| Total Liabilities and<br>Shareholders' Equity                          | \$ 2,697,362                                |           |                     | \$ 2,482,002 |                    |          |                     |
| Net Interest Income  |   | \$ 23,200 |                     |              | \$ 20,193          |          |                     |
| Net Interest Income as a Percent<br>of Average Interest Earning Assets |   |           | 3.66 %              |              |                    | 3.51 %   |                     |

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

(2) Annualized

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## Average Balances and Tax Equivalent Rates

|  | Nine Months Ended<br>September 30,<br>2017 |           |                     |              | 2016               |          |                     |
|--|--|-----------|---------------------|--------------|--------------------|----------|---------------------|
|  | Average<br>Balance                         | Interest  | Rate <sup>(2)</sup> |              | Average<br>Balance | Interest | Rate <sup>(2)</sup> |
|  | (Dollars in thousands)                     |           |                     |              |                    |          |                     |
| <b>Assets</b>  |  |           |                     |              |                    |          |                     |
| Taxable loans  | \$ 1,792,381                               | \$ 61,544 | 4.59 %              | \$ 1,577,758 | \$ 55,255          | 4.67 %   |                     |
| Tax-exempt loans <sup>(1)</sup>  | 3,410                                      | 145       | 5.69                | 3,564        | 163                | 6.11     |                     |
| Taxable securities   | 499,886                                    | 8,300     | 2.21                | 532,576      | 7,261              | 1.82     |                     |
| Tax-exempt securities <sup>(1)</sup>                                   | 85,853                                     | 2,264     | 3.52                | 50,286       | 1,320              | 3.50     |                     |
| Interest bearing cash  | 42,610                                     | 229       | 0.72                | 75,121       | 292                | 0.52     |                     |
| Other investments  | 15,543                                     | 638       | 5.49                | 15,456       | 592                | 5.12     |                     |
| Interest Earning Assets  | 2,439,683                                  | 73,120    | 4.00                | 2,254,761    | 64,883             | 3.84     |                     |
| Cash and due from banks  | 32,492                                     |           |                     | 38,069       |                    |          |                     |
| Other assets, net  | 146,753                                    |           |                     | 157,570      |                    |          |                     |
| Total Assets   | \$ 2,618,928                               |           |                     | \$ 2,450,400 |                    |          |                     |
| <b>Liabilities</b>   |  |           |                     |              |                    |          |                     |
| Savings and interest-bearing checking                                  | \$ 1,051,395                               | 1,007     | 0.13                | \$ 1,018,727 | 831                | 0.11     |                     |
| Time deposits  | 494,219                                    | 3,747     | 1.01                | 435,146      | 2,689              | 0.83     |                     |
| Other borrowings   | 66,392                                     | 1,659     | 3.34                | 47,405       | 1,455              | 4.10     |                     |
| Interest Bearing Liabilities   | 1,612,006                                  | 6,413     | 0.53                | 1,501,278    | 4,975              | 0.44     |                     |
| Non-interest bearing deposits  | 717,589                                    |           |                     | 677,645      |                    |          |                     |
| Other liabilities  | 30,372                                     |           |                     | 25,612       |                    |          |                     |
| Shareholders' equity   | 258,961                                    |           |                     | 245,865      |                    |          |                     |
| Total liabilities and<br>shareholders' equity                          | \$ 2,618,928                               |           |                     | \$ 2,450,400 |                    |          |                     |
| Net Interest Income  |  | \$ 66,707 |                     |              | \$ 59,908          |          |                     |
| Net Interest Income as a Percent<br>of Average Interest Earning Assets |  |           | 3.65 %              |              |                    | 3.55 %   |                     |

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

(2) Annualized

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## Reconciliation of Net Interest Margin, Fully Taxable Equivalent ("FTE")

|   | Three Months Ended     |           | Nine Months Ended      |           |      |  |   |
|---|------------------------|-----------|------------------------|-----------|------|--|---|
|   | September 30,          |           | September 30,          |           |      |  |   |
|   | 2017                   | 2016      | 2017                   | 2016      |      |  |   |
|   | (Dollars in thousands) |           | (Dollars in thousands) |           |      |  |   |
| Net interest income                       | \$ 22,912              | \$ 19,998 | \$ 65,870              | \$ 59,391 |      |  |   |
| Add: taxable equivalent adjustment        | 288                    | 195       | 837                    | 517       |      |  |   |
| Net interest income - taxable equivalent  | \$ 23,200              | \$ 20,193 | \$ 66,707              | \$ 59,908 |      |  |   |
| Net interest margin (GAAP) <sup>(1)</sup> | 3.60                   | % 3.47    | % 3.61                 | %         | 3.52 |  | % |
| Net interest margin (FTE) <sup>(1)</sup>  | 3.66                   | % 3.51    | % 3.65                 | %         | 3.55 |  | % |

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**(1) Annualized**

Provision for loan losses. The provision for loan losses was an expense of \$0.6 million and a credit \$0.2 million during the three months ended September 30, 2017 and 2016, respectively. During the nine-month periods ended September 30, 2017 and 2016, the provision was an expense of \$0.8 million and a credit of \$1.4 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan growth, loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See "Portfolio Loans and asset quality" for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the third quarter and first nine months of 2017.

Non-interest income. Non-interest income is a significant element in assessing our results of operations. Non-interest income totaled \$10.3 million during the third quarter of 2017 compared to \$11.7 million in 2016. For the first nine months of 2017 non-interest income totaled \$31.1 million compared to \$29.1 million for the first nine months of 2016. The components of non-interest income are as follows:

**Non-Interest Income**

|                                     | Three months ended |           | Nine months ended |           |  |
|-------------------------------------|--------------------|-----------|-------------------|-----------|--|
|                                     | September 30,      |           | September 30,     |           |  |
|                                     | 2017               | 2016      | 2017              | 2016      |  |
|                                     | (In thousands)     |           |                   |           |  |
| Service charges on deposit accounts | \$ 3,281           | \$ 3,281  | \$ 9,465          | \$ 9,164  |  |
| Interchange income                  | 1,942              | 1,943     | 5,869             | 5,797     |  |
| Net gains (losses) on assets:       |                    |           |                   |           |  |
| Mortgage loans                      | 2,971              | 3,556     | 8,886             | 7,727     |  |
| Securities                          | 69                 | (45 )     | 62                | 302       |  |
| Mortgage loan servicing, net        | 1                  | 858       | 668               | (454 )    |  |
| Investment and insurance            |                    |           |                   |           |  |
| commissions                         | 606                | 427       | 1,541             | 1,278     |  |
| Bank owned life insurance           | 283                | 282       | 776               | 870       |  |
| Other                               | 1,151              | 1,406     | 3,822             | 4,413     |  |
| Total non-interest income           | \$ 10,304          | \$ 11,708 | \$ 31,089         | \$ 29,097 |  |



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Service charges on deposit accounts were unchanged on a comparative quarterly basis and increased on a year-to-date basis in 2017 as compared to 2016. The year-to-date increase was principally due to higher service charges on commercial accounts and a modest increase in non-sufficient funds occurrences.

Interchange income was unchanged on a comparative quarterly basis and increased slightly on a year-to-date basis in 2017 as compared to 2016. The year-to-date increase is due primarily to increased debit card transaction activity.

Net gains on mortgage loans decreased on a comparative quarterly basis and increased on a year to date basis in 2017 as compared to 2016. Mortgage loan activity is summarized as follows:

## Mortgage Loan Activity

|   | Three months ended     |           | Nine months ended |            |
|---|------------------------|-----------|-------------------|------------|
|   | September 30,          |           | September 30,     |            |
|   | 2017                   | 2016      | 2017              | 2016       |
|   | (Dollars in thousands) |           |                   |            |
| Mortgage loans originated   | \$264,177              | \$123,124 | \$ 657,345        | \$ 288,592 |
| Mortgage loans sold   | 120,981                | 89,349    | 305,386           | 215,494    |
| Net gains on mortgage loans   | 2,971                  | 3,556     | 8,886             | 7,727      |
| Net gains as a percent of mortgage loans sold ("Loan Sales Margin") | 2.46                   | % 3.98    | % 2.91            | % 3.59     |
| Fair value adjustments included in the Loan Sales Margin            | (0.22 )                | 0.55      | 0.08              | 0.40       |

The increase in mortgage loan originations, sales and net gains (for the year-to-date period) in 2017 as compared to 2016 is due primarily to the expansion of our mortgage-banking operations. The decline in net gains in the third quarter of 2017 compared to the third quarter of 2016 was due to a decline in the Loan Sales Margin as described below.

During the last quarter of 2016 and the first half of 2017, we significantly expanded our mortgage-banking operations by adding new employees and opening new loan production offices (Ann Arbor, Brighton, Dearborn, Grosse Pointe, Traverse City and Troy, Michigan and Columbus and Fairlawn, Ohio). Overall, we have increased average full-time equivalent employees in mortgage lending sales and operations by 80.8% and by 67.0%, in the third quarter and first nine months of 2017, respectively, over the same periods in 2016. This business expansion has increased net gains on mortgage loans (on a year-to-date basis) and has accelerated the growth of portfolio mortgage loans and mortgage loans serviced for others, leading to increased mortgage loan interest income and mortgage loan servicing revenue. However, this expansion has also increased non-interest expenses, particularly compensation and employee benefits and occupancy. In addition, due to higher interest rates, mortgage loan refinance volume has declined in 2017 on an industry-wide basis. It is important to our future results of operations that we effectively and successfully manage this business expansion.

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



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Our Loan Sales Margin is impacted by several factors including competition and the manner in which the loan is sold. Net gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding the aforementioned fair value accounting adjustments, the Loan Sales Margin would have been 2.68% and 3.43% in the third quarters of 2017 and 2016, respectively and 2.83% and 3.19% for the comparative 2017 and 2016 year-to-date periods, respectively. The decrease in the Loan Sales Margin (excluding fair value adjustments) in 2017 was generally due to a narrowing of primary-to-secondary market pricing spreads due to competitive factors throughout the mortgage banking industry (generally higher mortgage loan interest rates and a decline in refinance volume). The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale.

Net gains (losses) on securities totaled \$0.069 million and \$0.062 million during the three and nine months ended September 30, 2017, respectively, and \$(0.045) million and \$0.302 million for the respective comparable periods in 2016. The third quarter 2017 securities net gains were due to a \$0.061 million increase in the fair value of trading securities and \$0.008 million of net gains on the sale of \$1.8 million of investments. The year-to-date 2017 securities net gains were due to \$0.125 million of net gains on the sale of \$9.6 million of investments that were partially offset by a \$0.063 million decrease in the fair value of trading securities. The third quarter 2016 securities net losses were primarily due to a \$0.058 million decrease in the fair value of trading securities that was partially offset by \$0.013 million of net gains on the sale of \$1.1 million of investments. The year-to-date 2016 securities net gains were due primarily to net gains of \$0.298 million on the sale of \$56.5 million of investments. (See "Securities.")

We recorded no net impairment losses in either 2017 or 2016 for other than temporary impairment of securities available for sale. (See "Securities.")

Mortgage loan servicing generated income of \$0.001 million and \$0.858 million in the third quarters of 2017 and 2016, respectively. For the first nine months of 2017, mortgage loan servicing generated income of \$0.668 million as compared to a loss of \$0.454 million in 2016. This activity is summarized in the following table:

|                                    | Three Months Ended |           | Nine Months Ended |           |
|------------------------------------|--------------------|-----------|-------------------|-----------|
|                                    | 9/30/2017          | 9/30/2016 | 9/30/2017         | 9/30/2016 |
| Mortgage loan servicing:           | (In thousands)     |           |                   |           |
| Revenue, net                       | \$ 1,091           | \$ 1,037  | \$ 3,253          | \$ 3,087  |
| Fair value change due to price     | (572 )             | --        | (1,075 )          | --        |
| Fair value change due to pay-downs | (518 )             | --        | (1,510 )          | --        |
| Amortization                       | --                 | (799 )    | --                | (2,065 )  |
| Impairment (charge) recovery       | --                 | 620       | --                | (1,476 )  |
| Total                              | \$ 1               | \$ 858    | \$ 668            | \$ (454 ) |

Effective on January 1, 2017, we adopted the fair value accounting method for capitalized mortgage loan servicing rights. Activity related to capitalized mortgage loan servicing rights is as follows:

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## Capitalized Mortgage Loan Servicing Rights

|   | Three months ended |          | Nine months ended  |           |
|---|--------------------|----------|--------------------|-----------|
|   | September 30, 2017 | 2016     | September 30, 2017 | 2016      |
|   | (In thousands)     |          |                    |           |
| Balance at beginning of period              | \$14,515           | \$10,331 | \$ 13,671          | \$ 12,436 |
| Change in accounting                        | -                  | -        | 542                | -         |
| Balance at beginning of period, as adjusted | \$14,515           | \$10,331 | \$ 14,213          | \$ 12,436 |
| Originated servicing rights capitalized     | 1,250              | 896      | 3,047              | 2,153     |
| Amortization                                | -                  | (799 )   | -                  | (2,065 )  |
| Change in valuation allowance               | -                  | 620      | -                  | (1,476 )  |
| Change in fair value                        | (1,090 )           | -        | (2,585 )           | -         |
| Balance at end of period                    | \$14,675           | \$11,048 | \$ 14,675          | \$ 11,048 |
| Valuation allowance at end of period        | \$-                | \$4,748  | \$ -               | \$ 4,748  |

At September 30, 2017 we were servicing approximately \$1.77 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.18% and a weighted average service fee of approximately 25.8 basis points. Capitalized mortgage loan servicing rights at September 30, 2017 totaled \$14.7 million, representing approximately 83 basis points on the related amount of mortgage loans serviced for others.

Investment and insurance commissions represent revenues generated on the sale or management of investments and insurance for our customers. These revenues increased on both a quarterly and year-to-date basis in 2017 as compared to 2016, due in part to increased product sales and growth in assets under management.

Income from bank owned life insurance was essentially unchanged on a comparative quarterly basis and declined on a year-to-date basis in 2017 compared to 2016. The year-to-date decline reflects a lower crediting rate on our cash surrender value. Our separate account is primarily invested in agency mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our bank owned life insurance was \$54.3 million and \$54.0 million at September 30, 2017 and December 31, 2016, respectively.

Other non-interest income declined on both a comparative quarterly and year-to-date basis in 2017 compared to 2016. These declines were due in part to lower ATM fees, check charges, rental income on other real estate and swap fees on commercial loans. In addition, the 2016 year-to-date period included a \$0.2 million death benefit related to a life insurance policy on a former director.

Non-interest expense. Non-interest expense is an important component of our results of operations. We strive to efficiently manage our cost structure.

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Non-interest expense increased by \$0.1 million to \$22.6 million and by \$3.5 million to \$68.9 million during the three- and nine-month periods ended September 30, 2017, respectively, compared to the same periods in 2016. The components of non-interest expense are as follows:

## Non-Interest Expense

|  | Three months<br>ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|--|--|----------|------------------------------------|-----------|
|  | 2017                                   | 2016     | 2017                               | 2016      |
|  | (In thousands)                         |          |                                    |           |
| Compensation   | \$8,494                                | \$8,310  | \$ 26,872                          | \$ 24,355 |
| Performance-based compensation                         | 2,688                                  | 2,409    | 6,819                              | 5,967     |
| Payroll taxes and employee benefits                    | 2,395                                  | 2,312    | 7,413                              | 6,590     |
| Compensation and employee benefits                     | 13,577                                 | 13,031   | 41,104                             | 36,912    |
| Occupancy, net   | 1,970                                  | 1,919    | 6,032                              | 5,982     |
| Data processing  | 1,796                                  | 1,971    | 5,670                              | 6,008     |
| Furniture, fixtures and equipment                      | 961                                    | 990      | 2,943                              | 2,939     |
| Communications   | 685                                    | 670      | 2,046                              | 2,280     |
| Loan and collection                                    | 481                                    | 568      | 1,564                              | 1,964     |
| Advertising  | 526                                    | 455      | 1,551                              | 1,410     |
| Legal and professional                                 | 550                                    | 420      | 1,376                              | 1,178     |
| Interchange expense                                    | 294                                    | 276      | 869                                | 809       |
| FDIC deposit insurance                                 | 208                                    | 187      | 608                                | 852       |
| Supplies   | 176                                    | 178      | 507                                | 551       |
| Credit card and bank service fees                      | 105                                    | 203      | 432                                | 588       |
| Costs related to unfunded lending commitments          | 92                                     | 73       | 332                                | 6         |
| Amortization of intangible assets                      | 87                                     | 86       | 260                                | 260       |
| Net losses on other real estate and repossessed assets | 30                                     | 263      | 132                                | 98        |
| Provision for loss reimbursement on sold loans         | 15                                     | 45       | 66                                 | 30        |
| Other  | 1,063                                  | 1,194    | 3,454                              | 3,602     |
| Total non-interest expense                             | \$22,616                               | \$22,529 | \$ 68,946                          | \$ 65,469 |

Compensation and employee benefits expenses, in total, increased \$0.5 million on a quarterly comparative basis and increased \$4.2 million for the first nine months of 2017 compared to the same periods in 2016.

Compensation expense increased by \$0.2 million and \$2.5 million in the third quarter and first nine months of 2017, respectively, compared to the same periods in 2016. Average full-time equivalent employees (“FTEs”) increased by approximately 8.4% and 8.6% during the third quarter and first nine months of 2017, respectively, compared to the year ago periods, due primarily to our mortgage banking expansion. The impact of the FTE increase was moderated (particularly in the third quarter of 2017) by an increased amount of compensation that was deferred as direct loan origination costs due to higher loan origination levels.

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Performance-based compensation increased by \$0.3 million and \$0.9 million in the third quarter and first nine months of 2017, respectively, versus the same periods in 2016, due primarily to relative comparative changes in the accrual for anticipated incentive compensation (including our mortgage loan officer retention program) based on our estimated full-year performance as compared to goals.

Payroll taxes and employee benefits increased by \$0.1 million and \$0.8 million in the third quarter and first nine months of 2017, respectively, compared to the same periods in 2016, due primarily to increases in payroll taxes, health insurance (year-to-date period only) and employee recruiting costs principally associated with our mortgage banking expansion.

Occupancy, net, increased by \$0.05 million for both the third quarter and first nine months of 2017, respectively, compared to the same periods in 2016. These increases were primarily due to costs associated with the recently opened loan production offices mentioned earlier that were partially offset by reduced occupancy costs related to the sale of our payment plan processing business (Mepco).

Data processing expenses decreased by \$0.2 million and \$0.3 million in the third quarter and first nine months of 2017, respectively, compared to the same periods in 2016. These decreases are primarily due to the sale of our payment plan processing business (Mepco). The third quarter of 2017 also included a \$0.1 million refund of certain previously billed and expensed costs from our core data processing vendor.

Furniture, fixtures and equipment expenses were relatively unchanged in 2017 as compared to 2016.

Communications expenses were relatively unchanged and decreased by \$0.2 million in the third quarter and first nine months of 2017, respectively, compared to the same periods in 2016. The 2017 year-to-date decrease is due primarily to reduced mailing costs, as the first quarter of 2016 included expenses for mailing out new chip enabled debit cards and new deposit product information.

Loan and collection expenses reflect costs related to new lending activity as well as the management and collection of non-performing loans and other problem credits. The quarterly and year-to-date comparative decreases in 2017 versus 2016 are primarily due to the reimbursement of previously incurred expenses related to the resolution and collection of non-accrual or previously charged-off loans. These declines were partially offset by costs related to new lending activity.

Advertising expenses increased on both a comparative quarterly and year-to-date basis in 2017 versus 2016, due primarily to direct mailing and strategic sponsorship costs.

Legal and professional fees increased on both a comparative quarterly and year-to-date basis in 2017 versus 2016, due primarily to an increase in outsourced internal audit costs, higher consulting fees related to a checking account program and higher legal fees principally associated with employment matters.

Interchange expense primarily represents our third-party cost to process debit card transactions. This cost increased slightly in 2017 on both a comparative quarterly and year-to-date basis due primarily to higher debit card transaction volume as described above.

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FDIC deposit insurance expense increased slightly and decreased on a comparative quarterly and year-to-date basis, respectively, in 2017 versus 2016. The comparative quarterly increase was due primarily to growth in our total assets. The comparative year-to-date decrease reflects a decline in our premium rate that became effective in the third quarter of 2016. At June 30, 2016, the FDIC Deposit Insurance Fund reserve ratio reached 1.15%, which triggered a new assessment method and generally lower deposit insurance premiums for banks with less than \$10 billion in assets.

Supplies expenses were relatively unchanged and decreased slightly on a comparative quarterly and year-to-date basis, respectively, in 2017 versus 2016. The comparative year-to-date decline was due primarily to initiatives with our various vendors to reduce these costs as well as internal “go green” efforts to reduce printing and paper costs.

Credit card and bank service fees decreased in 2017 versus 2016 on both a comparative quarterly and year-to-date basis primarily due to the sale of our payment plan processing business (Mepco).

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

The amortization of intangible assets primarily relates to branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$1.7 million and \$1.9 million at September 30, 2017 and December 31, 2016, respectively. See Note #7 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets.

Net losses on other real estate and repossessed assets primarily represent the gain or loss on the sale or additional write downs on these assets subsequent to the transfer of the asset from our loan portfolio. This transfer occurs at the time we acquire the collateral that secured the loan. At the time of acquisition, the other real estate or repossessed asset is valued at fair value, less estimated costs to sell, which becomes the new basis for the asset. Any write-downs at the time of acquisition are charged to the allowance for loan losses.

The provision for loss reimbursement on sold loans was an expense of \$0.015 million and \$0.066 million in the third quarter and first nine months of 2017, respectively, compared to an expense of \$0.045 million and \$0.030 million in the third quarter and first nine months of 2016, respectively. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank of Indianapolis). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The reserve for loss reimbursements on sold mortgage loans totaled \$0.56 million at both September 30, 2017 and December 31, 2016, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition.

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Other non-interest expenses declined in both the third quarter and first nine months of 2017 compared to the same periods in 2016 due primarily to lower temporary employee and insurance costs and lower debit card fraud losses.

Income tax expense. We recorded an income tax expense of \$3.2 million and \$8.4 million in the third quarter and the first nine months of 2017, respectively. This compares to an income tax expense of \$3.0 million and \$7.5 million in the third quarter and the first nine months of 2016, respectively.

Year-to-date 2016 included a \$0.3 million income tax benefit resulting from the adoption of Financial Accounting Standards Board Accounting Standards Update 2016-09 "Compensation – Stock Compensation (718) Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09") during the second quarter.

Our actual income tax expense is different than the amount computed by applying our statutory income tax rate to our income before income tax primarily due to tax-exempt interest income, tax-exempt income from the increase in the cash surrender value on life insurance, and differences in the value of stock awards that vest and stock options that are exercised as compared to the initial fair values that were expensed.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at September 30, 2017 and 2016 and at December 31, 2016, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

We had maintained a valuation allowance against our deferred tax assets of approximately \$1.1 million at December 31, 2016. This valuation allowance on our deferred tax assets related to state income taxes at Mepco. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. That conclusion was based on the pending sale of Mepco's payment plan business. After accounting for the May 2017 sale of our payment plan business, all that remained of these deferred tax assets were loss carryforwards that we wrote off against the related valuation allowance as of June 30, 2017 as we will no longer be doing business in those states.

Financial Condition

Summary. Our total assets increased by \$204.5 million during the first nine months of 2017. Loans, excluding loans held for sale ("Portfolio Loans"), totaled \$1.94 billion at September 30, 2017, an increase of \$328.8 million, or 20.4%, from December 31, 2016. (See "Portfolio Loans and asset quality.")

Deposits totaled \$2.34 billion at September 30, 2017, compared to \$2.23 billion at December 31, 2016. The \$118.0 million increase in total deposits during the period reflects growth in all categories, except time deposits, which declined by \$41.3 million. The decline in time deposits primarily reflects maturities with one municipal customer, where we elected to allow the deposits to run-off rather than rebidding for these funds.

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

## Securities

|                               | Amortized<br>Cost<br>(In thousands) | Unrealized |         | Fair<br>Value |
|-------------------------------|-------------------------------------|------------|---------|---------------|
|                               |                                     | Gains      | Losses  |               |
| Securities available for sale |                                     |            |         |               |
| September 30, 2017            | \$545,672                           | \$5,023    | \$1,830 | \$548,865     |
| December 31, 2016             | 615,709                             | 2,548      | 7,641   | 610,616       |

We adopted ASU 2017-08 during the first quarter of 2017 using a modified retrospective approach. As a result, the amortized cost of securities as of January 1, 2017 was adjusted lower by \$0.46 million (see note #2).

Securities available for sale declined by \$61.8 million during the first nine months of 2017 as these funds were utilized to support net Portfolio Loan growth. Our portfolio of securities available for sale is reviewed quarterly for impairment in value. In performing this review, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet these recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. We recorded no impairment losses related to other than temporary impairment on securities available for sale in either the first nine months of 2017 or 2016.

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

|                        | Nine months ended<br>September 30, |           |
|------------------------|------------------------------------|-----------|
|                        | 2017                               | 2016      |
|                        | (In thousands)                     |           |
| Proceeds (1)           | \$ 9,594                           | \$ 56,451 |
| Gross gains            | \$ 125                             | \$ 350    |
| Gross losses           | -                                  | (52 )     |
| Net impairment charges | -                                  | -         |
| Fair value adjustments | (63 )                              | 4         |
| Net gains              | \$ 62                              | \$ 302    |

(1) 2017 includes \$0.760 million for trades that did not settle until after September 30, 2017.

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

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

We generally retain loans that may be profitably funded within established risk parameters. (See “Asset/liability management.”) As a result, we may hold adjustable-rate conventional and fixed rate jumbo mortgage loans as Portfolio Loans, while 15- and 30-year fixed-rate non-jumbo mortgage loans are generally sold to mitigate exposure to changes in interest rates. (See “Non-interest income.”) Due primarily to the expansion of our mortgage-banking activities and a change in mix in our mortgage loan originations, we are now originating and putting into Portfolio Loans more fixed rate mortgage loans than as compared to past periods. These fixed rate mortgage loans generally have terms from 15 to 30 years, do not have prepayment penalties and expose us to more interest rate risk. To date, our interest rate risk profile has not changed significantly. However, we are carefully monitoring this change in the composition of our Portfolio Loans and the impact of potential future changes in interest rates on our changes in market value of portfolio equity and changes in net interest income. (See “Asset/liability management.”). As a result, we have added and may continue to add some longer-term borrowings, may utilize derivatives (interest rate swaps and interest rate caps) to manage interest rate risk and may begin to attempt to sell fixed rate jumbo mortgage loans in the future.



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

|  | September<br>30,<br>2017 | December 31,<br>2016 |        |   |
|--|--------------------------|----------------------|--------|---|
|  | (Dollars in thousands)   |                      |        |   |
| Non-accrual loans  | \$ 8,410                 | \$ 13,364            |        |   |
| Loans 90 days or more past due and still accruing interest     | --                       | --                   |        |   |
| Total non-performing loans                                     | 8,410                    | 13,364               |        |   |
| Other real estate and repossessed assets                       | 2,150                    | 5,004                |        |   |
| Total non-performing assets                                    | \$ 10,560                | \$ 18,368            |        |   |
| As a percent of Portfolio Loans                                |                          |                      |        |   |
| Non-performing loans   | 0.43                     | %                    | 0.83   | % |
| Allowance for loan losses                                      | 1.11                     |                      | 1.26   |   |
| Non-performing assets to total assets                          | 0.38                     |                      | 0.72   |   |
| Allowance for loan losses as a percent of non-performing loans | 255.39                   |                      | 151.41 |   |

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

Non-performing loans decreased by \$5.0 million, or 37.1%, during the first nine months of 2017. This decline primarily reflects the pay-off or liquidation of non-performing commercial loans. In general, stable economic conditions in our market areas, as well as our collection and resolution efforts, have resulted in a downward trend in non-performing loans. However, we are still experiencing some loan defaults, particularly related to commercial loans secured by income-producing property and mortgage loans secured by resort/vacation property.

Non-performing loans exclude performing loans that are classified as troubled debt restructurings (“TDRs”). Performing TDRs totaled \$63.2 million, or 3.3% of total Portfolio Loans, and \$70.3 million, or 4.4% of total Portfolio Loans, at September 30, 2017 and December 31, 2016, respectively. The decrease in the amount of performing TDRs in the first nine months of 2017 primarily reflects pay-downs and payoffs. See Note #4 to the Condensed Consolidated Financial Statements for additional information on TDRs.

Other real estate and repossessed assets totaled \$2.2 million at September 30, 2017, compared to \$5.0 million at December 31, 2016. This decrease is primarily the result of the sale of a group of commercial properties in the second quarter of 2017.

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

The ratio of loan net charge-offs to average Portfolio Loans was a negative 0.03% (as a result of net recoveries) on an annualized basis in the first nine months of 2017 compared to a negative 0.08% in the first nine months of 2016. The \$0.5 million decrease in total loan net recoveries is due to a decline in commercial loan net recoveries.

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## Allowance for loan losses

|   | Nine months ended<br>September 30,<br>2017 |                         | 2016     |                         |
|---|--|-------------------------|----------|-------------------------|
|   | Loans<br>(Dollars in thousands)            | Unfunded<br>Commitments | Loans    | Unfunded<br>Commitments |
| Balance at beginning of period  | \$20,234                                   | \$ 650                  | \$22,570 | \$ 652                  |
| Additions (deductions)  |  |                         |          |                         |
| Provision for loan losses   | 806  | -                       | (1,439 ) | -                       |
| Recoveries credited to allowance                                      | 2,998                                      | -                       | 3,623    | -                       |
| Loans charged against the allowance                                   | (2,560 )                                   | -                       | (2,711 ) | -                       |
| Additions included in non-interest expense                            | -  | 332                     | -        | 6                       |
| Balance at end of period  | \$21,478                                   | \$ 982                  | \$22,043 | \$ 658                  |
| Net loans charged against the allowance to average<br>Portfolio Loans | (0.03 )%                                   |                         | (0.08 )% |                         |

## Allocation of the Allowance for Loan Losses

|  | September      |                      |
|--|----------------|----------------------|
|  | 30,<br>2017    | December 31,<br>2016 |
|  | (In thousands) |                      |
| Specific allocations                               | \$ 7,061       | \$ 9,152             |
| Other adversely rated commercial loans             | 792            | 491                  |
| Historical loss allocations                        | 6,540          | 4,929                |
| Additional allocations based on subjective factors | 7,085          | 5,662                |
| Total  | \$ 21,478      | \$ 20,234            |

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

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

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

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

The allowance for loan losses increased \$1.2 million to \$21.5 million at September 30, 2017 from \$20.2 million at December 31, 2016 and was equal to 1.11% of total Portfolio Loans at September 30, 2017 compared to 1.26% at December 31, 2016.

Three of the four components of the allowance for loan losses outlined above increased in the first nine months of 2017. The allowance for loan losses related to specific loans decreased \$2.1 million in 2017 due primarily to a decline in the balance of individually impaired loans as well as charge-offs. In particular, we received a full payoff in March 2017 on a commercial loan that had a specific reserve of \$1.2 million at December 31, 2016. The allowance for loan losses related to other adversely rated commercial loans increased \$0.3 million in 2017 primarily due to an increase in the balance of such loans included in this component to \$23.2 million at September 30, 2017 from \$11.8 million at December 31, 2016. The allowance for loan losses related to historical losses increased \$1.6 million during 2017 due principally to slight upward adjustments in our probability of default and expected loss rates for commercial loans, an additional component of approximately \$0.6 million added for loans secured by commercial real estate due primarily to emerging risks in this sector (such as retail store closings and potential overdevelopment in certain markets) and loan growth. We also extended our historical lookback period to be more representative of the probability of default and account for infrequent migration events and extremely low levels of watch credits. The allowance for loan losses related to subjective factors increased \$1.4 million during 2017 primarily due to loan growth.

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By comparison, two of the four components of the allowance for loan losses outlined above declined in the first nine months of 2016. The allowance for loan losses related to specific loans decreased \$0.6 million in 2016 due primarily to a \$7.0 million decline in the balance of individually impaired loans as well as charge-offs. The allowance for loan losses related to other adversely rated commercial loans decreased \$0.5 million in 2016 primarily due to a decrease in the balance of such loans included in this component to \$13.8 million at September 30, 2016 from \$27.8 million at December 31, 2015. The allowance for loan losses related to historical losses increased \$0.3 million during 2016 due principally to loan growth. The allowance for loan losses related to subjective factors increased \$0.3 million during 2016 also primarily due to overall growth of the loan portfolio.

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

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

Deposits totaled \$2.34 billion and \$2.23 billion at September 30, 2017 and December 31, 2016, respectively. The \$118.0 million increase in deposits in the first nine months of 2017 is due to growth in all categories of deposits, except time deposits. Reciprocal deposits totaled \$49.1 million and \$38.7 million at September 30, 2017 and December 31, 2016, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network's Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum. We also added \$87.6 million of brokered time deposits during the first nine months of 2017. This increase, replaced in part, the run-off of time deposits with one municipal customer as described earlier.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At September 30, 2017, we had approximately \$557.9 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

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

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Other borrowings, comprised almost entirely of advances from the Federal Home Loan Bank (the “FHLB”), totaled \$72.8 million and \$9.4 million at September 30, 2017 and December 31, 2016, respectively. The increase in other borrowings during the first nine months of 2017 was utilized to fund Portfolio Loan growth.

As described above, we utilize wholesale funding, including FHLB borrowings and Brokered CDs to augment our core deposits and fund a portion of our assets. At September 30, 2017, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$212.5 million, or 8.8% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all. Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. We discontinued the active use of derivative financial instruments during 2008. We began to again utilize interest-rate swaps in 2014, primarily relating to our commercial lending activities. During the first nine months of 2017 and 2016, we entered into \$14.6 million and \$23.0 million (aggregate notional amounts), respectively, of interest rate swaps with commercial loan customers, which were offset with interest rate swaps that the Bank entered into with a broker-dealer. We recorded \$0.2 million and \$0.4 million of fee income related to these transactions during the first nine months of 2017 and 2016, respectively. In September 2017 we also entered into a \$15.0 million (notional amount) pay fixed interest rate swap that matures in September 2021. This fixed pay interest rate swap is hedging short-term Brokered CDs.

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

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

At September 30, 2017, we had \$432.2 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$1.81 billion of our deposits at September 30, 2017, were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

We also believe that the available cash on hand at the parent company (including time deposits) of approximately \$23.4 million as of September 30, 2017 provides sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures and to pay a cash dividend on our common stock for the foreseeable future.

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

## Capitalization

|   | September<br>30,<br>2017 | December 31,<br>2016 |   |
|---|--------------------------|----------------------|---|
|   | (In thousands)           |                      |   |
| Subordinated debentures                     | \$35,569                 | \$ 35,569            |   |
| Amount not qualifying as regulatory capital | (1,069 )                 | (1,069 )             | ) |
| Amount qualifying as regulatory capital     | 34,500                   | 34,500               |   |
| Shareholders' equity                        |                          |                      |   |
| Common stock                                | 324,607                  | 323,745              |   |
| Accumulated deficit                         | (53,240 )                | (65,657 )            | ) |
| Accumulated other comprehensive loss        | (3,657 )                 | (9,108 )             | ) |
| Total shareholders' equity                  | 267,710                  | 248,980              |   |
| Total capitalization                        | \$302,210                | \$ 283,480           |   |

We currently have three special purpose entities with \$34.5 million of outstanding cumulative trust preferred securities. These special purpose entities issued common securities and provided cash to our parent company that in turn issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Condensed Consolidated Statements of Financial Condition.

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The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at September 30, 2017 and December 31, 2016. Although the Dodd-Frank Act further limited Tier 1 treatment for trust preferred securities, those new limits did not apply to our outstanding trust preferred securities. Further, the New Capital Rules grandfathered the treatment of our trust preferred securities as qualifying regulatory capital.

Common shareholders' equity increased to \$267.7 million at September 30, 2017 from \$249.0 million at December 31, 2016 due primarily to our net income and a decline in our accumulated other comprehensive loss that were partially offset by dividends that we paid. Our tangible common equity ("TCE") totaled \$266.0 million and \$247.0 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 9.67% and 9.70% at September 30, 2017 and December 31, 2016, respectively. TCE and the ratio of TCE to tangible assets are non-GAAP measures. TCE represents total common equity less intangible assets.

On January 23, 2017, our Board of Directors authorized a share repurchase plan. Under the terms of the 2017 share repurchase plan, we are authorized to buy back up to 5% of our outstanding common stock. This repurchase plan is authorized to last through December 31, 2017. We did not repurchase any shares during the first nine months of 2017.

In October 2017 and 2016, our Board of Directors increased the quarterly cash dividend on our common stock to 12 cents and ten cents per share, respectively.

As of September 30, 2017 and December 31, 2016, our Bank (and holding company) continued to meet the requirements to be considered "well-capitalized" under federal regulatory standards (also see note #10 to the Condensed Consolidated Financial Statements included within this report).

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

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

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

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

| Change in Interest Rates | Market Value Of Portfolio |        | Net Interest Income(2) | Percent Change |         |
|--------------------------|---------------------------|--------|------------------------|----------------|---------|
|                          | Equity(1)                 | Change |                        |                |         |
| September 30, 2017       |                           |        |                        |                |         |
| 200 basis point rise     | \$410,500                 | (0.02  | )% \$ 94,100           | 1.51           | %       |
| 100 basis point rise     | 415,900                   | 1.29   | 94,000                 | 1.40           |         |
| Base-rate scenario       | 410,600                   | -      | 92,700                 | -              |         |
| 100 basis point decline  | 379,800                   | (7.50  | )                      | 87,000         | (6.15 ) |
| December 31, 2016        |                           |        |                        |                |         |
| 200 basis point rise     | \$427,400                 | 6.90   | % \$ 84,800            | 6.94           | %       |
| 100 basis point rise     | 417,800                   | 4.50   | 82,500                 | 4.04           |         |
| Base-rate scenario       | 399,800                   | -      | 79,300                 | -              |         |
| 100 basis point decline  | 366,000                   | (8.45  | )                      | 73,500         | (7.31 ) |

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

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

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

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



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We utilize fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. FASB ASC topic 820 differentiates between those assets and liabilities required to be carried at fair value at every reporting period (“recurring”) and those assets and liabilities that are only required to be adjusted to fair value under certain circumstances (“nonrecurring”). Trading securities, securities available for sale, loans held for sale, derivatives and capitalized mortgage loan servicing rights (as of January 1, 2017) are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a nonrecurring basis, such as loans held for investment, capitalized mortgage loan servicing rights (prior to 2017) and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. See note #11 to the Condensed Consolidated Financial Statements included within this report for a complete discussion on our use of fair valuation of financial instruments and the related measurement techniques.

### Litigation Matters

As described in “Recent Developments” we settled a litigation matter in December 2016 and recorded a \$2.3 million expense in the fourth quarter of 2016. We are also involved in various other litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is insignificant. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.

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

### Critical Accounting Policies

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for the AFL, capitalized mortgage loan servicing rights, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2016.

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Item 3.

Quantitative and Qualitative Disclosures about Market Risk

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

Item 4.

Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

With the participation of management, our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) for the period ended September 30, 2017, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended September 30, 2017, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## Part II

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2016.

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

The Company maintains a Deferred Compensation and Stock Purchase Plan for Non-Employee Directors (the "Plan") pursuant to which non-employee directors can elect to receive shares of the Company's common stock in lieu of fees otherwise payable to the director for his or her service as a director. A director can elect to receive shares on a current basis or to defer receipt of the shares, in which case the shares are issued to a trust to be held for the account of the director and then generally distributed to the director after his or her retirement from the Board. Pursuant to this Plan, during the third quarter of 2017, the Company issued 677 shares of common stock to non-employee directors on a current basis and 1,697 shares of common stock to the trust for distribution to directors on a deferred basis. 1,705 shares were issued on July 1, 2017, at a price of \$21.75 per share and 669 shares were issued on July 19, 2017 at a price of \$21.30 per share, representing aggregate fees of \$0.05 million. The price per share was the consolidated closing bid price per share of the Company's common stock as of the date of issuance, as determined in accordance with NASDAQ Marketplace Rules. The Company issued the shares pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933 due to the fact that the issuance of the shares was made on a private basis pursuant to the Plan.

The following table shows certain information relating to repurchases of common stock for the three-months ended September 30, 2017:

| Period            | Total Number of<br>Shares Purchased<br>(1) | Average Price<br>Paid Per Share | Total Number of<br>Shares Purchased<br>as Part of a<br>Publicly<br>Announced Plan | Remaining<br>Number of<br>Shares Authorized<br>for Purchase<br>Under the Plan |
|-------------------|--|---------------------------------|---|---|
| July 2017         | 196  | \$ 21.75                        | -   | 1,062,905   |
| August 2017       | 2,080                                      | 20.25                           | -   | 1,062,905   |
| September<br>2017 | 132  | 20.60                           | -   | 1,062,905   |
| Total             | 2,408                                      | \$ 20.39                        | -   | 1,062,905   |

(1) Represents shares withheld from the shares that would otherwise have been issued to certain officers in order to satisfy tax withholding obligations resulting from vesting of restricted stock.

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Item 6. Exhibits

(a) The following exhibits (listed by number corresponding to the Exhibit Table as Item 601 in Regulation S-K) are filed with this report:

3.1 Restated Articles of Incorporation, effective October 26, 2017.

31.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

31.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

32.1 Certificate of the Chief Executive Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

32.2 Certificate of the Chief Financial Officer of Independent Bank Corporation pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

101.INS Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

Date November 3, 2017 By/s/ Robert N. Shuster  
Robert N. Shuster, Principal Financial Officer

Date November 3, 2017 By/s/ James J. Twarozynski  
James J. Twarozynski, Principal Accounting Officer

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