

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

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2014

Commission file number 0-7818

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

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

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

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

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

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

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Common stock, no par value	22,942,101
Class	Outstanding at August 4, 2014

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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FORWARD-LOOKING STATEMENTS

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

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

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all inclusive. The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks that our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us, that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

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Part I - Item 1.

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Financial Condition

	June 30, 2014 (unaudited)	December 31, 2013
	(In thousands, except share amounts)	
Assets		
Cash and due from banks	\$58,599	\$48,156
Interest bearing deposits and repurchase agreement	46,938	70,925
Cash and Cash Equivalents	105,537	119,081
Interest bearing deposits - time	15,340	17,999
Trading securities	609	498
Securities available for sale	518,126	462,481
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	23,414	23,419
Loans held for sale, carried at fair value	23,199	20,390
Loans		
Commercial	654,248	635,234
Mortgage	472,202	486,633
Installment	201,206	192,065
Payment plan receivables	49,838	60,638
Total Loans	1,377,494	1,374,570
Allowance for loan losses	(28,197)	(32,325)
Net Loans	1,349,297	1,342,245
Other real estate and repossessed assets	18,121	18,282
Property and equipment, net	46,842	48,594
Bank-owned life insurance	52,913	52,253
Deferred tax assets, net	52,676	57,550
Capitalized mortgage loan servicing rights	12,796	13,710
Vehicle service contract counterparty receivables, net	7,104	7,716
Other intangibles	2,895	3,163
Accrued income and other assets	20,995	22,562
Total Assets	\$2,249,864	\$2,209,943
Liabilities and Shareholders' Equity		
Deposits		
Non-interest bearing	\$548,090	\$518,658
Savings and interest-bearing checking	937,031	910,352
Reciprocal	63,183	83,527
Retail time	346,534	358,800
Brokered time	13,233	13,469
Total Deposits	1,908,071	1,884,806
Other borrowings	26,614	17,188
Subordinated debentures	40,723	40,723
Vehicle service contract counterparty payables	3,088	4,089

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Accrued expenses and other liabilities	28,407	31,556
Total Liabilities	2,006,903	1,978,362
Shareholders' Equity		
Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding	-	-
Common stock, no par value, 500,000,000 shares authorized; issued and outstanding: 22,931,769 shares at June 30, 2014 and 22,819,136 shares at December 31, 2013	351,791	351,173
Accumulated deficit	(102,532)	(110,347)
Accumulated other comprehensive loss	(6,298)	(9,245)
Total Shareholders' Equity	242,961	231,581
Total Liabilities and Shareholders' Equity	\$2,249,864	\$2,209,943

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
	(In thousands)			
Interest Income				
Interest and fees on loans	\$ 18,146	\$ 20,303	\$ 36,361	\$ 41,013
Interest on securities				
Taxable	1,596	993	2,979	1,663
Tax-exempt	287	242	549	480
Other investments	328	324	751	656
Total Interest Income	20,357	21,862	40,640	43,812
Interest Expense				
Deposits	1,260	1,463	2,553	2,992
Other borrowings	559	876	1,071	1,741
Total Interest Expense	1,819	2,339	3,624	4,733
Net Interest Income	18,538	19,523	37,016	39,079
Provision for loan losses	(1,845)	(2,107)	(1,417)	(2,798)
Net Interest Income After Provision for Loan Losses	20,383	21,630	38,433	41,877
Non-interest Income				
Service charges on deposit accounts	3,532	3,583	6,587	6,989
Interchange income	2,067	1,933	4,008	3,690
Net gains (losses) on assets				
Mortgage loans	1,505	3,208	2,649	6,845
Securities	54	107	166	191
Other than temporary impairment loss on securities				
Total impairment loss	-	(26)	-	(26)
Loss recognized in other comprehensive loss	-	-	-	-
Net impairment loss recognized in earnings	-	(26)	-	(26)
Mortgage loan servicing	193	1,654	457	2,276
Title insurance fees	217	368	491	852
Decrease (increase) in fair value of U.S. Treasury warrant	-	20	-	(1,025)
Other	2,508	2,164	4,673	4,287
Total Non-interest Income	10,076	13,011	19,031	24,079
Non-Interest Expense				
Compensation and employee benefits	11,818	11,715	23,056	23,022
Occupancy, net	2,153	2,147	4,636	4,571
Data processing	1,777	2,042	3,863	3,958
Loan and collection	1,427	1,702	2,892	3,928
Furniture, fixtures and equipment	1,053	1,088	2,122	2,120
Communications	711	730	1,500	1,510
Advertising	601	659	1,120	1,229
FDIC deposit insurance	422	711	839	1,341
Legal and professional	420	664	821	1,356
Interchange expense	342	418	744	828
Credit card and bank service fees	245	331	508	665
Vehicle service contract counterparty contingencies	73	3,127	141	3,254
Costs related to unfunded lending commitments	5	48	15	29

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Provision for loss reimbursement on sold loans	15	356	(466)	1,019
Net (gains) losses on other real estate and repossessed assets	(38)	320	(125)	972
Other	1,536	1,684	3,294	3,413
Total Non-interest Expense	22,560	27,742	44,960	53,215
Income Before Income Tax	7,899	6,899	12,504	12,741
Income tax expense (benefit)	1,847	(56,489)	3,314	(56,454)
Net Income	\$6,052	\$63,388	\$9,190	\$69,195
Preferred stock dividends and discount accretion	-	(1,157)	-	(2,252)
Net Income Applicable to Common Stock	\$6,052	\$62,231	\$9,190	\$66,943
Net Income Per Common Share				
Basic	\$0.26	\$6.56	\$0.40	\$7.14
Diluted	\$0.26	\$2.64	\$0.39	\$2.90
Dividends Per Common Share				
Declared	\$0.06	\$-	\$0.06	\$-
Paid	\$0.06	\$-	\$0.06	\$-

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

	Three months ended		Six months ended	
	June 30,		June 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
	(In thousands)		(In thousands)	
Net income	\$6,052	\$63,388	\$9,190	\$69,195
Other comprehensive income, before tax				
Available for sale securities				
Unrealized gain (loss) arising during period	1,759	(2,463)	4,009	(1,489)
Change in unrealized losses for which a portion of other than temporary impairment has been recognized in earnings	219	258	338	291
Reclassification adjustment for other than temporary impairment included in earnings	-	26	-	26
Reclassification adjustments for gains included in earnings	(2)	(15)	(2)	(8)
Unrealized gains (losses) recognized in other comprehensive income on available for sale securities	1,976	(2,194)	4,345	(1,180)
Income tax expense (benefit)	691	(413)	1,521	(413)
Unrealized gains (losses) recognized in other comprehensive income on available for sale securities, net of tax	1,285	(1,781)	2,824	(767)
Derivative instruments				
Unrealized loss arising during period	-	(35)	-	(38)
Reclassification adjustment for expense recognized in earnings	-	114	-	208
Reclassification adjustment for accretion on settled derivatives	95	-	190	-
Unrealized gains recognized in other comprehensive income on derivative instruments	95	79	190	170
Income tax expense (benefit)	34	(1,385)	67	(1,385)
Unrealized gains recognized in other comprehensive income on derivative instruments, net of tax	61	1,464	123	1,555
Other comprehensive income (loss)	1,346	(317)	2,947	788
Comprehensive income	\$7,398	\$63,071	\$12,137	\$69,983

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

	Six months ended June 30,	
	2014	2013
	(unaudited - In thousands)	
Net Income	\$9,190	\$69,195
Adjustments to Reconcile Net Income to Net Cash from Operating Activities		
Proceeds from sales of loans held for sale	96,384	249,123
Disbursements for loans held for sale	(96,544)	(230,320)
Provision for loan losses	(1,417)	(2,798)
Deferred federal income tax expense (benefit)	4,874	(58,066)
Deferred loan fees	(526)	(86)
Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities and loans	1,019	(1,735)
Net gains on mortgage loans	(2,649)	(6,845)
Net gains on securities	(166)	(191)
Securities impairment recognized in earnings	-	26
Net (gains) losses on other real estate and repossessed assets	(125)	972
Vehicle service contract counterparty contingencies	141	3,254
Share based compensation	581	427
Decrease in accrued income and other assets	511	12,210
Increase (decrease) in accrued expenses and other liabilities	(3,115)	1,228
Total Adjustments	(1,032)	(32,801)
Net Cash From Operating Activities	8,158	36,394
Cash Flow used in Investing Activities		
Proceeds from the sale of securities available for sale	5,126	2,940
Proceeds from the maturity of securities available for sale	39,579	23,750
Principal payments received on securities available for sale	38,891	14,697
Purchases of securities available for sale	(136,127)	(185,450)
Purchases of interest bearing deposits	-	(8,488)
Proceeds from the maturity of interest bearing deposits	2,593	-
Purchase of Federal Reserve Bank Stock	-	(658)
Redemption of Federal Reserve Bank Stock	5	-
Net (increase) decrease in portfolio loans (loans originated, net of principal payments)	(3,712)	24,938
Net proceeds from the sale of watch, substandard and non-performing loans	-	6,721
Net cash from branch sale	-	3,292
Proceeds from the collection of vehicle service contract counterparty receivables	327	560
Proceeds from the sale of other real estate and repossessed assets	2,870	9,821
Proceeds from the sale of property and equipment	-	3
Capital expenditures	(1,606)	(3,881)
Net Cash used in Investing Activities	(52,054)	(111,755)
Cash Flow from Financing Activities		
Net increase in total deposits	23,265	36,552
Net increase in other borrowings	13,799	-
Proceeds from Federal Home Loan Bank advances	-	100
Payments of Federal Home Loan Bank advances	(4,373)	(222)
Net decrease in vehicle service contract counterparty payables	(1,001)	(1,433)

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Dividends paid	(1,375)	-
Proceeds from issuance of common stock	37	957
Net Cash from Financing Activities	30,352	35,954
Net decrease in Cash and Cash Equivalents	(13,544)	(39,407)
Cash and Cash Equivalents at Beginning of Period	119,081	179,782
Cash and Cash Equivalents at End of Period	\$105,537	\$140,375
Cash paid during the period for		
Interest	\$3,659	\$3,617
Income taxes	5	76
Transfers to other real estate and repossessed assets	2,584	2,450
Transfer of payment plan receivables to vehicle service contract counterparty receivables	297	418
Purchase of securities available for sale not yet settled	-	3,211

See notes to interim condensed consolidated financial statements (unaudited)

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INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

	Six months ended June 30,	
	2014	2013
	(unaudited)	
	(In thousands)	
Balance at beginning of period	\$231,581	\$134,975
Net income	9,190	69,195
Cash dividends declared	(1,375)	-
Issuance of common stock	37	1,966
Share based compensation	581	427
Common stock warrant	-	1,484
Net change in accumulated other comprehensive loss, net of related tax effect	2,947	788
Balance at end of period	\$242,961	\$208,835

See notes to interim condensed consolidated financial statements (unaudited)

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Preparation of Financial Statements

The condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2013 included in our Annual Report on Form 10-K.

In our opinion, the accompanying unaudited condensed consolidated financial statements contain all the adjustments necessary to present fairly our consolidated financial condition as of June 30, 2014 and December 31, 2013, and the results of operations for the three and six-month periods ended June 30, 2014 and 2013. The results of operations for the three and six-month periods ended June 30, 2014, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the assessment for other than temporary impairment (“OTTI”) on investment securities, the determination of the allowance for loan losses, the determination of vehicle service contract counterparty contingencies, the valuation of originated mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2013 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

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

In May, 2014 the FASB issued 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, 2017 and is not expected to have a material impact on our consolidated operating results or financial condition.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

3. Securities

Securities available for sale consist of the following:

	Amortized Unrealized			Fair Value
	Cost	Gains	Losses	
	(In thousands)			
June 30, 2014				
U.S. agency	\$31,495	\$170	\$85	\$31,580
U.S. agency residential mortgage-backed	248,930	1,402	465	249,867
U.S. agency commercial mortgage-backed	17,731	71	44	17,758
Private label residential mortgage-backed	6,802	173	345	6,630
Other asset backed	37,530	58	58	37,530
Obligations of states and political subdivisions	153,488	945	2,088	152,345
Corporate	19,824	116	19	19,921
Trust preferred	2,906	-	411	2,495
Total	\$518,706	\$2,935	\$3,515	\$518,126
December 31, 2013				
U.S. agency	\$32,106	\$44	\$342	\$31,808
U.S. agency residential mortgage-backed	202,649	1,343	532	203,460
Private label residential mortgage-backed	7,294	112	618	6,788
Other asset backed	45,369	10	194	45,185
Obligations of states and political subdivisions	157,966	496	4,784	153,678
Corporate	19,120	43	26	19,137
Trust preferred	2,902	-	477	2,425
Total	\$467,406	\$2,048	\$6,973	\$462,481

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Less Than Twelve Months		Twelve Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
June 30, 2014						
U.S. agency	\$6,079	\$ 10	\$8,044	\$ 75	\$14,123	\$ 85
U.S. agency residential mortgage-backed	91,491	318	20,514	147	112,005	465
U.S. agency commercial mortgage-backed	10,624	44	-	-	10,624	44
Private label residential mortgage-backed	-	-	4,491	345	4,491	345
Other asset backed	18,345	58	-	-	18,345	58
Obligations of states and political subdivisions	51,974	1,070	26,541	1,018	78,515	2,088
Corporate	2,740	19	-	-	2,740	19
Trust preferred	-	-	2,495	411	2,495	411
Total	\$181,253	\$ 1,519	\$62,085	\$ 1,996	\$243,338	\$ 3,515
December 31, 2013						
U.S. agency	\$16,715	\$ 342	\$-	\$ -	\$16,715	\$ 342
U.S. agency residential mortgage-backed	78,256	532	-	-	78,256	532
Private label residential mortgage-backed	407	6	4,602	612	5,009	618
Other asset backed	33,862	194	-	-	33,862	194
Obligations of states and political subdivisions	103,942	4,645	4,805	139	108,747	4,784
Corporate	7,105	26	-	-	7,105	26
Trust preferred	-	-	2,425	477	2,425	477
Total	\$240,287	\$ 5,745	\$11,832	\$ 1,228	\$252,119	\$ 6,973

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at June 30, 2014 we had eight U.S. agency, 56 U.S. agency residential mortgage-backed securities and 11 U.S. agency commercial mortgage-backed whose fair market value is less than amortized cost. The unrealized losses are largely attributed to rises in term interest rates and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label residential mortgage backed securities — at June 30, 2014 we had five of this type of security, four of which had a fair value less than amortized cost. Two of the four issues are rated by a major rating agency as investment grade while the other two are below investment grade. Two of these bonds have impairment in excess of 10% and all four of these holdings have been impaired for more than 12 months.

The unrealized losses are largely attributable to credit spread widening on these securities since their acquisition. The underlying loans within these securities include Jumbo (68%) and Alt A (32%) at June 30, 2014.

June 30, 2014		December 31, 2013	
Fair Value	Net Unrealized Gain (Loss)	Fair Value	Net Unrealized Loss
(In thousands)			

Private label residential mortgage-backed

Jumbo	\$4,520	\$ (211)	\$4,687	\$ (441)
Alt-A	2,110	39	2,101	(65)

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

All private label residential mortgage-backed securities are reviewed for OTTI utilizing a cash flow projection. The cash flow analysis forecasts cash flow from the underlying loans in each transaction and then applies these cash flows to the bonds in the securitization. The cash flows from the underlying loans consider contractual payment terms (scheduled amortization), prepayments, defaults and severity of loss given default. The analysis uses dynamic assumptions for prepayments, defaults and loss severity. Near term prepayment assumptions are based on recently observed prepayment rates. More weight is given to longer term historic performance (12 months). In some cases, recently observed prepayment rates are lower than historic norms due to a minimal amount of new jumbo loan issuances. This loan market is heavily dependent upon securitization for funding, and new securitization transactions have been minimal. Our model projections anticipate that prepayment rates gradually revert to historical levels. For seasoned ARM transactions, normalized prepayment rates range from 10% to 25% CPR. For fixed rate collateral (one transaction), the prepayment speeds are projected to remain stable.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Default assumptions are largely based on the volume of existing real estate owned, pending foreclosures and severe delinquencies. Other considerations include the quality of loan underwriting, recent default experience, realized loss performance and the volume of less severe delinquencies. Default levels generally are projected to remain elevated or increase for a period of time sufficient to address the level of distressed loans in the transaction. Our projections expect defaults to then decline, generally beginning in year three. Current loss severity assumptions are based on recent observations when meaningful data is available. Loss severity is expected to remain elevated for the next 12 months. Severity is expected to decline after this period due to improving overall economic conditions, improving real estate prices and a reduced inventory of foreclosed properties on the market. Except for three securities discussed in further detail below (all three are currently below investment grade), our cash flow analysis forecasts complete recovery of our cost basis for each reviewed security.

At June 30, 2014 three below investment grade private label residential mortgage-backed securities had credit related OTTI and are summarized as follows:

	Senior Security	Super Senior Security	Senior Support Security	Total
(In thousands)				
As of June 30, 2014				
Fair value	\$2,459	\$ 1,722	\$ 42	\$4,223
Amortized cost	2,548	1,592	-	4,140
Non-credit unrealized loss	89	-	-	89
Unrealized gain	-	130	42	172
Cumulative credit related OTTI	748	457	380	1,585

Credit related OTTI recognized in our Condensed Consolidated Statements of Operations

For the three months ended June 30,

2014	\$-	\$-	\$-	\$-
2013	26	-	-	26

For the six months ended June 30,

2014	-	-	-	-
2013	26	-	-	26

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. Two of these securities have unrealized gains and one has an unrealized loss at June 30, 2014. Prior to the second quarter of 2013 all three of these securities had an unrealized loss. The original amortized cost for each of these securities has been permanently adjusted downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for two of these securities is now less than previously recorded credit related OTTI amounts. The remaining non-credit related unrealized loss in the senior security is attributed to other factors and is reflected in other comprehensive income during those same periods.

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Other asset backed — at June 30, 2014 we had 15 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to widening discount margins. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at June 30, 2014 we had 97 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to increases in interest rates since the securities acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at June 30, 2014 we had three corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at June 30, 2014 we had three trust preferred securities whose fair value is less than amortized cost. All of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities over the past several years has suffered from credit spread widening fueled by uncertainty regarding potential losses of financial companies and repricing of risk related to these hybrid capital securities.

One of the three securities is rated by two major rating agencies as investment grade, while one (a Bank of America issuance) is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.8 million as of June 30, 2014, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of June 30, 2014 and December 31, 2013:

June 30, 2014		December 31, 2013	
Fair Value	Net Unrealized Loss	Fair Value	Net Unrealized Loss
(In thousands)			

Trust preferred securities					
Rated issues	\$1,693	\$ (213)	\$1,600	\$ (302)	
Unrated issues	802	(198)	825	(175)	

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

We recorded no credit related OTTI charges in earnings on securities available for sale during the three and six month periods ended June 30, 2014. We recorded \$0.026 million of credit related OTTI charges during both the three and six month periods ended June 30, 2013 (see discussion above).

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Three months ended		Six months ended	
	June 30,		June 30,	
	2014	2013	2014	2013
	(In thousands)			
Balance at beginning of period	\$1,835	\$1,809	\$1,835	\$1,809
Additions to credit losses on securities for which no previous OTTI was recognized	-	-	-	-
Increases to credit losses on securities for which OTTI was previously recognized	-	26	-	26
Balance at end of period	\$1,835	\$1,835	\$1,835	\$1,835

The amortized cost and fair value of securities available for sale at June 30, 2014, by contractual maturity, follow:

	Amortized Fair	
	Cost	Value
	(In thousands)	
Maturing within one year	\$18,937	\$18,994
Maturing after one year but within five years	72,390	72,741
Maturing after five years but within ten years	43,186	43,415
Maturing after ten years	73,200	71,191
	207,713	206,341
U.S. agency residential mortgage-backed	248,930	249,867
U.S. agency commercial mortgage-backed	17,731	17,758
Private label residential mortgage-backed	6,802	6,630
Other asset backed	37,530	37,530
Total	\$518,706	\$518,126

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 six month periods ending June 30, follows:

	Realized			
	Gains		Losses	
	Proceeds(1)	(2)		
	(In thousands)			
2014	\$5,126	\$2	\$	-
2013	2,940	15		7

(1) Gains in 2014 exclude \$0.053 million of unrealized gain related to a U.S. Treasury short position.

(2) Losses in 2013 exclude \$0.026 million of credit related OTTI recognized in earnings.

During 2014 and 2013 our trading securities consisted of various preferred stocks. During the first six months of 2014 and 2013 we recognized gains on trading securities of \$0.111 million and \$0.183 million, respectively that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. Both of these amounts relate to gains recognized on trading securities still held at each respective period end.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

4. Loans

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

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

	Commercial	Mortgage	Installment	Payment Plan Receivables	Unallocated	Total
	(In thousands)					
2014						
Balance at beginning of period	\$5,763	\$ 17,000	\$ 2,061	\$ 87	\$ 5,526	\$30,437
Additions (deductions)						
Provision for loan losses	(1,070)	(579)	(76)	(6)	(114)	(1,845)
Recoveries credited to allowance	2,138	400	352	1	-	2,891
Loans charged against the allowance	(1,656)	(1,279)	(349)	(2)	-	(3,286)
Balance at end of period	\$5,175	\$ 15,542	\$ 1,988	\$ 80	\$ 5,412	\$28,197
2013						
Balance at beginning of period	\$10,058	\$ 20,163	\$ 3,162	\$ 129	\$ 7,253	\$40,765
Additions (deductions)						
Provision for loan losses	(1,404)	(349)	141	(12)	(483)	(2,107)
Recoveries credited to allowance	3,181	450	306	21	-	3,958
Loans charged against the allowance	(3,599)	(1,605)	(613)	(13)	-	(5,830)
Balance at end of period	\$8,236	\$ 18,659	\$ 2,996	\$ 125	\$ 6,770	\$36,786

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Commercial	Mortgage	Installment	Payment Plan Receivables	Unallocated	Total
	(In thousands)					
2014						
Balance at beginning of period	\$6,827	\$ 17,195	\$ 2,246	\$ 97	\$ 5,960	\$32,325
Additions (deductions)						
Provision for loan losses	(563)	(386)	100	(20)	(548)	(1,417)
Recoveries credited to allowance	2,493	858	603	5	-	3,959
Loans charged against the allowance	(3,582)	(2,125)	(961)	(2)	-	(6,670)
Balance at end of period	\$5,175	\$ 15,542	\$ 1,988	\$ 80	\$ 5,412	\$28,197
2013						
Balance at beginning of period	\$11,402	\$ 21,447	\$ 3,378	\$ 144	\$ 7,904	\$44,275
Additions (deductions)						
Provision for loan losses	(1,676)	(488)	516	(16)	(1,134)	(2,798)
Recoveries credited to allowance	3,717	1,072	592	28	-	5,409
Loans charged against the allowance	(5,207)	(3,372)	(1,490)	(31)	-	(10,100)
Balance at end of period	\$8,236	\$ 18,659	\$ 2,996	\$ 125	\$ 6,770	\$36,786

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Commercial	Mortgage	Installment	Payment Plan Receivables	Unallocated	Total
	(In thousands)					
June 30, 2014						
Allowance for loan losses:						
Individually evaluated for impairment	\$2,482	\$10,029	\$ 718	\$ -	\$ -	\$13,229
Collectively evaluated for impairment	2,693	5,513	1,270	80	5,412	14,968
Total ending allowance balance	\$5,175	\$15,542	\$ 1,988	\$ 80	\$ 5,412	\$28,197
Loans						
Individually evaluated for impairment	\$36,764	\$75,899	\$ 6,960	\$ -		\$119,623
Collectively evaluated for impairment	618,953	398,512	194,902	49,838		1,262,205
Total loans recorded investment	655,717	474,411	201,862	49,838		1,381,828
Accrued interest included in recorded investment	1,469	2,209	656	-		4,334
Total loans	\$654,248	\$472,202	\$ 201,206	\$ 49,838		\$1,377,494
December 31, 2013						
Allowance for loan losses:						
Individually evaluated for impairment	\$3,878	\$10,488	\$ 792	\$ -	\$ -	\$15,158
Collectively evaluated for impairment	2,949	6,707	1,454	97	5,960	17,167
Total ending allowance balance	\$6,827	\$17,195	\$ 2,246	\$ 97	\$ 5,960	\$32,325
Loans						
Individually evaluated for impairment	\$40,623	\$78,022	\$ 7,068	\$ -		\$125,713
Collectively evaluated for impairment	596,235	410,887	185,676	60,638		1,253,436
Total loans recorded investment	636,858	488,909	192,744	60,638		1,379,149
Accrued interest included in recorded investment	1,624	2,276	679	-		4,579
Total loans	\$635,234	\$486,633	\$ 192,065	\$ 60,638		\$1,374,570

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	90+ and Still Accruing (In thousands)	Non- Accrual	Total Non- Performing Loans
June 30, 2014			
Commercial			
Income producing - real estate	\$-	\$1,454	\$ 1,454
Land, land development and construction - real estate	-	687	687
Commercial and industrial	126	2,842	2,968
Mortgage			
1-4 family	-	6,373	6,373
Resort lending	-	2,838	2,838
Home equity - 1st lien	-	392	392
Home equity - 2nd lien	-	917	917
Installment			
Home equity - 1st lien	-	730	730
Home equity - 2nd lien	-	586	586
Loans not secured by real estate	-	387	387
Other	-	2	2
Payment plan receivables			
Full refund	-	8	8
Partial refund	-	-	-
Other	-	3	3
Total recorded investment	\$126	\$17,219	\$ 17,345
Accrued interest included in recorded investment	\$2	\$-	\$ 2
December 31, 2013			
Commercial			
Income producing - real estate	\$-	\$1,899	\$ 1,899
Land, land development and construction - real estate	-	1,036	1,036
Commercial and industrial	-	2,434	2,434
Mortgage			
1-4 family	-	6,594	6,594
Resort lending	-	2,668	2,668
Home equity - 1st lien	-	415	415
Home equity - 2nd lien	-	689	689
Installment			
Home equity - 1st lien	-	938	938
Home equity - 2nd lien	-	571	571
Loans not secured by real estate	-	638	638
Other	-	-	-
Payment plan receivables			
Full refund	-	20	20
Partial refund	-	3	3
Other	-	-	-

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An aging analysis of loans by class follows:

	Loans Past Due			Total	Loans not Past Due	Total Loans
	30-59 days	60-89 days	90+ days			
(In thousands)						
June 30, 2014						
Commercial						
Income producing - real estate	\$77	\$-	\$1,051	\$1,128	\$241,402	\$242,530
Land, land development and construction - real estate	41	-	241	282	33,758	34,040
Commercial and industrial	617	413	2,354	3,384	375,763	379,147
Mortgage						
1-4 family	3,314	1,023	6,373	10,710	265,569	276,279
Resort lending	607	677	2,838	4,122	133,432	137,554
Home equity - 1st lien	173	-	392	565	18,798	19,363
Home equity - 2nd lien	396	61	917	1,374	39,841	41,215
Installment						
Home equity - 1st lien	306	149	730	1,185	23,680	24,865
Home equity - 2nd lien	310	26	586	922	33,048	33,970
Loans not secured by real estate	429	198	387	1,014	139,535	140,549
Other	15	9	2	26	2,452	2,478
Payment plan receivables						
Full refund	842	273	8	1,123	36,357	37,480
Partial refund	260	42	-	302	5,522	5,824
Other	140	36	3	179	6,355	6,534
Total recorded investment	\$7,527	\$2,907	\$15,882	\$26,316	\$1,355,512	\$1,381,828
Accrued interest included in recorded investment	\$70	\$24	\$2	\$96	\$4,238	\$4,334
December 31, 2013						
Commercial						
Income producing - real estate	\$1,014	\$428	\$878	\$2,320	\$249,313	\$251,633
Land, land development and construction - real estate	781	129	256	1,166	30,670	31,836
Commercial and industrial	1,155	1,665	318	3,138	350,251	353,389
Mortgage						
1-4 family	3,750	224	6,594	10,568	270,855	281,423
Resort lending	698	234	2,668	3,600	142,356	145,956
Home equity - 1st lien	172	-	415	587	18,214	18,801
Home equity - 2nd lien	663	73	689	1,425	41,304	42,729
Installment						
Home equity - 1st lien	557	134	938	1,629	25,513	27,142
Home equity - 2nd lien	536	136	571	1,243	36,701	37,944
Loans not secured by real estate	833	281	638	1,752	123,295	125,047
Other	22	12	-	34	2,577	2,611
Payment plan receivables						
Full refund	1,364	349	20	1,733	46,344	48,077

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans are as follows :

	June 30, 2014	December 31, 2013
Impaired loans with no allocated allowance		
TDR	\$12,147	\$13,006
Non - TDR	240	334
Impaired loans with an allocated allowance		
TDR - allowance based on collateral	9,493	10,085
TDR - allowance based on present value cash flow	96,720	101,131
Non - TDR - allowance based on collateral	615	688
Non - TDR - allowance based on present value cash flow	-	-
Total impaired loans	\$119,215	\$125,244
Amount of allowance for loan losses allocated		
TDR - allowance based on collateral	\$2,208	\$3,127
TDR - allowance based on present value cash flow	10,852	11,777
Non - TDR - allowance based on collateral	169	254
Non - TDR - allowance based on present value cash flow	-	-
Total amount of allowance for loan losses allocated	\$13,229	\$15,158

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows (1):

	June 30, 2014			December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
(In thousands)						
With no related allowance recorded:						
Commercial						
Income producing - real estate	\$7,923	\$7,906	\$ -	\$7,042	\$7,178	\$ -
Land, land development & construction-real estate	872	1,411	-	2,185	3,217	-
Commercial and industrial	3,538	3,520	-	4,110	4,087	-
Mortgage						
1-4 family	57	62	-	8	8	-
Resort lending	35	163	-	35	163	-
Home equity - 1st lien	-	-	-	-	-	-
Home equity - 2nd lien	-	-	-	-	-	-
Installment						
Home equity - 1st lien	-	37	-	-	-	-
Home equity - 2nd lien	-	-	-	-	-	-
Loans not secured by real estate	-	-	-	-	-	-
Other	-	-	-	-	-	-
	12,425	13,099	-	13,380	14,653	-
With an allowance recorded:						
Commercial						
Income producing - real estate	12,047	13,304	732	14,538	15,631	1,161
Land, land development & construction-real estate	4,148	5,341	630	3,366	4,130	686
Commercial and industrial	8,236	7,747	1,120	9,382	9,529	2,031
Mortgage						
1-4 family	56,254	59,341	6,813	57,612	60,768	7,236
Resort lending	19,349	20,326	3,183	20,171	20,608	3,221
Home equity - 1st lien	166	180	16	154	164	11
Home equity - 2nd lien	38	116	17	42	118	20
Installment						
Home equity - 1st lien	2,841	3,017	215	2,959	3,115	254
Home equity - 2nd lien	3,421	3,421	411	3,352	3,347	462
Loans not secured by real estate	684	801	91	741	902	75
Other	14	14	1	16	16	1
	107,198	113,608	13,229	112,333	118,328	15,158
Total						
Commercial						
Income producing - real estate	19,970	21,210	732	21,580	22,809	1,161
Land, land development & construction-real estate	5,020	6,752	630	5,551	7,347	686
Commercial and industrial	11,774	11,267	1,120	13,492	13,616	2,031
Mortgage						

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1-4 family	56,311	59,403	6,813	57,620	60,776	7,236
Resort lending	19,384	20,489	3,183	20,206	20,771	3,221
Home equity - 1st lien	166	180	16	154	164	11
Home equity - 2nd lien	38	116	17	42	118	20
Installment						
Home equity - 1st lien	2,841	3,054	215	2,959	3,115	254
Home equity - 2nd lien	3,421	3,421	411	3,352	3,347	462
Loans not secured by real estate	684	801	91	741	902	75
Other	14	14	1	16	16	1
Total	\$ 119,623	\$ 126,707	\$ 13,229	\$ 125,713	\$ 132,981	\$ 15,158

Accrued interest included in recorded investment

\$408

\$469

(1) There were no impaired payment plan receivables at June 30, 2014 or December 31, 2013.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	2014		2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
With no related allowance recorded:				
Commercial				
Income producing - real estate	\$8,403	\$ 86	\$4,856	\$ 42
Land, land development & construction-real estate	821	15	3,212	42
Commercial and industrial	3,352	26	4,400	76
Mortgage				
1-4 family	33	-	4	-
Resort lending	35	-	35	-
Home equity line of credit - 1st lien	-	-	-	-
Home equity line of credit - 2nd lien	-	-	-	-
Installment				
Home equity installment - 1st lien	-	1	2,020	28
Home equity installment - 2nd lien	-	-	2,313	33
Loans not secured by real estate	-	-	599	7
Other	-	-	19	-
	12,644	128	17,458	228
With an allowance recorded:				
Commercial				
Income producing - real estate	12,780	141	20,745	176
Land, land development & construction-real estate	4,418	40	6,837	55
Commercial and industrial	8,615	80	11,886	88
Mortgage				
1-4 family	56,778	589	62,011	682
Resort lending	19,485	195	21,916	222
Home equity line of credit - 1st lien	160	2	156	-
Home equity line of credit - 2nd lien	40	-	42	-
Installment				
Home equity installment - 1st lien	2,861	44	1,023	8
Home equity installment - 2nd lien	3,453	48	1,074	12
Loans not secured by real estate	715	7	221	4
Other	15	1	-	-
	109,320	1,147	125,911	1,247
Total				
Commercial				
Income producing - real estate	21,183	227	25,601	218
Land, land development & construction-real estate	5,239	55	10,049	97
Commercial and industrial	11,967	106	16,286	164
Mortgage				
1-4 family	56,811	589	62,015	682
Resort lending	19,520	195	21,951	222

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Home equity line of credit - 1st lien	160	2	156	-
Home equity line of credit - 2nd lien	40	-	42	-
Installment				
Home equity installment - 1st lien	2,861	45	3,043	36
Home equity installment - 2nd lien	3,453	48	3,387	45
Loans not secured by real estate	715	7	820	11
Other	15	1	19	-
Total	\$121,964	\$ 1,275	\$143,369	\$ 1,475

(1) There were no impaired payment plan receivables during the three month periods ended June 30, 2014 and 2013, respectively.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	2014		2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
With no related allowance recorded:				
Commercial				
Income producing - real estate	\$7,949	\$ 186	\$4,587	\$ 105
Land, land development & construction-real estate	1,276	28	3,243	84
Commercial and industrial	3,605	66	3,803	114
Mortgage				
1-4 family	24	-	3	-
Resort lending	35	-	23	-
Home equity line of credit - 1st lien	-	-	-	-
Home equity line of credit - 2nd lien	-	-	-	-
Installment				
Home equity installment - 1st lien	-	1	2,022	52
Home equity installment - 2nd lien	-	-	2,301	62
Loans not secured by real estate	-	-	602	15
Other	-	-	19	1
	12,889	281	16,603	433
With an allowance recorded:				
Commercial				
Income producing - real estate	13,366	281	20,706	313
Land, land development & construction-real estate	4,067	82	7,494	111
Commercial and industrial	8,871	158	13,335	228
Mortgage				
1-4 family	57,056	1,219	62,727	1,388
Resort lending	19,713	386	22,532	441
Home equity line of credit - 1st lien	158	3	125	1
Home equity line of credit - 2nd lien	41	1	42	1
Installment				
Home equity installment - 1st lien	2,894	89	1,087	20
Home equity installment - 2nd lien	3,419	97	1,103	25
Loans not secured by real estate	724	17	212	6
Other	15	1	-	-
	110,324	2,334	129,363	2,534
Total				
Commercial				
Income producing - real estate	21,315	467	25,293	418
Land, land development & construction-real estate	5,343	110	10,737	195
Commercial and industrial	12,476	224	17,138	342
Mortgage				
1-4 family	57,080	1,219	62,730	1,388
Resort lending	19,748	386	22,555	441

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Home equity line of credit - 1st lien	158	3	125	1
Home equity line of credit - 2nd lien	41	1	42	1
Installment				
Home equity installment - 1st lien	2,894	90	3,109	72
Home equity installment - 2nd lien	3,419	97	3,404	87
Loans not secured by real estate	724	17	814	21
Other	15	1	19	1
Total	\$123,213	\$ 2,615	\$145,966	\$ 2,967

(1) There were no impaired payment plan receivables during the six month periods ended June 30, 2014 and 2013, respectively.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our average investment in impaired loans was approximately \$122.0 million and \$143.4 million for the three-month periods ended June 30, 2014 and 2013, respectively and \$123.2 million and \$146.0 million for the six-month periods ended June 30, 2014 and 2013, respectively. Cash receipts on impaired loans on non-accrual status are generally applied to the principal balance. Interest income recognized on impaired loans during the three months ending June 30, 2014 and 2013 was approximately \$1.3 million and \$1.5 million, respectively and was approximately \$2.6 million and \$3.0 million during the six months ending June 30, 2014 and 2013, respectively.

Troubled debt restructurings follow:

	June 30, 2014		Total
	Commercial	Retail	
	(In thousands)		
Performing TDR's	\$31,678	\$77,044	\$108,722
Non-performing TDR's(1)	4,128	5,510 ⁽²⁾	9,638
Total	\$35,806	\$82,554	\$118,360

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

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

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

We allocated \$13.1 million and \$14.9 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2014 and December 31, 2013, respectively.

During the six months ended June 30, 2014 and 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan have generally been for periods ranging from 9 months to 36 months but have extended to as much as 480 months in certain circumstances. Modifications involving an extension of the maturity date have generally been for periods ranging from 1 month to 60 months but have extended to as much as 240 months in certain circumstances.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

		Pre-modification Number of Recorded Contributions (Dollars in thousands)	Post-modification Recorded Balance
2014			
Commercial			
Income producing - real estate	1	\$ 141	\$ 122
Land, land development & construction-real estate	1	15	15
Commercial and industrial	2	1,177	1,439
Mortgage			
1-4 family	3	226	229
Resort lending	1	339	341
Home equity - 1st lien	1	17	14
Home equity - 2nd lien	-	-	-
Installment			
Home equity - 1st lien	2	314	294
Home equity - 2nd lien	2	73	72
Loans not secured by real estate	-	-	-
Other	-	-	-
Total	13	\$ 2,302	\$ 2,526
2013			
Commercial			
Income producing - real estate	2	\$ 395	\$ 287
Land, land development & construction-real estate	-	-	-
Commercial and industrial	2	72	70
Mortgage			
1-4 family	6	482	451
Resort lending	1	234	231
Home equity - 1st lien	-	-	-
Home equity - 2nd lien	-	-	-
Installment			
Home equity - 1st lien	6	153	144
Home equity - 2nd lien	4	64	66
Loans not secured by real estate	1	27	27
Other	-	-	-
Total	22	\$ 1,427	\$ 1,276

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

		Pre-modification Number of Recorded Contributions (Dollars in thousands)	Post-modification Recorded Balance
2014			
Commercial			
Income producing - real estate	3	\$ 354	\$ 332
Land, land development & construction-real estate	1	15	15
Commercial and industrial	6	1,367	1,628
Mortgage			
1-4 family	7	950	968
Resort lending	3	633	634
Home equity - 1st lien	1	17	14
Home equity - 2nd lien	-	-	-
Installment			
Home equity - 1st lien	5	420	372
Home equity - 2nd lien	5	294	292
Loans not secured by real estate	2	33	29
Other	-	-	-
Total	33	\$ 4,083	\$ 4,284
2013			
Commercial			
Income producing - real estate	5	\$ 4,478	\$ 3,877
Land, land development & construction-real estate	1	16	-
Commercial and industrial	15	912	810
Mortgage			
1-4 family	13	1,273	1,235
Resort lending	4	1,033	1,022
Home equity - 1st lien	1	95	96
Home equity - 2nd lien	-	-	-
Installment			
Home equity - 1st lien	13	326	317
Home equity - 2nd lien	10	212	212
Loans not secured by real estate	3	84	54
Other	-	-	-
Total	65	\$ 8,429	\$ 7,623

The troubled debt restructurings described above for 2014 decreased the allowance for loan losses by \$0.1 million and resulted in \$0.02 million of charge offs during the three months ended June 30, 2014 and increased the allowance by \$0.1 million and resulted in \$0.03 million of charge offs during the six months ended June 30, 2014.

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

and resulted in \$0.3 million of charge offs during the six months ended June 30, 2013.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Number of Recorded Contracts (Dollars in thousands)	Balance
2014		
Commercial		
Income producing - real estate	-	\$ -
Land, land development & construction-real estate	-	-
Commercial and industrial	1	253
Mortgage		
1-4 family	-	-
Resort lending	-	-
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Installment		
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Loans not secured by real estate	-	-
Other	-	-
	1	\$ 253
2013		
Commercial		
Income producing - real estate	-	\$ -
Land, land development & construction-real estate	-	-
Commercial and industrial	-	-
Mortgage		
1-4 family	-	-
Resort lending	-	-
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Installment		
Home equity - 1st lien	-	-
Home equity - 2nd lien	1	22
Loans not secured by real estate	-	-
Other	-	-
	1	\$ 22

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Number of Recorded Contracts (Dollars in thousands)	Balance
2014		
Commercial		
Income producing - real estate	-	\$ -
Land, land development & construction-real estate	-	-
Commercial and industrial	1	253
Mortgage		
1-4 family	-	-
Resort lending	-	-
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Installment		
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Loans not secured by real estate	-	-
Other	-	-
	1	\$ 253
2013		
Commercial		
Income producing - real estate	-	\$ -
Land, land development & construction-real estate	1	334
Commercial and industrial	2	143
Mortgage		
1-4 family	1	106
Resort lending	1	156
Home equity - 1st lien	-	-
Home equity - 2nd lien	-	-
Installment		
Home equity - 1st lien	-	-
Home equity - 2nd lien	1	22
Loans not secured by real estate	-	-
Other	-	-
	6	\$ 761

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

The troubled debt restructurings that subsequently defaulted described above for 2014 increased the allowance for loan losses by \$0.2 million and resulted in zero charge offs during the three months ended June 30, 2014 and

increased the allowance for loan losses by \$0.2 million and resulted in zero charge offs during the six months ended June 30, 2014.

The troubled debt restructurings that subsequently defaulted described above for 2013 decreased the allowance for loan losses by \$0.01 million and resulted in \$0.02 million of charge offs during the three months ended June 30, 2013 and increased the allowance for loan losses by \$0.05 million and resulted in charge offs of \$0.12 million during the six months ended June 30, 2013.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

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

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

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

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Commercial		Substandard Accrual 9 (In thousands)	Non- Accrual 10-11	Total
	Non-watch 1-6	Watch 7-8			
June 30, 2014					
Income producing - real estate	\$225,104	\$14,394	\$ 1,578	\$ 1,454	\$242,530
Land, land development and construction - real estate	23,433	9,377	543	687	34,040
Commercial and industrial	345,007	24,282	7,016	2,842	379,147
Total	\$593,544	\$48,053	\$ 9,137	\$4,983	\$655,717
Accrued interest included in total	\$1,312	\$127	\$ 30	\$-	\$1,469
December 31, 2013					
Income producing - real estate	\$227,957	\$17,882	\$ 3,895	\$ 1,899	\$251,633
Land, land development and construction - real estate	25,654	4,829	317	1,036	31,836
Commercial and industrial	318,183	26,303	6,469	2,434	353,389
Total	\$571,794	\$49,014	\$ 10,681	\$ 5,369	\$636,858
Accrued interest included in total	\$1,433	\$147	\$ 44	\$-	\$1,624

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Mortgage (1)		Home	Home	
	Resort		Equity	Equity	
	1-4		1st Lien	2nd	Total
	Family	Lending		Lien	
	(In thousands)				
June 30, 2014					
800 and above	\$27,501	\$14,476	\$3,471	\$5,536	\$50,984
750-799	62,721	52,210	5,889	11,184	132,004
700-749	53,004	34,112	3,076	8,637	98,829
650-699	46,330	19,308	2,692	6,589	74,919
600-649	32,528	6,077	1,837	5,081	45,523
550-599	22,983	4,985	1,076	2,156	31,200
500-549	16,805	2,672	716	1,308	21,501
Under 500	5,817	892	362	536	7,607
Unknown	8,590	2,822	244	188	11,844
Total	\$276,279	\$137,554	\$19,363	\$41,215	\$474,411
Accrued interest included in total	\$1,299	\$611	\$94	\$205	\$2,209
December 31, 2013					
800 and above	\$23,924	\$13,487	\$3,650	\$5,354	\$46,415
750-799	60,728	56,880	4,560	11,809	133,977
700-749	58,269	35,767	3,289	8,628	105,953
650-699	49,771	21,696	2,316	7,145	80,928
600-649	34,991	8,555	2,621	5,141	51,308
550-599	24,616	3,261	1,165	2,485	31,527
500-549	14,823	2,271	644	1,560	19,298
Under 500	9,492	1,160	323	360	11,335
Unknown	4,809	2,879	233	247	8,168
Total	\$281,423	\$145,956	\$18,801	\$42,729	\$488,909
Accrued interest included in total	\$1,300	\$650	\$97	\$229	\$2,276

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

	Installment(1)		Loans not Secured by Real Estate	Other	Total
	Home Equity 1st Lien	Home Equity 2nd Lien			
	(In thousands)				
June 30, 2014					
800 and above	\$2,887	\$2,979	\$27,022	\$127	\$33,015
750-799	5,758	10,656	59,405	497	76,316
700-749	4,369	7,573	26,885	705	39,532
650-699	4,197	6,335	14,972	544	26,048
600-649	3,169	2,739	5,340	287	11,535
550-599	2,487	1,786	2,480	136	6,889
500-549	1,517	1,408	1,172	111	4,208
Under 500	401	443	653	36	1,533
Unknown	80	51	2,620	35	2,786
Total	\$24,865	\$33,970	\$140,549	\$2,478	\$201,862
Accrued interest included in total	\$102	\$124	\$410	\$20	\$656
December 31, 2013					
800 and above	\$2,977	\$3,062	\$23,649	\$53	\$29,741
750-799	6,585	11,197	48,585	557	66,924
700-749	4,353	9,487	25,343	683	39,866
650-699	4,815	6,832	15,256	646	27,549
600-649	3,173	2,824	5,289	258	11,544
550-599	2,843	2,084	2,785	213	7,925
500-549	1,483	1,715	1,732	130	5,060
Under 500	751	663	516	29	1,959
Unknown	162	80	1,892	42	2,176
Total	\$27,142	\$37,944	\$125,047	\$2,611	\$192,744
Accrued interest included in total	\$114	\$144	\$399	\$22	\$679

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

Mepco Finance Corporation (“Mepco”) is a wholly-owned subsidiary of our Bank that operates a vehicle service contract payment plan business throughout the United States. See Note #14 for more information about Mepco’s business. As of June 30, 2014, approximately 75.2% of Mepco’s outstanding payment plan receivables relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the full refund owing upon cancellation of the related service contract (including with respect to both the portion funded to the service contract seller and the portion funded to the administrator). These receivables are shown as “Full Refund” in the table below. Another approximately 11.7% of Mepco’s outstanding payment plan receivables as of June 30, 2014, relate to programs in which a third party insurer or risk retention group is obligated to pay Mepco the refund owing upon cancellation only with respect to the unearned portion previously funded by Mepco to the administrator (but not to the service contract seller). These receivables are shown as “Partial Refund” in the table below. The balance of Mepco’s outstanding payment plan receivables relate to programs in which there is no insurer or risk retention group that has

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Payment Plan Receivables			
	Full Refund	Partial Refund	Other	Total
	(In thousands)			
June 30, 2014				
AM Best rating				
A+	\$-	\$22	\$-	\$22
A	15,513	4,569	-	20,082
A-	1,564	930	6,534	9,028
Not rated	20,403	303	-	20,706
Total	\$37,480	\$5,824	\$6,534	\$49,838
December 31, 2013				
AM Best rating				
A	\$20,203	\$4,221	\$-	\$24,424
A-	4,058	832	7,496	12,386
Not rated	23,816	-	12	23,828
Total	\$48,077	\$5,053	\$7,508	\$60,638

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

5. Segments

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	IB(1)	Mepco	Other(1)(2)	Elimination(3)	Total
	(In thousands)				
Total assets					
June 30, 2014	\$2,142,496	\$82,334	\$297,632	\$ (272,598)	) \$2,249,864
December 31, 2013	2,104,550	94,648	272,348	(261,603)	) 2,209,943
For the three months ended June 30,					
2014					
Interest income	\$18,511	\$1,846	\$16	\$ (16)	) \$20,357
Net interest income	17,384	1,480	(326)	) -	18,538
Provision for loan losses	(1,838)	) (7)	) -	-	(1,845)
Income (loss) before income tax	8,014	305	(397)	) (23)	) 7,899
Net income (loss)	6,115	201	(136)	) (128)	) 6,052
2013					
Interest income	\$18,935	\$2,927	\$-	\$-	\$21,862
Net interest income	17,807	2,306	(590)	) -	19,523
Provision for loan losses	(2,093)	) (14)	) -	-	(2,107)
Income (loss) before income tax	10,637	(2,973)	(742)	) (23)	) 6,899
Net income (loss)	57,442	(1,839)	7,808	(23)	) 63,388
For the six months ended June 30,					
2014					
Interest income	\$36,709	\$3,931	\$16	\$ (16)	) \$40,640
Net interest income	34,467	3,162	(613)	) -	37,016
Provision for loan losses	(1,395)	) (22)	) -	-	(1,417)
Income (loss) before income tax	12,692	661	(802)	) (47)	) 12,504
Net income (loss)	9,297	444	(399)	) (152)	) 9,190
2013					
Interest income	\$37,715	\$6,097	\$-	\$-	\$43,812
Net interest income	35,423	4,827	(1,171)	) -	39,079
Provision for loan losses	(2,780)	) (18)	) -	-	(2,798)
Income (loss) before income tax	17,456	(2,150)	(2,518)	) (47)	) 12,741
Net income (loss)	64,506	(1,296)	6,032	(47)	) 69,195

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

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

6. Earnings Per Common Share

	Three Months		Six Months Ended	
	Ended June 30, 2014	2013	June 30, 2014	2013
	(In thousands, except per share amounts)			
Net income applicable to common stock	\$6,052	\$62,231	\$9,190	\$66,943
Convertible preferred stock dividends	-	1,157	-	2,252
Net income applicable to common stock for calculation of diluted earnings per share	\$6,052	\$63,388	\$9,190	\$69,195
Weighted average shares outstanding (1)	22,928	9,480	22,908	9,374
Restricted stock units	305	391	304	376
Effect of stock options	126	84	126	75
Stock units for deferred compensation plan for non-employee directors	107	123	116	119
Effect of convertible preferred stock	-	13,953	-	13,953
Weighted average shares outstanding for calculation of diluted earnings per share	23,466	24,031	23,454	23,897
Net income per common share				
Basic (1)	\$0.26	\$6.56	\$0.40	\$7.14
Diluted	\$0.26	\$2.64	\$0.39	\$2.90

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

Weighted average stock options outstanding that were not considered in computing diluted net income per share because they were anti-dilutive totaled 0.03 million and 0.06 million for the three-month periods ended June 30, 2014 and 2013, respectively and totaled 0.03 million and 0.05 million for the six-month periods ended June 30, 2014 and 2013, respectively. The warrant to purchase 346,154 shares of our common stock (see note #15) was not considered in computing diluted net income per share in each period in 2013 as it was anti-dilutive.

7. Derivative Financial Instruments

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	June 30, 2014		
		Average	
	Notional	Maturity	Fair
	Amount	(years)	Value
	(Dollars in thousands)		
No hedge designation			
Rate-lock mortgage loan commitments	\$21,138	0.1	\$590
Mandatory commitments to sell mortgage loans	42,308	0.1	(226)
Pay-fixed interest rate swap agreements	2,359	9.7	(99)
Pay-variable interest rate swap agreements	2,359	9.7	99
U.S. Treasury short position	13,000	0.6	52
Total	\$81,164	0.7	\$416

	December 31, 2013		
		Average	
	Notional	Maturity	Fair
	Amount	(years)	Value
	(Dollars in thousands)		
No hedge designation			
Rate-lock mortgage loan commitments	\$15,754	0.1	\$366
Mandatory commitments to sell mortgage loans	35,412	0.1	128
Total	\$51,166	0.1	\$494

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

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"). Cash Flow Hedges during 2013 included certain pay-fixed interest-rate swaps which converted the variable-rate cash flows on debt obligations to fixed-rates. During the second quarter of 2013 we terminated our last Cash Flow Hedge pay-fixed interest rate swap and paid a termination fee of \$0.6 million.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

During the second quarter of 2014 we began 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 relate to this program.

Also during the second quarter of 2014 we completed a securities trade in which we shorted a \$13 million U.S. Treasury security. The change in the fair value of this short position has been recorded in gain on securities in our Condensed Consolidated Statements of Operations.

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Fair Values of Derivative Instruments

	Asset Derivatives				Liability Derivatives			
	June 30, 2014		December 31, 2013		June 30, 2014		December 31, 2013	
	Balance	Balance	Balance	Balance	Balance	Balance	Balance	Balance
	Sheet	Fair	Sheet	Fair	Sheet	Fair	Sheet	Fair
	Location	Value	Location	Value	Location	Value	Location	Value
	(In thousands)							
Derivatives not designated as hedging instruments								
Rate-lock mortgage loan commitments	Other assets	\$ 590	Other assets	\$ 366	Other liabilities	\$ -	Other liabilities	\$ -
Mandatory commitments to sell mortgage loans	Other assets	-	Other assets	128	Other liabilities	226	Other liabilities	-
Pay-fixed interest rate swap agreements	Other assets	-	Other assets	-	Other liabilities	99	Other liabilities	-
Pay-variable interest rate swap agreements	Other assets	99	Other assets	-	Other liabilities	-	Other liabilities	-
U.S. Treasury short position	Other assets	52	Other assets	-	Other liabilities	-	Other liabilities	-
Total derivatives		\$ 741		\$ 494		\$ 325		\$ -

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Three Month Periods Ended June 30,

		Location of Gain (Loss) Reclassified from						
	Gain (Loss) Recognized in	Accumulated Other	Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion) 2014	Loss into Comprehensive Income (Effective Portion) 2013	Other Comprehensive Loss into Comprehensive Income (Effective Portion) 2014	2013	Location of Gain (Loss) Recognized in Income (1) 2014	Gain (Loss) Recognized in Income (1) 2013
	(In thousands)							
Cash Flow Hedges								
Pay-fixed interest rate swap agreements	\$-	\$(35)	Interest expense	\$ (95)	\$ (114)			\$- \$-
Total	\$-	\$(35)		\$ (95)	\$ (114)			\$- \$-
No hedge designation								
Rate-lock mortgage loan commitments							Net mortgage loan gains	\$238 \$(783)
Mandatory commitments to sell mortgage loans							Net mortgage loan gains	(271) 2,185
Pay-fixed interest rate swap agreements							Interest income	(99) -
Pay-variable interest rate swap agreements							Interest income	99 -
U.S. Treasury short position							Gain on securities	52 -
							Increase in fair value of U.S. Treasury warrant	- 20
Amended warrant								- 20
Total								\$19 \$1,422

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Six Month Periods Ended June 30,

		Location of Gain (Loss) Reclassified from							
	Gain (Loss) Recognized in	Accumulated Other	Gain (Loss) Reclassified from Accumulated Other	Comprehensive Loss into Income (Effective Portion) 2014	Comprehensive Loss into Income (Effective Portion) 2013	Location of Gain (Loss) Recognized in Income (1) 2014	Gain (Loss) Recognized in Income (1) 2013		
	(In thousands)								
Cash Flow Hedges									
Pay-fixed interest rate swap agreements	\$-	\$(38)	Interest expense	\$(190)	\$(208)			\$-	\$-
Total	\$-	\$(38)		\$(190)	\$(208)			\$-	\$-
No hedge designation									
Rate-lock mortgage loan commitments						Net mortgage loan gains	\$224	\$(992)	
Mandatory commitments to sell mortgage loans						Net mortgage loan gains	(354)	2,121	
Pay-fixed interest rate swap agreements						Interest income	(99)	-	
Pay-variable interest rate swap agreements						Interest income	99	-	
U.S. Treasury short position						Gain on securities	52	-	
						Increase in fair value of U.S. Treasury warrant	-	(1,025)	
Amended warrant									
Total							\$(78)	\$104	

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

8. Intangible Assets

The following table summarizes intangible assets, net of amortization:

	June 30, 2014	December 31, 2013
	Gross	Gross
	Carrying Accumulated	Carrying Accumulated

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Amount Amortization Amount Amortization
(In thousands)

Amortized intangible assets - core deposits	\$23,703	\$ 20,808	\$23,703	\$ 20,540
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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	(In thousands)
Six months ending December 31, 2014	\$ 268
2015	347
2016	347
2017	346
2018	346
2019 and thereafter	1,241
Total	\$ 2,895

9. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.4 million shares of common stock as of June 30, 2014. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of June 30, 2014. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

During the first quarter of 2014, pursuant to our long-term incentive plan, we granted 0.07 million shares of restricted stock and 0.03 million performance stock units (“PSUs”) to certain officers. The shares of restricted stock vest ratably over three years and the 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.

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

Our directors may elect to receive at least a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis) pursuant to the non-employee director stock purchase plan referenced above. Shares equal in value to that portion of each director’s fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.007 million shares and 0.034 million shares to directors during the first six months of 2014 and 2013, respectively, and expensed their value during those same periods.

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$0.3 million and \$0.5 million during the three and six month periods ended June 30, 2014, respectively, and was \$0.1 million and \$0.3 million during the same periods in 2013, respectively. The corresponding tax benefit relating to this expense was \$0.1 million and \$0.2 million for the three and six month periods ended June 30, 2014, respectively and zero for each period during 2013. Total expense recognized for non-employee director share based payments was \$0.05 million and \$0.09 million during the three and six month periods ended June 30, 2014, respectively, and was \$0.09 million and \$0.17 million during the same periods in 2013, respectively. The corresponding tax benefit relating to this expense was \$0.02 million and \$0.03 million for the three and six month periods ended June 30, 2014, respectively and zero for each period during 2013.

At June 30, 2014, the total expected compensation cost related to non-vested stock options, restricted stock, PSUs and restricted stock unit awards not yet recognized was \$2.0 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 Shares	Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregated Intrinsic Value (In thousands)
Outstanding at January 1, 2014	320,300	\$ 4.52		
Granted	-			
Exercised	(11,241)	3.23		
Forfeited	(4,401)	5.17		
Expired	(284)	3.46		
Outstanding at June 30, 2014	304,374	\$ 4.56	7.60	\$ 2,610
Vested and expected to vest at June 30, 2014	296,442	\$ 4.55	7.57	\$ 2,541
Exercisable at June 30, 2014	184,525	\$ 4.77	7.02	\$ 1,576

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

	Number of Shares	Weighted- Average Grant Date Fair Value
Outstanding at January 1, 2014	303,980	\$ 3.77
Granted	102,561	13.84
Vested	-	

Forfeited	(1,292)	12.78
Outstanding at June 30, 2014	405,249	\$ 6.29

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Certain information regarding options exercised during the periods follows:

	Three Months Ended June 30, 2014		Six Months Ended June 30, 2013	
	2013	2014	2013	2014
	(In thousands)			
Intrinsic value	\$93	\$ 6	\$108	\$ 21
Cash proceeds received	\$26	\$ 2	\$36	\$ 13
Tax benefit realized	\$32	\$ -	\$37	\$ -

10. Income Tax

Income tax expense (benefit) was \$1.8 million and \$(56.5) million during the three months ended June 30, 2014 and 2013, respectively and \$3.3 million and \$(56.5) million during the six months ended June 30, 2014 and 2013, respectively. Prior to the second quarter of 2013, we had established a deferred tax asset valuation allowance against all of our net deferred tax assets. The reversal of substantially all of this valuation allowance on our deferred tax assets during the second quarter of 2013 resulted in our recording an income tax benefit of \$57.6 million. In addition, during the second quarter of 2013, we recorded \$1.4 million of income tax expense to clear from accumulated other comprehensive loss ("AOCL") the disproportionate tax effects from cash flow hedges. These disproportionate tax effects had been charged to other comprehensive income and credited to income tax expense due to our valuation allowance on deferred tax assets (see Note #16). Because we terminated our last remaining cash flow hedge in the second quarter of 2013, it was appropriate to clear these disproportionate tax effects from AOCL.

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

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

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

The valuation allowance against our deferred tax assets totaled \$1.0 million and \$1.1 million at June 30, 2014 and December 31, 2013, respectively. We did not reverse approximately \$1.0 million of valuation allowance on our deferred tax assets that primarily relates to state income taxes from our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco's future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco's business over the past three

years.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual federal income tax expense (benefit) is different than the amount computed by applying our statutory federal income tax rate to our pre-tax income (loss) primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance and also for the second quarter and first six months of 2013, the impact of the change in the deferred tax asset valuation allowance. In addition, the second quarter and year-to-date 2014 income tax expense was reduced by a credit of approximately \$0.7 million due to a true-up of the amount of unrecognized tax benefits relative to certain net operating loss carryforwards and the reversal of the valuation allowance on our capital loss carryforward that we now believe is more likely than not to be realized due to a strategy executed during the second quarter of 2014.

At June 30, 2014 and December 31, 2013, we had gross unrecognized tax benefits of approximately \$1.1 million and \$1.7 million, respectively. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease during the balance of 2014.

11. Regulatory Matters

Capital guidelines adopted by Federal and State regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank's current year's net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of June 30, 2014, the Bank had negative undivided profits of \$40.3 million. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2014, we requested regulatory approval for a \$15.0 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on March 28, 2014 and the Bank returned \$15.0 million of capital to the parent company on April 9, 2014. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of June 30, 2014 and December 31, 2013 categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation ("FDIC") categorization.

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual capital amounts and ratios follow:

	Actual		Minimum for Adequately Capitalized Institutions		Minimum for Well-Capitalized Institutions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
June 30, 2014						
Total capital to risk-weighted assets						
Consolidated	\$259,196	18.00 %	\$115,195	8.00 %	NA	NA
Independent Bank	234,562	16.33	114,910	8.00	143,638	10.00 %
Tier 1 capital to risk-weighted assets						
Consolidated	\$240,978	16.74 %	\$57,597	4.00 %	NA	NA
Independent Bank	216,394	15.07	57,455	4.00	86,183	6.00 %
Tier 1 capital to average assets						
Consolidated	\$240,978	11.00 %	\$87,643	4.00 %	NA	NA
Independent Bank	216,394	9.91	87,384	4.00	109,230	5.00 %
December 31, 2013						
Total capital to risk-weighted assets						
Consolidated	\$245,284	17.35 %	\$113,086	8.00 %	NA	NA
Independent Bank	234,078	16.57	113,013	8.00	\$141,267	10.00 %
Tier 1 capital to risk-weighted assets						
Consolidated	\$227,338	16.08 %	\$56,543	4.00 %	NA	NA
Independent Bank	216,146	15.30	56,507	4.00	84,760	6.00 %
Tier 1 capital to average assets						
Consolidated	\$227,338	10.61 %	\$85,729	4.00 %	NA	NA
Independent Bank	216,146	10.09	85,681	4.00	107,101	5.00 %

NA - Not applicable

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The components of our regulatory capital are as follows:

	Consolidated		Independent Bank	
	December		December	
	June 30,	31,	June 30,	31,
	2014	2013	2014	2013
	(In thousands)			
Total shareholders' equity	\$242,961	\$231,581	\$247,995	\$250,306
Add (deduct)				
Qualifying trust preferred securities	39,500	39,500	-	-
Accumulated other comprehensive loss	6,298	9,245	6,298	9,245
Intangible assets	(2,895)	(3,163)	(2,895)	(3,163)
Disallowed deferred tax assets	(44,200)	(49,609)	(34,318)	(40,026)
Disallowed capitalized mortgage loan servicing rights	(686)	(216)	(686)	(216)
Tier 1 capital	240,978	227,338	216,394	216,146
Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets	18,218	17,946	18,168	17,932
Total risk-based capital	\$259,196	\$245,284	\$234,562	\$234,078

12. Fair Value Disclosures

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

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

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

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2014 and December 31, 2013, all of our total impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

Derivatives: The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets (recurring Level 2). 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 the U.S. Treasury short position is based on the market value of the underlying security (recurring Level 2).

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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 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2014:			
Measured at Fair Value on a Recurring Basis:			
Assets			
Trading securities	\$609	\$609	\$ -
Securities available for sale			
U.S. agency	31,580	-	31,580
U.S. agency residential mortgage-backed	249,867	-	249,867
U.S. agency commercial mortgage-backed	17,758	-	17,758
Private label residential mortgage-backed	6,630	-	6,630
Other asset backed	37,530	-	37,530
Obligations of states and political subdivisions	152,345	-	152,345
Corporate	19,921	-	19,921
Trust preferred	2,495	-	2,495
Loans held for sale	23,199	-	23,199
Derivatives (1)	741	-	741
Liabilities			
Derivatives (2)	325	-	325
Measured at Fair Value on a Non-recurring basis:			
Assets			
Capitalized mortgage loan servicing rights (3)	7,643	-	-
Impaired loans (4)			
Commercial			
Income producing - real estate	1,660	-	-
Land, land development & construction-real estate	441	-	-
Commercial and industrial	3,671	-	-
Mortgage			
1-4 Family	1,524	-	-
Resort Lending	435	-	-
Other real estate (5)			

Commercial				
Income producing - real estate	559	-	-	559
Land, land development & construction-real estate	1,048	-	-	1,048
Mortgage				
1-4 Family	1,053	-	-	1,053
Payment plan receivables				
Full refund/partial refund	2,668	-	-	2,668

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

1-4 Family	337	-	-	337
Resort Lending	1,257	-	-	1,257
Installment				
Home equity - 1st lien	29	-	-	29
Payment plan receivables				
Full refund/partial refund	2,668	-	-	2,668

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2014 and 2013.

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

Changes in Fair Values for the Six-Month Periods Ended June 30 for Items Measured at Fair Value Pursuant to Election of the Fair Value Option						
2014			2013			
			Total Change in Fair Values Included in Current Period Earnings			Total Change in Fair Values Included in Current Period Earnings
			Net Gains (Losses) on Assets Securities (In thousands)	Net Gains (Losses) on Assets Securities		
Trading securities	\$ 111	\$ -	\$ 111	\$ 183	\$ -	\$ 183
Loans held for sale	-	348	348	-	(2,241)	(2,241)

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

The following represent impairment charges recognized during the three and six month periods ended June 30, 2014 and 2013 relating to assets measured at fair value on a non-recurring basis:

Capitalized mortgage loan servicing rights, whose individual strata are measured at fair value, had a carrying amount of \$7.6 million which is net of a valuation allowance of \$3.3 million at June 30, 2014 and had a carrying amount of \$7.8 million which is net of a valuation allowance of \$2.9 million at December 31, 2013. A recovery (charge) of \$(0.2) million and \$(0.5) million was included in our results of operations for the three and six month periods ending June 30, 2014, respectively and \$1.7 million and \$2.5 million during the same periods in 2013.

Loans which are measured for impairment using the fair value of collateral for collateral dependent loans, had a carrying amount of \$10.1 million, with a valuation allowance of \$2.4 million at June 30, 2014 and had a carrying amount of \$10.8 million, with a valuation allowance of \$3.4 million at December 31, 2013. The provision for loan losses included in our results of operations relating to impaired loans was an expense of \$0.2 million and a credit of \$0.7 million for the three month periods ending June 30, 2014 and 2013, respectively and an expense of \$1.5 million and a credit of \$0.3 million for the six month periods ending June 30, 2014 and 2013, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$5.3 million which is net of a valuation allowance of \$3.6 million at June 30, 2014 and a carrying amount of \$5.9 million which is net of a valuation allowance of \$4.0 million at December 31, 2013. An additional charge relating to other real estate measured at fair value of \$0.03 million and \$0.06 million was included in our results of operations during the three and six month periods ended June 30, 2014, respectively and \$1.0 million and \$1.6 million during the same periods in 2013.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	(Liability)	
	Amended Warrant	
	Three	Six Months
	Months	Months
	Ended	Ended
	June 30,	June 30,
	2014	2013
	2013	2013
	(In thousands)	
Beginning balance	\$-	\$(1,504)
Total gains (losses) realized and unrealized:		
Included in results of operations	-	(1,025)
Included in other comprehensive income	-	-
Purchases, issuances, settlements, maturities and calls	-	-
Reclassification to shareholders' equity	-	1,484
Transfers in and/or out of Level 3	-	-
Ending balance	\$-	\$-

Amount of total gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at June 30	\$-	\$20	\$-	\$(1,025)
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Because of certain anti-dilution features included in the Amended Warrant, it was not considered to be indexed to our common stock and was therefore accounted for as a derivative instrument (see Note #7). Any change in value of this warrant was recorded in other income in our Condensed Consolidated Statements of Operations. However, the anti-dilution features in the Amended Warrant which caused it to be accounted for as a derivative and included in accrued expenses and other liabilities expired on April 16, 2013. As a result, the Amended Warrant was reclassified into shareholders' equity on that date at its then fair value which totaled \$1.5 million. During the third quarter of 2013 we repurchased the Amended Warrant from the UST (see Note #15).

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 (Liability) Fair Value (In thousands)	Valuation Technique	Unobservable Inputs	Weighted Average	
June 30, 2014					
Capitalized mortgage loan servicing rights	\$ 7,643	Present value of net servicing revenue	Discount rate Cost to service Ancillary income Float rate	10.06 \$ 81 25 1.70	% %
Impaired loans Commercial	5,772	Sales comparison approach	Adjustment for differences between comparable sales	1.5	%
Mortgage	1,959	Income approach Sales comparison approach	Capitalization rate Adjustment for differences between comparable sales	9.3 5.4	
Other real estate Commercial	1,607	Sales comparison approach	Adjustment for differences between comparable sales	(5.7))
Mortgage and installment	1,053	Sales comparison approach	Adjustment for differences between comparable sales	64.1	
Payment plan receivables	2,668	Sales comparison approach	Adjustment for differences between comparable sales	10.4	
December 31, 2013					
Capitalized mortgage loan servicing rights	\$ 7,773	Present value of net servicing revenue	Discount rate Cost to service Ancillary income Float rate	10.09 \$ 81 29 1.79	% %
Impaired loans Commercial	5,597	Sales comparison approach	Adjustment for differences between comparable sales	(1.9))%
Mortgage	1,795	Income approach Sales comparison approach	Capitalization rate Adjustment for differences between comparable sales	9.3 3.2	
Other real estate Commercial	1,606	Sales comparison approach	Adjustment for differences between comparable sales	(5.7))
Mortgage and installment	1,623	Sales comparison approach	Adjustment for differences		

		approach	between comparable sales	55.7
Payment plan receivables	2,668	Sales comparison approach	Adjustment for differences between comparable sales	10.4

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

	Aggregate Fair Value	Difference	Contractual Principal
	(In thousands)		
Loans held for sale			
June 30, 2014	\$23,199	\$ 714	\$ 22,485
December 31, 2013	20,390	366	20,024

13. Fair Values of Financial Instruments

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

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

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

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

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

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

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

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Derivative financial instruments: 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 the U.S. Treasury short position is based on the market value of the underlying security (recurring Level 2).

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

Other borrowings: FHLB advances 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. The liability to broker relating our U.S. Treasury short position is valued at book value (Level 2 classification).

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

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The estimated recorded book balances and fair values follow:

	Recorded Book Balance (In thousands)	Fair Value	Fair Value Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Un- observable Inputs (Level 3)
June 30, 2014					
Assets					
Cash and due from banks	\$58,599	\$58,599	\$58,599	\$ -	\$ -
Interest bearing deposits and repurchase agreement	46,938	46,938	46,938	-	-
Interest bearing deposits - time	15,340	15,381	-	15,381	-
Trading securities	609	609	609	-	-
Securities available for sale	518,126	518,126	-	518,126	-
Federal Home Loan Bank and Federal Reserve					
Bank Stock	23,414	NA	NA	NA	NA
Net loans and loans held for sale	1,372,496	1,367,420	-	23,199	1,344,221
Accrued interest receivable	5,996	5,996	2	1,632	4,362
Derivative financial instruments	741	741	-	741	-
Liabilities					
Deposits with no stated maturity (1)	\$1,503,461	\$1,503,461	\$1,503,461	\$ -	\$ -
Deposits with stated maturity (1)	404,610	404,264	-	404,264	-
Other borrowings	26,614	29,002	-	29,002	-
Subordinated debentures	40,723	26,966	-	26,966	-
Accrued interest payable	410	410	19	391	-
Derivative financial instruments	325	325	-	325	-
December 31, 2013					
Assets					
Cash and due from banks	\$48,156	\$48,156	\$48,156	\$ -	\$ -
Interest bearing deposits	70,925	70,925	70,925	-	-
Interest bearing deposits - time	17,999	18,000	-	18,000	-
Trading securities	498	498	498	-	-
Securities available for sale	462,481	462,481	-	462,481	-
Federal Home Loan Bank and Federal Reserve					
Bank Stock	23,419	NA	NA	NA	NA
Net loans and loans held for sale	1,362,635	1,333,229	-	20,390	1,312,839
Accrued interest receivable	5,948	5,948	1	1,426	4,521
Derivative financial instruments	494	494	-	494	-
Liabilities					

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

(1) Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$18.3 million and \$11.2 million at June 30, 2014 and December 31, 2013, respectively. Deposits with a stated maturity include reciprocal deposits with a recorded book balance of \$44.8 million and \$72.3 million at June 30, 2014 and December 31, 2013, respectively.

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

14. Contingent Liabilities

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

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

Our Mepco segment conducts its payment plan business activities across the United States. Mepco acquires the payment plans from companies (which we refer to as Mepco's "counterparties") at a discount from the face amount of the payment plan. Each payment plan (which are classified as payment plan receivables in our Consolidated Statements of Financial Condition) permits a consumer to purchase a vehicle service contract by making installment payments, generally for a term of 12 to 24 months, to the sellers of those contracts (one of the "counterparties"). Mepco thereafter collects the paymen