

# Annual Report 2015



**INDEPENDENT**  
BANK

Member FDIC





# LETTER FROM THE PRESIDENT AND CEO

Dear Shareholders:

## 2015 HIGHLIGHTS

As we look back on 2015, we continued to execute on our operating plan, which yielded a double-digit increase in both net income and earnings per share, growth in revenue, continued growth in loan and deposit balances, and continued improvements in asset quality. For the year ended December 31, 2015, the Company reported net income of \$20.0 million, or \$0.86 per diluted share, compared to net income of \$18.0 million, or \$0.77 per diluted share, in 2014. This represents annual increases of 11.1% and 11.7% in net income and diluted earnings per share, respectively. These results were directly related to an increase in net interest income of \$1.7 million and a reduction in non-interest expenses of \$1.5 million. Total assets were \$2.41 billion as of December 31, 2015, an increase of \$160.3 million from December 31, 2014. Commercial, mortgage, and installment loans all increased over the prior year, with total net portfolio loan growth of \$105.1 million, or 7.5% (adjusted to 5.2% when excluding a bulk mortgage loan purchase). In addition to the growth in our loan portfolio, we also originated \$337 million in residential mortgages, selling \$281 million for gains of \$7.4 million, as compared to 2014, in which we originated \$265 million in residential mortgage loans, selling \$224 million for gains of \$5.6 million. Also during 2015, we generated a \$161.7 million, or 8.4%, increase in total deposits. This growth was spread amongst non-interest bearing, savings, and interest-bearing checking as well as time deposits.

The credit quality of our loan portfolios continues to be strong and positively trending with a \$3.8 million, or 17.6%, decrease in non-performing assets. We finished the year with total non-performing loans to total loans at 0.71%, an improvement from the prior year's 1.08%. Our loan net charge-offs for the year were \$0.7 million, or 0.05%, of total loans. This represents a 77.9% decline in loan net charge-offs from the prior year. The 0.05% loan net charge-off rate is our lowest in well over a decade.

We continue to maintain very strong capital levels with a tangible common equity to tangible assets ratio of 10.34% as of December 31, 2015, as compared to 11.03% as of the end of the prior year. For 2015, we returned almost 100% of our earnings through a combination of dividends and share repurchases. During 2015, we increased our dividend rate from \$0.06 per share to \$0.08 per share and we repurchased 967,199 shares at a weighted average price of \$13.96 per share. Our tangible book value is \$11.18 as of December 31, 2015, up 3.6% over the prior year end. Over the past three years our tangible book value growth (plus dividends) has been 6.0% in 2015, 9.6% in 2014, and 94.4% in 2013.

This past year we were very pleased to announce the addition of Ms. Joan Budden, President and CEO of Priority Health, to our Board of Directors. Joan is very familiar with our markets and what it takes to operate in a highly competitive and regulated industry undergoing significant change. In addition, her marketing expertise and general business and leadership experience make her an important addition to our Board.

## COMMUNITY BANKING AND THE MICHIGAN MARKET

Late in 2015, the Federal Open Market Committee decided to raise the target range for the federal funds rate, marking the end of a seven-year period during which the federal funds rate was held near zero. However, as we begin the seventh year of the current economic expansion, inflation continues to run below the Fed's 2% target level, and the Fed continues to maintain a very accommodative monetary policy. GDP growth for the full year of 2015 was 2.4%, however the growth rate was trending weaker during the year with 3.9% growth in the second quarter, 2.0% in the third quarter, and 1.0% in the fourth quarter. Overall, Michigan market conditions remain solid as compared to one year ago. The Michigan unemployment rate at 5.0%, compares favorably to the U.S. unemployment rate of 5.1%, and as compared to the Michigan rate of 6.4% one year ago. Michigan's nonfarm payrolls grew by 79,800, or 1.9% over 2014. The increase has been led by gains in construction, professional and business services, manufacturing, and wholesale trade. Michigan housing conditions also continue to trend upward as measured by total housing sales, housing starts, and the median sales price of single-family homes. Michigan building permits for new houses are up 26.1% over one year ago. Commercial real estate vacancy rates in Grand Rapids, Lansing, and Detroit continue to be positively trending or flat as compared to one year ago. Michigan motor vehicle production totaled 158,600 units in December of 2015, which was down 8.8% from one year ago. However, forecasts are favorable for vehicle production in 2016.

We believe that our footprint, a combination of rural, mid-sized, and urban markets across Michigan's Lower Peninsula, combined with our size, provides meaningful and exciting growth opportunities. Moreover, our strong market position in many rural communities and lesser market position in some of the more densely populated communities enhances our growth potential. Independent Bank, the fifth-largest bank headquartered in Michigan, fills a need in each of these markets; we have the scale to meet the demands of the heightened regulatory environment, combined with the local knowledge to compete with the larger banks, whose headquarters and decision makers are located outside of Michigan. In addition, recent bank

mergers have and will continue to create some level of market disruption that, in turn, creates opportunities for us to attract new customers and new professionals to our team.

## **2016 AND BEYOND**

We are very optimistic about the future of Independent Bank Corporation. For the full year, our return on average assets was 0.86%, up from 0.80% in 2014. Our return on average equity was 7.89% in 2015, up from 7.43% in 2014. Our management team recognizes that we need to continue to grow revenue and improve our overall earnings as we work toward our next performance milestones of 1% or better return on assets, and 10% or better return on equity. As we look ahead, we will continue to execute on strategies and initiatives designed to increase long-term shareholder value and returns. The foundation of our Company is built on our values of trust, accountability, exceptional service, customer focus, and extraordinary teamwork.

### **Growth**

Our first strategy is revenue growth through asset migration from lower-yielding investment securities into higher-yielding loans. We believe that our existing balance sheet has the room to absorb this change in the earning-asset mix, with a current loans-to-assets ratio of 63%. Our commercial banking team, with a target market of small- to medium-size businesses, \$1 million to \$10 million in borrowings, and \$1 million to \$100 million in sales, should continue to lead our efforts in growing interest income and loan fee income. We have an experienced team that has produced strong results each of the last two years and are well positioned for growth, particularly in our more urban markets. Our retail banking team has undergone significant change in recent years as we have shed branches, consolidated our branch network, adapted to regulatory changes that impacted our service charges on deposits, and matured in our sales culture. We believe that our retail banking team, targeting consumer checking and payment needs, is well positioned to grow our fee income in both interchange and service charge categories. For many years, we have had a strong indirect lending business with a special emphasis on financing recreational vehicles and marine and power-sports products. In 2015, this team produced very solid results, and we are optimistic about their prospects for continued success in 2016.

Independent Bank's total deposits were \$2.09 billion at the end of 2015. A bank's core deposit base is often viewed as the real value of a community bank franchise. Independent Bank's deposit base is substantially all core funding, with \$1.66 billion or 80% in transaction accounts. In the near-term, we believe the present compressed interest rate environment (both low rates and a relatively flat yield curve) makes it difficult to optimize the full value of our core deposit base, at least until we move to a higher loans-to-assets ratio. However, we continue to invest in growing the deposit base, and incent and reward our staff for doing so.

### **Efficiency**

Our second strategy is to improve our efficiency ratio, primarily through revenue increases but also by continuing to aggressively reduce our cost structure. A little background on this subject may be helpful in understanding where we have been, and where we are headed. As a result of some of the business segments with which we have chosen to compete, particularly branch banking and mortgage banking, our efficiency ratio will have a tendency to run higher than banks focused exclusively on commercial banking. In addition, coming out of the recession, we consciously made several strategic decisions that impacted both our size, scale, and earning asset mix. These decisions included the exiting, or scaling back, of several out-of-market lines of business, and the sale of twenty-one branches. These decisions were made to improve the risk profile of the institution for the long run, and I believe we accomplished this, but at a cost of earnings in the short run. We have made significant progress on this front each of the last three years. For 2015, our efficiency ratio was 77%, as compared to 80% in 2014, and 83% in 2013. Our near-term target is 70%, while our longer-term target is 65%. We believe that our efficiency ratio is an important barometer of our improvements, and accordingly, it is one of our four performance metrics in our annual incentive plan.

As I discuss efficiency with our shareholders, industry experts, and other interested parties, I am asked: "Why don't we just shed more branches?" I respond by sharing the fact that we have executed on a branch optimization strategy over the last three years, that has reduced our footprint from 106 branches to the present 63 branches in 21 counties. Since the end of 2011, we have improved the average profitability per branch, and increased the average deposits per branch, from \$20 million to just over \$33 million as of the end of 2015. While we continue to review and consider further branch optimization scenarios, we are at a point where the cost reduction benefits are more than offset by the likely loss of revenue. Concurrent with reductions in our physical infrastructure, we have made investments in our technology driven platforms, i.e. debit cards and electronic banking (Internet banking, mobile banking, person to person, and remote capture). Internally, we have focused on two objectives, first, to make it easy for our customers to bank with us, and second, to make it easy for our staff to service our customers. We believe this hybrid approach of physical infrastructure and technology platforms to be relevant to meeting the demands of our customers going forward, and toward us achieving our efficiency goals.

## **Risk Management**

Our third strategy is to have in place and ensure that we have an effective enterprise-wide risk management function. In 2012, we created a Chief Risk Officer position at the executive team level, and each year thereafter we have built on this infrastructure to create a very strong and effective risk management system. Today, we monitor, report, and manage our credit risk, market risk, operational risk, regulatory risk, legal risk, and reputational risk in a fully-integrated risk management framework. This framework has been very important in building our balance sheet with an acceptable risk-return profile, implementing many new regulatory requirements, and continually working to earn and retain the trust of our customers in a global marketplace with heightened cybersecurity risk.

## **Talent Development**

When discussing our future plans, I would be remiss if I did not speak to the retention of our talented associates, their ongoing development, and the attraction of new talent. The senior leadership of our team has on average, over 30 years of experience in the industry and 20 years of experience with our Company. This group has been instrumental in the successful turnaround of the Company and into its current phase of growth. At the same time, we have many talented associates on the team working hard, and with career aspirations to be the next generation of leaders within our Company. We are committed to continue to invest in this group of professionals, with on-going sales and leadership development training, as well as continuing to build their skill set and career experiences to assist them in reaching their full potential.

## **Capital Management**

As it relates to our capital, our near-term target for the ratio of tangible common equity to tangible assets is 9.5% to 10.5%, and our longer-term target is to range between 8.5% and 9.5%. As of December 31, 2015, our ratio of tangible common equity to tangible assets was 10.34%. In setting these targeted capital ranges, consideration is given to our cost of capital, the profile of our balance sheet (including a large deferred tax asset and an elevated restructured loan portfolio), the current economic environment, and uncertainty surrounding the implications of the proposed current expected credit loss (or CECL) accounting requirement. Our plan is to retain capital for organic loan growth and return capital through a consistent dividend payout and share repurchase plan. Our 2015 share repurchase plan expired on December 31, 2015. On January 21, 2016, the Board of Directors of the Company authorized a 2016 share repurchase plan. Under the terms of the 2016 share repurchase plan, the Company is authorized to buy back up to 5% of its outstanding common stock. The repurchase plan is authorized to last through December 31, 2016.

Our strong capital position also allows us to consider, and more actively explore acquisition opportunities. Our management team has a proven track record of effectively acquiring and integrating financial institutions. While the success of our operating plan is not necessarily contingent on acquired growth, selective acquisitions could accelerate our growth and create enhanced economies of scale. As such, we will continue to monitor and evaluate attractive acquisition opportunities.

## **CLOSING**

### **Virtual Shareholder Meeting**

For the second consecutive year, in order for Independent Bank Corporation to reach a greater number of shareholders, we are pleased to announce that we will conduct our Annual Meeting of Shareholders in an online format. This is an increasing trend among public companies, and we believe that it is a more cost-effective and efficient means to communicate with our shareholders. To attend the April 26, 2016 meeting, please log on to the Internet at [www.virtualshareholdermeeting.com/IBCP2016](http://www.virtualshareholdermeeting.com/IBCP2016).

### **Recognition of Directors Hetzler and Palmer**

Finally, on behalf of our entire Board, I would like to recognize and thank two much esteemed individuals (Mr. Robert Hetzler and Mr. Charles Palmer) who served our Company well as directors for many years, and who retired from the Board at the end of 2015.

In closing, as we begin our 152nd year of serving individuals and businesses in our communities, I would like to acknowledge the commitment and ongoing effort of your Board of Directors, our Bank officers, and all of our Bank associates. Their dedication and service is exemplary, and each is truly making a positive difference in the lives of our customers, our shareholders, and the communities we serve.

Sincerely,



William B. (Brad) Kessel  
President and CEO

# FINANCIAL HIGHLIGHTS (dollars in thousands, except per share data)

	2015	2014	CHANGE AMOUNT	CHANGE PERCENT
<b>FOR THE YEAR</b>				
Interest income	\$ 80,842	\$ 80,555	\$ 287	0.36 %
Interest expense	5,856	7,299	(1,443)	(19.77)
Net interest income	74,986	73,256	1,730	2.36
Provision for loan losses	(2,714)	(3,136)	422	13.46
Net gains on securities	20	320	(300)	(93.75)
Other non-interest income	40,110	38,455	1,655	4.30
Non-interest expense	88,450	89,951	(1,501)	(1.67)
Income before income tax	29,380	25,216	4,164	16.51
Income tax expense	9,363	7,195	2,168	30.13
Net income	\$ 20,017	\$ 18,021	\$1,996	11.08 %

## PER COMMON SHARE DATA

### Net income per common share

Basic	\$ 0.88	\$ 0.79	\$ 0.09	11.39 %
Diluted	0.86	0.77	0.09	11.69
Cash dividends declared	0.26	0.18	0.08	44.44

## AT YEAR END

Assets	\$ 2,409,066	\$ 2,248,730	\$ 160,336	7.13 %
Loans	1,515,050	1,409,962	105,088	7.45
Deposits	2,085,963	1,924,302	161,661	8.40
Interest-earning assets	2,187,408	2,026,175	161,233	7.96
Shareholders' equity	251,092	250,371	721	0.29
Book value per common share	11.28	10.91	0.37	3.39

## RATIOS

### Net income to

Average common equity	7.89%	7.43%	0.46 %	6.19 %
Average assets	0.86	0.80	0.06	7.50

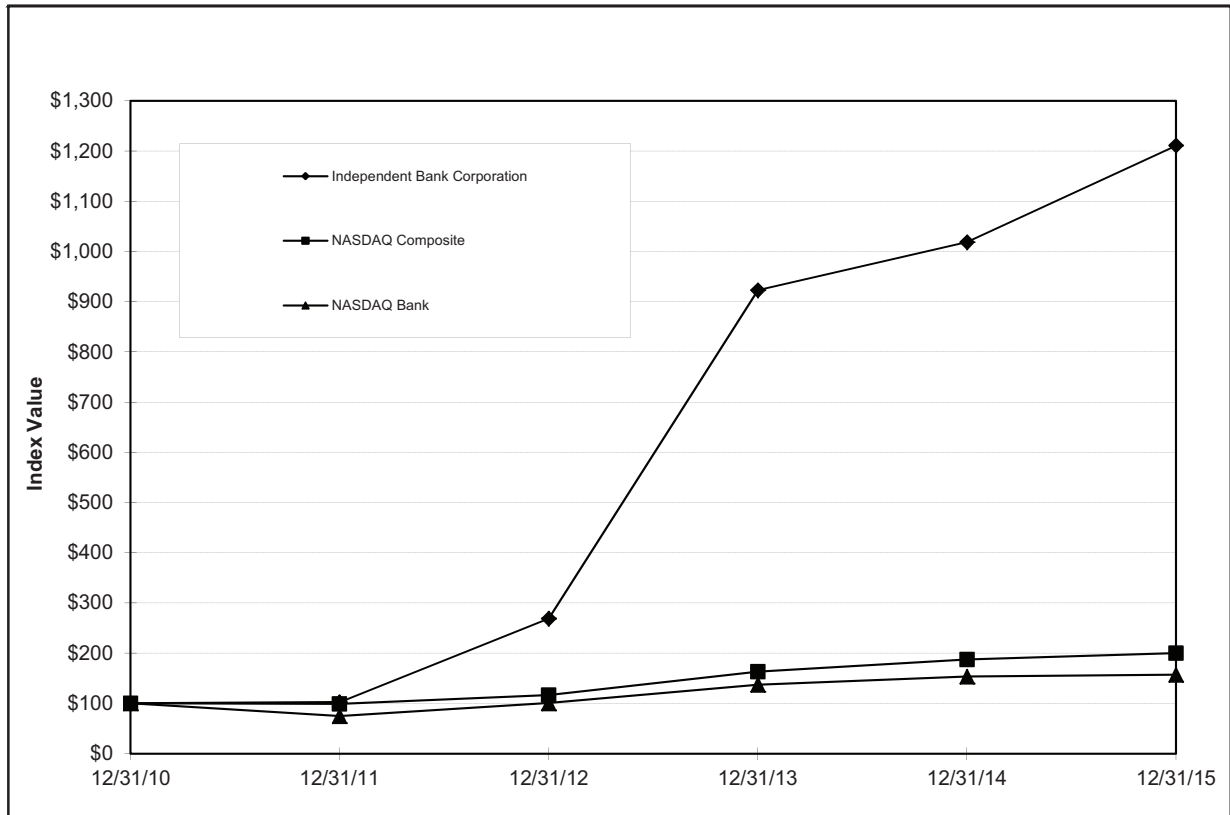
### As a percent of average interest-earning assets

Interest income	3.86%	4.03%	(0.17)%	(4.22)%
Interest expense	0.28	0.36	(0.08)	(22.22)
Net interest income	3.58	3.67	(0.09)	(2.45)

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## PERFORMANCE GRAPH

The graph below compares the total returns (assuming reinvestment of dividends) of Independent Bank Corporation common stock, the NASDAQ Composite Index and the NASDAQ Bank Stock Index. The graph assumes \$100 invested in Independent Bank Corporation common stock (returns based on stock prices per the NASDAQ) and each of the indices on December 31, 2010 and the reinvestment of all dividends during the periods presented. The performance shown on the graph is not necessarily indicative of future performance.



Index	Period Ending					
	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Independent Bank Corporation . . . . .	\$100.00	\$102.31	\$269.23	\$923.08	\$1,018.77	\$1,211.04
NASDAQ Composite . . . . .	100.00	99.17	116.48	163.21	187.27	200.31
NASDAQ Bank . . . . .	100.00	74.57	100.48	137.27	153.50	156.89



# **SELECTED CONSOLIDATED FINANCIAL DATA (1)**

	Year Ended December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands, except per share amounts)				
SUMMARY OF OPERATIONS					
Interest income . . . . .	\$ 80,842	\$ 80,555	\$ 87,121	\$ 99,398	\$ 114,762
Interest expense . . . . .	5,856	7,299	9,162	13,143	20,193
Net interest income . . . . .	74,986	73,256	77,959	86,255	94,569
Provision for loan losses . . . . .	(2,714)	(3,136)	(3,988)	6,887	27,946
Net gains (losses) on securities . . . . .	20	320	369	887	(511)
Net gain on branch sale . . . . .	1,193	—	—	5,402	—
Gain on extinguishment of debt . . . . .	—	500	—	—	—
Other non-interest income . . . . .	38,917	37,955	44,460	57,276	47,424
Non-interest expenses. . . . .	88,450	89,951	104,118	116,735	133,948
Income (loss) before income tax . . . . .	29,380	25,216	22,658	26,198	(20,412)
Income tax expense (benefit). . . . .	9,363	7,195	(54,851)	—	(212)
Net income (loss) . . . . .	<u>\$ 20,017</u>	<u>\$ 18,021</u>	<u>\$ 77,509</u>	<u>\$ 26,198</u>	<u>\$ (20,200)</u>
Preferred Stock Dividends . . . . .	—	—	(3,001)	(4,347)	(4,157)
Preferred Stock Discount . . . . .	—	—	7,554	—	—
Net income (loss) applicable to common stock. . . . .	<u>\$ 20,017</u>	<u>\$ 18,021</u>	<u>\$ 82,062</u>	<u>\$ 21,851</u>	<u>\$ (24,357)</u>
PER COMMON SHARE DATA					
Net income (loss) per common share					
Basic . . . . .	\$ 0.88	\$ 0.79	\$ 5.87	\$ 2.51	\$ (2.94)
Diluted . . . . .	0.86	0.77	3.55	0.80	(2.94)
Cash dividends declared. . . . .	0.26	0.18	0.00	0.00	0.00
Book value . . . . .	11.28	10.91	10.15	5.58	2.68
SELECTED BALANCES					
Assets . . . . .	\$2,409,066	\$2,248,730	\$2,209,943	\$2,023,867	\$2,307,406
Loans. . . . .	1,515,050	1,409,962	1,374,570	1,419,139	1,576,608
Allowance for loan losses . . . . .	22,570	25,990	32,325	44,275	58,884
Deposits . . . . .	2,085,963	1,924,302	1,884,806	1,779,537	2,086,125
Shareholders' equity . . . . .	251,092	250,371	231,581	134,975	102,627
Long-term debt - FHLB advances. . . . .	11,954	12,470	17,188	17,622	33,384
Subordinated debentures . . . . .	35,569	35,569	40,723	50,175	50,175
SELECTED RATIOS					
Net interest income to average interest earning assets . . . . .	3.58%	3.67%	4.11%	4.04%	4.46%
Net income (loss) to (2)					
Average common equity . . . . .	7.89	7.43	64.22	68.29	(68.44)
Average assets . . . . .	0.86	0.80	3.87	0.92	(1.02)
Average shareholders' equity to average assets. . . . .	10.93	10.83	8.69	4.82	4.76
Tier 1 capital to average assets . . . . .	10.91	11.18	10.61	8.08	6.25
Non-performing loans to Portfolio Loans . . . . .	0.71	1.08	1.30	2.32	3.80

- (1) The significant variations in the results of operations for the five years presented above is a result of a number of factors, including asset quality challenges, our consolidation, closing or sale of 36 branches in 2012, our exit from the Troubled Asset Relief Program in 2013, and a significant income tax benefit realized in 2013. Please read "Management's Discussion and Analysis of Financial Condition and Results of Operations" below for more information regarding these factors and others.
- (2) These amounts are calculated using net income (loss) applicable to common stock.

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

*Disclaimer Regarding Forward-Looking Statements.* Statements in this report that are not statements of historical fact, including statements that include terms such as “will,” “may,” “should,” “believe,” “expect,” “forecast,” “anticipate,” “estimate,” “project,” “intend,” “likely,” “optimistic” and “plan” 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, 2015, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

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

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

Economic conditions in Michigan began to show signs of improvement during 2010. Generally, these improvements have continued into 2015, albeit at an uneven pace. There has been an overall decline in the unemployment rate as well as generally improving housing prices and other related statistics (such as home sales and new building permits). In addition, since early- to mid-2009, we have seen an improvement in our asset quality metrics. In particular, since early 2012, we have generally experienced a decline in non-performing assets, reduced levels of new loan defaults, and reduced levels of loan net charge-offs. As a result of the foregoing factors and others, we returned to profitability in 2012 and have now been profitable for 16 consecutive quarters. In addition, during 2013, we completed various transactions to improve our capital structure.

*Recent Developments.* On April 29, 2015 the Bank entered into a Purchase and Assumption Agreement ("PAA") with Isabella Bank (based in Mt. Pleasant, Michigan). Pursuant to the PAA, on August 28, 2015, we sold the fixed assets, real property and certain other assets of our bank branch located in Midland, Michigan (the "Midland Branch") to Isabella Bank. The deposit liabilities of the Midland Branch were assumed by Isabella Bank. Under the terms of the PAA, Isabella Bank paid a premium of \$0.6 million (which was equal to 6.0% of the average deposit liabilities of \$9.7 million based on the 20-day average ending two business days prior to the closing date of August 28, 2015) and \$0.85 million for the real property and fixed assets (including the ATM). The real property and the fixed assets had a net book value of approximately \$0.2 million as of August 28, 2015. We recorded a net gain of \$1.2 million in the third quarter of 2015 on the sale of the Midland Branch.

In January 2015, we adopted a plan to consolidate certain branch offices (the "Branch Consolidation"). This Branch Consolidation reflects our ongoing cost reduction initiatives and undertakings to further improve the overall efficiency of our operations. The Branch Consolidation resulted in the closing of six of our branch offices on April 30, 2015. We also undertook certain additional staffing reductions related to our retail banking operations. In connection with the Branch Consolidation and these staffing reductions, we recorded \$0.2 million of severance expenses in the first quarter of 2015. We recorded a net gain of approximately \$0.2 million in the second quarter of 2015 (included in Other Non-Interest Income) that was comprised of a \$0.3 million gain on the sale of the real property of two of the branches that was partially offset by \$0.1 million of write-downs of the fixed assets (including real property) of the other four branches. We donated two of these four remaining branches to community groups during 2015 and the other two branches are for sale.

*Regulation.* On July 2, 2013, the Federal Reserve Board (the "FRB") approved a final rule that establishes an integrated regulatory capital framework (the "New Capital Rules"). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The 2.5% capital conservation buffer is being phased in over a four-year period beginning in 2016. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. Under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital. We were subject to the New Capital Rules beginning on January 1, 2015, and as of December 31, 2015 we exceeded all of the capital ratio requirements of the New Capital Rules.

It is against this backdrop that we discuss our results of operations and financial condition in 2015 as compared to earlier periods.

## RESULTS OF OPERATIONS

*Summary.* We recorded net income of \$20.0 million, or \$0.86 per diluted share, in 2015, as compared to \$18.0 million, or \$0.77 per diluted share, in 2014. We recorded net income applicable to common stock of \$82.1 million, or \$3.55 per diluted share, in 2013. The significantly higher earnings in 2013, as compared to 2015 and 2014, primarily reflects the income tax benefit associated with the reversal of substantially all of the valuation allowance on our deferred tax assets (see “Income tax benefit”) and the discount on our redemption of our preferred stock.

### KEY PERFORMANCE RATIOS

	Year Ended December 31,		
	2015	2014	2013
Net income to			
Average common equity .....	7.89%	7.43%	64.22%
Average assets .....	0.86	0.80	3.87
Net income per common share			
Basic .....	\$0.88	\$0.79	\$ 5.87
Diluted .....	0.86	0.77	3.55

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

Net interest income totaled \$75.0 million during 2015, compared to \$73.3 million and \$78.0 million during 2014 and 2013, respectively. The increase in net interest income in 2015 compared to 2014 primarily reflects a \$96.5 million increase in average interest-earning assets that was partially offset by a nine basis point decrease in our tax equivalent net interest income as a percent of average interest-earning assets (the “net interest margin”).

The decline in our net interest margin is primarily due to the prolonged low interest rate environment that has pushed our average yield on loans lower.

Interest rates have generally been at extremely low levels since 2008 due primarily to the Federal Reserve Bank’s (“FRB”) monetary policies and its efforts to stimulate the U.S. economy. This very low interest rate environment has generally had an adverse impact on our interest income and net interest income. The FRB did move the target federal funds rate up by 0.25% in mid-December 2015. Future changes in the target federal funds rate are uncertain, however, we anticipate that any upward movements in short-term interest rates will be very gradual. Given the repricing characteristics of our interest-earning assets and interest-bearing liabilities (and our level of non-interest bearing demand deposits), we would expect that our net interest margin will generally benefit on a long-term basis from rising interest rates.

The decrease in net interest income in 2014 compared to 2013 primarily reflects a 44 basis point decrease in our net interest margin that was partially offset by a \$100.3 million increase in average interest-earning assets.

Our net interest income is also impacted by our level of non-accrual loans. Average non-accrual loans totaled \$13.8 million, \$17.9 million and \$24.1 million in 2015, 2014 and 2013, respectively.



## AVERAGE BALANCES AND RATES

	2015			2014			2013		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate	Average Balance	Interest	Rate
	(Dollars in thousands)								
ASSETS (1)									
Taxable loans . . . . .	\$1,457,508	\$70,770	4.86%	\$1,383,883	\$71,621	5.18%	\$1,408,305	\$80,434	5.71%
Tax-exempt loans (2) . . . . .	3,972	246	6.19	4,889	310	6.34	5,491	354	6.45
Taxable securities . . . . .	529,571	7,805	1.47	475,917	6,341	1.33	305,468	4,059	1.33
Tax-exempt securities (2) . . . . .	34,039	1,388	4.08	40,200	1,510	3.76	32,051	1,680	5.24
Interest bearing cash and repurchase agreement . . . . .	66,595	275	0.41	84,244	282	0.33	139,082	396	0.28
Other investments . . . . .	<u>17,171</u>	<u>925</u>	5.39	<u>23,252</u>	<u>1,118</u>	4.81	<u>21,673</u>	<u>901</u>	4.16
Interest earning assets . . . . .	2,108,856	<u>81,409</u>	3.86	2,012,385	<u>81,182</u>	4.03	1,912,070	<u>87,824</u>	4.59
Cash and due from banks . . . . .	44,842			45,213			44,745		
Other assets, net . . . . .	<u>166,363</u>			<u>182,099</u>			<u>164,281</u>		
Total assets . . . . .	<u>\$2,320,061</u>			<u>\$2,239,697</u>			<u>\$2,121,096</u>		
LIABILITIES									
Savings and interest-bearing checking . . . . .	\$ 988,504	1,056	0.11	\$ 951,745	1,064	0.11	\$ 908,740	1,131	0.12
Time deposits . . . . .	386,035	2,953	0.76	413,729	3,903	0.94	423,291	4,575	1.08
Other borrowings . . . . .	<u>47,842</u>	<u>1,847</u>	3.86	<u>60,225</u>	<u>2,332</u>	3.87	<u>65,517</u>	<u>3,456</u>	5.27
Interest bearing liabilities . . . . .	1,422,381	<u>5,856</u>	0.41	1,425,699	<u>7,299</u>	0.51	1,397,548	<u>9,162</u>	0.66
Non-interest bearing deposits . . . . .	619,206			540,107			500,673		
Other liabilities . . . . .	24,840			31,247			38,462		
Shareholders' equity . . . . .	<u>253,634</u>			<u>242,644</u>			<u>184,413</u>		
Total liabilities and shareholders' equity . . . . .	<u>\$2,320,061</u>			<u>\$2,239,697</u>			<u>\$2,121,096</u>		
Net interest income . . . . .		<u>\$75,553</u>			<u>\$73,883</u>			<u>\$78,662</u>	
Net interest income as a percent of average interest earning assets . . . . .			<u>3.58%</u>			<u>3.67%</u>			<u>4.11%</u>

(1) All domestic.

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

## CHANGE IN NET INTEREST INCOME

	2015 compared to 2014			2014 compared to 2013		
	Volume	Rate	Net	Volume	Rate	Net
	(In thousands)					
Increase (decrease) in interest income (1, 2)						
Taxable loans . . . . .	\$3,701	\$(4,552)	\$ (851)	\$(1,374)	\$(7,439)	\$(8,813)
Tax-exempt loans (3) . . . . .	(57)	(7)	(64)	(38)	(6)	(44)
Taxable securities . . . . .	754	710	1,464	2,271	11	2,282
Tax-exempt securities (3) . . . . .	(244)	122	(122)	370	(540)	(170)
Interest bearing cash and repurchase agreement . . . . .	(66)	59	(7)	(175)	61	(114)
Other investments . . . . .	(316)	123	(193)	69	148	217
Total interest income . . . . .	<u>3,772</u>	<u>(3,545)</u>	<u>227</u>	<u>1,123</u>	<u>(7,765)</u>	<u>(6,642)</u>
Increase (decrease) in interest expense (1)						
Savings and interest bearing checking . . . . .	40	(48)	(8)	52	(119)	(67)
Time deposits . . . . .	(248)	(702)	(950)	(101)	(571)	(672)
Other borrowings . . . . .	(478)	(7)	(485)	(262)	(862)	(1,124)
Total interest expense . . . . .	<u>(686)</u>	<u>(757)</u>	<u>(1,443)</u>	<u>(311)</u>	<u>(1,552)</u>	<u>(1,863)</u>
Net interest income . . . . .	<u>\$4,458</u>	<u>\$(2,788)</u>	<u>\$ 1,670</u>	<u>\$ 1,434</u>	<u>\$(6,213)</u>	<u>\$(4,779)</u>

- (1) The change in interest due to changes in both balance and rate has been allocated to change due to balance and change due to rate in proportion to the relationship of the absolute dollar amounts of change in each.
- (2) All domestic.
- (3) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 35%.

## COMPOSITION OF AVERAGE INTEREST EARNING ASSETS AND INTEREST BEARING LIABILITIES

	Year Ended December 31,		
	2015	2014	2013
As a percent of average interest earning assets			
Loans (1) . . . . .	69.3%	69.0%	73.9%
Other interest earning assets . . . . .	<u>30.7</u>	<u>31.0</u>	<u>26.1</u>
Average interest earning assets . . . . .	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Savings and NOW . . . . .	46.9%	47.3%	47.5%
Time deposits . . . . .	18.2	19.9	21.4
Brokered CDs . . . . .	0.1	0.6	0.8
Other borrowings and long-term debt . . . . .	<u>2.2</u>	<u>3.0</u>	<u>3.4</u>
Average interest bearing liabilities . . . . .	<u>67.4%</u>	<u>70.8%</u>	<u>73.1%</u>
Earning asset ratio . . . . .	90.9%	89.9%	90.1%
Free-funds ratio (2) . . . . .	32.6	29.2	26.9

- (1) All domestic.
- (2) Average interest earning assets less average interest bearing liabilities.

*Provision for loan losses.* The provision for loan losses was a credit in each of 2015, 2014 and 2013, of \$2.7 million, \$3.1 million and \$4.0 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related

losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See “Portfolio Loans and asset quality” for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses.

*Non-interest income.* Non-interest income is a significant element in assessing our results of operations. We regard net gains on mortgage loans as a core recurring source of revenue but they are quite cyclical and thus can be volatile. We regard net gains (losses) on securities as a “non-operating” component of non-interest income.

Non-interest income totaled \$40.1 million during 2015 compared to \$38.8 million and \$44.8 million during 2014 and 2013, respectively. The components of non-interest income are as follows:

## NON-INTEREST INCOME

	Year Ended December 31,		
	2015	2014	2013
	(In thousands)		
Service charges on deposit accounts.....	\$12,389	\$13,446	\$14,076
Interchange income .....	8,481	8,164	7,362
Net gains (losses) on assets			
Mortgage loans.....	7,448	5,628	10,022
Securities .....	20	329	395
Other than temporary impairment loss on securities:			
Total impairment loss .....	—	(9)	(26)
Loss recognized in other comprehensive loss .....	—	—	—
Net impairment loss recognized in earnings.....	—	(9)	(26)
Mortgage loan servicing, net.....	1,751	791	3,806
Investment and insurance commissions .....	1,827	1,814	1,709
Bank owned life insurance .....	1,282	1,371	1,363
Title insurance fees .....	1,156	995	1,682
Net gain on branch sale.....	1,193	—	—
Gain on extinguishment of debt .....	—	500	—
Increase in fair value of U.S. Treasury warrant.....	—	—	(1,025)
Other.....	4,583	5,746	5,465
Total non-interest income .....	<u>\$40,130</u>	<u>\$38,775</u>	<u>\$44,829</u>

Service charges on deposit accounts totaled \$12.4 million during 2015, compared to \$13.4 million and \$14.1 million during 2014 and 2013, respectively. The decreases in such service charges principally reflect a decline in non-sufficient funds (“NSF”) occurrences and related NSF fees. We believe the decline in NSF occurrences is primarily due to our customers managing their finances more closely in order to reduce NSF activity and avoid the associated fees.

Interchange income totaled \$8.5 million in 2015 compared to \$8.2 million in 2014 and \$7.4 million in 2013. The increase in interchange income primarily results from a new Debit Brand Agreement with MasterCard (which replaces our former agreement with VISA) that we executed in January 2014. We began converting our debit card base to MasterCard in June 2014 and completed the conversion in September 2014. Certain volume incentives under the new Debit Brand Agreement began to abate in the fourth quarter of 2015, and as a result, absent transaction volume growth, further increases in interchange income could be a near-term challenge.

The Dodd-Frank Act includes a provision under which interchange fees for debit cards are set by the FRB under a restrictive “reasonable and proportional cost” per transaction standard. On June 29, 2011, the FRB issued final rules (that were effective October 1, 2011) on interchange fees for debit cards. Overall, these final rules established price caps for debit card interchange fees that were significantly lower than previous averages. However, debit card issuers

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

We realized net gains of \$7.4 million on mortgage loans during 2015, compared to \$5.6 million and \$10.0 million during 2014 and 2013 respectively. The volume of loans sold is dependent upon our ability to originate mortgage loans as well as the demand for fixed-rate obligations and other loans that we choose to not put into our portfolio because of our established interest-rate risk parameters. (See “Portfolio Loans and asset quality.”) Net gains on mortgage loans are also dependent upon economic and competitive factors as well as our ability to effectively manage exposure to changes in interest rates and thus can often be a volatile part of our overall revenues.

## MORTGAGE LOAN ACTIVITY

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Mortgage loans originated . . . . .	\$336,618	\$265,494	\$419,494
Mortgage loans sold . . . . .	281,494	223,580	407,235
Mortgage loans sold with servicing rights released . . . . .	4,897	37,476	57,099
Net gains on the sale of mortgage loans . . . . .	7,448	5,628	10,022
Net gains as a percent of mortgage loans sold (“Loan Sales Margin”) . . . . .	2.65%	2.52%	2.46%
Fair value adjustments included in the Loan Sales Margin . . . . .	0.16	0.01	(0.55)

Net gains on mortgage loans increased in 2015 as compared to 2014 due primarily to a decrease in mortgage loan interest rates during parts of 2015 that resulted in an increase in mortgage loan refinance volumes as well as an improving housing market which has resulted in an increase in purchase money mortgage origination volume. Net gains on mortgage loans declined in 2014 as compared to 2013 due primarily to decreases in mortgage loan originations and sales. These declines in mortgage loan originations and sales are due primarily to significantly lower mortgage loan refinance volumes.

Net gains as a percentage of mortgage loans sold (our “Loan Sales Margin”) are impacted by several factors including competition and the manner in which the loan is sold (with servicing rights retained or released). Our decision to sell or retain mortgage loan servicing rights is primarily influenced by an evaluation of the price being paid for mortgage loan servicing by outside third parties compared to our calculation of the economic value of retaining such servicing. Gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding these fair value accounting adjustments, the Loan Sales Margin would have been 2.49% in 2015, 2.51% in 2014 and 3.01% in 2013. The lower Loan Sales Margins in 2015 and 2014, as compared to 2013, were principally due to less favorable competitive conditions including narrower primary-to-secondary market pricing spreads. In general, as overall industry-wide mortgage loan origination levels drop, pricing becomes more competitive. The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale during each period.

We generated securities net gains of \$0.02 million in 2015, and \$0.3 million and \$0.4 million in 2014 and 2013, respectively. The 2015 net securities gain was due primarily to the sales of U.S. agency residential mortgage-backed securities that were partially offset by a \$0.06 million decline in the fair value of trading securities. The 2014 securities net gain was primarily due to the sales of U.S. Government agency securities and municipal securities as well as fair value adjustments on a U.S. treasury short sale position that were partially offset by a \$0.3 million decline in the fair value of trading securities. The 2013 securities net gain was due to a \$0.4 million increase in the fair value of trading securities.

We recorded no net impairment losses in 2015 as compared to net impairment losses of \$0.01 million and \$0.03 million in 2014 and 2013, respectively, related to other than temporary impairment of securities available for sale. The 2014 and 2013 impairment charges related to private label residential mortgage-backed securities.



## GAINS AND LOSSES ON SECURITIES

Year Ended December 31,	Proceeds	Gains (1) (In thousands)	Losses (2)	Net
2015.....	\$12,037	\$ 75	\$ 55	\$ 20
2014.....	14,633	624	304	320
2013.....	2,940	402	33	369

- (1) Gains in 2014 include \$0.295 million relating to a U.S. Treasury short position and gains in 2013 include \$0.388 million related to an increase in the fair value of trading securities.
- (2) Losses in 2014 and 2013 include \$0.009 million and \$0.026 million, respectively of other than temporary impairment charges and 2015 and 2014 includes \$0.055 million and \$0.295 million, respectively related to a decrease in the fair value of trading securities.

Mortgage loan servicing generated net earnings of \$1.8 million, \$0.8 million and \$3.8 million in 2015, 2014 and 2013, respectively. These yearly comparative variances are primarily due to changes in the valuation allowance on capitalized mortgage loan servicing rights and the level of amortization of this asset. The period end valuation allowance is based on the valuation of the mortgage loan servicing portfolio and the amortization is primarily impacted by prepayment activity. The changes in the valuation allowance are principally due to changes in the estimated future prepayment rates being used in the period end valuations.

## CAPITALIZED MORTGAGE LOAN SERVICING RIGHTS

	2015	2014 (In thousands)	2013
Balance at January 1,.....	\$12,106	\$13,710	\$11,013
Originated servicing rights capitalized .....	2,697	1,823	3,210
Amortization.....	(2,868)	(2,509)	(3,745)
Change in valuation allowance .....	501	(918)	3,232
Balance at December 31,.....	<u>\$12,436</u>	<u>\$12,106</u>	<u>\$13,710</u>
Valuation allowance at December 31,.....	<u>\$ 3,272</u>	<u>\$ 3,773</u>	<u>\$ 2,855</u>

At December 31, 2015, we were servicing approximately \$1.64 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.32% and a weighted average service fee of approximately 25.4 basis points. Remaining capitalized mortgage loan servicing rights at December 31, 2015 totaled \$12.4 million, representing approximately 76 basis points on the related amount of mortgage loans serviced for others. The capitalized mortgage loan servicing rights had an estimated fair market value of \$12.9 million at December 31, 2015.

Investment and insurance commissions have been relatively unchanged and totaled \$1.8 million, \$1.8 million and \$1.7 million in 2015, 2014 and 2013, respectively.

We earned \$1.3 million, \$1.4 million and \$1.4 million in 2015, 2014 and 2013, respectively, on our separate account bank owned life insurance principally as a result of increases in the cash surrender value. Our separate account is primarily invested in agency mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our bank owned life insurance was \$54.4 million and \$53.6 million at December 31, 2015 and 2014, respectively.

Title insurance fees totaled \$1.2 million in 2015, \$1.0 million in 2014 and \$1.7 million in 2013. The fluctuation in title insurance fees is primarily a function of the level of mortgage loans that we originated.

In the third quarter of 2015, we recorded a \$1.2 million gain on the sale of our Midland Branch as described earlier.

On December 1, 2014, we entered into a Securities Purchase Agreement with EJF Capital LLC. Under the terms of this agreement, we purchased 5,000 shares of trust preferred securities (liquidation amount of \$1,000 per security) that were issued by IBC Capital Finance IV, a special purpose entity whose common stock we own. The trust preferred securities have been retired along with certain related common stock issued by IBC Capital Finance IV and subordinated debentures issued by us. We paid \$4.5 million for the trust preferred securities that had a par value of \$5.0 million, as well as \$0.033 million in accrued and unpaid interest. We recorded a gain on the extinguishment of debt of \$0.5 million in the fourth quarter of 2014.

Changes in the fair value of the Amended Warrant issued to the United States Department of the Treasury (“UST”) in April 2010 had been recorded as a component of non-interest income. Up until April 16, 2013, the fair value of this Amended Warrant was included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. The provision in the Amended Warrant which caused it to be accounted for as a derivative and included in accrued expenses and other liabilities expired on April 16, 2013. As a result, the Amended Warrant was reclassified into shareholders’ equity on that date at its then fair value (which was approximately \$1.5 million). (See “Liquidity and capital resources.”) We purchased (and subsequently cancelled) the Amended Warrant from the UST on August 30, 2013.

Two significant inputs in the valuation model for the Amended Warrant were our common stock price and the probability of triggering anti-dilution provisions in this instrument related to certain equity transactions. The fair value of the Amended Warrant increased by \$1.0 million in 2013 (through April 16) due primarily to a rise in our common stock price during the relevant period.

Other non-interest income totaled \$4.6 million, \$5.7 million and \$5.5 million in 2015, 2014 and 2013, respectively. The decrease in 2015 compared to 2014 is primarily due to declines in rental income on other real estate (“ORE”) and income from merchant card processing that was partially offset by an increase in swap fee income. The decline in rental income on ORE is due to the sales of income-producing properties. The decline in income from merchant card processing is due principally to a change in our third-party processing provider and the timeframe required to transition customers from the prior provider. The increase in 2014 compared to 2013 is primarily due to the change in results of our private mortgage insurance (“PMI”) reinsurance captive (\$0.1 million of income in 2014 as compared to a \$0.2 million loss in 2013). Our PMI reinsurance captive (which we originally formed in 2002) was placed into run-off during 2013.

*Non-interest expense.* Non-interest expense is an important component of our results of operations. We strive to efficiently manage our cost structure and management is focused on a number of initiatives to reduce and contain non-interest expenses.

Non-interest expense totaled \$88.5 million in 2015, \$90.0 million in 2014, and \$104.1 million in 2013. The components of non-interest expense are as follows:

## NON-INTEREST EXPENSE

	Year ended December 31,		
	2015	2014	2013
	(In thousands)		
Compensation . . . . .	\$33,346	\$33,833	\$ 33,515
Performance-based compensation . . . . .	6,732	5,154	6,507
Payroll taxes and employee benefits . . . . .	8,108	8,234	7,902
Compensation and employee benefits . . . . .	48,186	47,221	47,924
Occupancy, net . . . . .	8,369	8,912	8,845
Data processing . . . . .	7,944	7,532	8,019
Furniture, fixtures and equipment . . . . .	3,892	4,137	4,293
Loan and collection . . . . .	3,609	5,392	6,886
Communications . . . . .	2,957	2,926	2,919
Advertising . . . . .	2,121	2,193	2,433
Legal and professional . . . . .	2,013	1,969	2,459
FDIC deposit insurance . . . . .	1,366	1,567	2,435
Interchange expense . . . . .	1,125	1,291	1,645
Supplies . . . . .	809	993	1,028
Credit card and bank service fees . . . . .	797	946	1,263
Amortization of intangible assets . . . . .	347	536	812
Vehicle service contract counterparty contingencies . . . . .	119	199	4,837
(Costs) recoveries related to unfunded lending commitments . . . . .	113	31	(90)
Provision for loss reimbursement on sold loans . . . . .	(59)	(466)	2,152
Net (gains) losses on other real estate and repossessed assets . . . . .	(180)	(500)	1,237
Other . . . . .	4,922	5,072	5,021
Total non-interest expense . . . . .	<u>\$88,450</u>	<u>\$89,951</u>	<u>\$104,118</u>

Compensation expense, which is primarily salaries, totaled \$33.3 million, \$33.8 million and \$33.5 million in 2015, 2014 and 2013, respectively. The decrease in 2015 as compared to 2014 is due to a decline in total full-time equivalent employees related to the Branch Consolidation and other staffing reductions. The increase in 2014 as compared to 2013 is due to a \$0.6 million decline in the amount of compensation that was deferred as direct loan origination costs principally resulting from the reduced levels of new mortgage loan volume in 2014. 2015 average total full-time equivalent employee levels have fallen by 4.1% compared to 2014 and by 7.7% compared to 2013.

Performance-based compensation expense totaled \$6.7 million, \$5.2 million and \$6.5 million in 2015, 2014 and 2013, respectively. The increase in 2015 as compared to 2014 is primarily related to an increase in compensation of \$1.0 million under our Management Incentive Compensation Plan based on our actual 2015 financial performance relative to plan targets and a \$0.4 million increase under our Long-Term Incentive Plan. The decrease in 2014 as compared to 2013 is primarily related to a decline in compensation of \$0.7 million under our Management Incentive Compensation Plan based on our actual 2014 financial performance relative to plan targets, a decline in loan production related compensation of \$0.3 million due to reduced levels of new mortgage loan volume, and a decline of \$0.3 million in the estimated employee stock ownership plan ("ESOP") contribution. During 2014, we decreased our ESOP contribution from 3% to 2% of eligible compensation and increased our 401(k) plan match from 1% to 2% of eligible compensation.

We maintain performance-based compensation plans. In addition to commissions and cash incentive awards, such plans include an ESOP and a long-term equity based incentive plan. The amount of expense recognized in 2015, 2014 and 2013 for share-based awards under our long-term equity based incentive plan was \$1.4 million, \$1.0 million and \$0.9 million, respectively. In 2015 and 2014, there were new grants of restricted stock and performance share awards. In 2013, there were new grants of restricted stock units, stock options and salary stock.

Payroll taxes and employee benefits expense totaled \$8.1 million, \$8.2 million and \$7.9 million in 2015, 2014 and 2013, respectively. The decrease in 2015 as compared to 2014 is primarily due to a \$0.3 million decrease in health insurance costs that was partially offset by a \$0.2 million increase in the 401(k) match. In 2015 we added auto-enrollment to our 401(k) plan. The increase in 2014 as compared to 2013 is primarily due to a \$0.2 million increase in health insurance costs and a \$0.1 million increase in the 401(k) plan match.

Occupancy expenses, net, totaled \$8.4 million, \$8.9 million and \$8.8 million in 2015, 2014 and 2013, respectively. The decrease in 2015 as compared to 2014 is primarily due to the Branch Consolidation and lower snow removal costs. The slight increase in 2014 as compared to 2013 is primarily due to higher snow removal costs associated with a harsh Michigan winter in 2014.

Data processing expenses totaled \$7.9 million, \$7.5 million, and \$8.0 million in 2015, 2014 and 2013, respectively. The increase in 2015 as compared to 2014 is due primarily to the addition of new products and services (desktop software, sales management software and a new mortgage loan origination platform) as well as increased costs due to growth in mobile banking usage. The decline in 2014 as compared to 2013 is due primarily to the impact of a new seven-year core data processing contract that we executed in March 2014. Under the terms of the new contract, we reduced core data processing and interchange costs by approximately \$1 million annually.

Loan and collection expenses primarily reflect costs related to the management and collection of non-performing loans and other problem credits. These expenses have declined steadily during the past several years primarily due to decreases in non-performing loans, new loan defaults and watch/problem credits. 2015, 2014 and 2013 also included \$0.02 million, \$0.5 million and \$0.7 million, respectively, of collection related costs at Mepco Finance Corporation (“Mepco”) primarily associated with the acquisition and management of collateral that related to receivables from vehicle service contract counterparties.

Furniture, fixtures and equipment expense declined by \$0.2 million in 2015 from 2014 and declined by \$0.2 million in 2014 from 2013. These declines are due primarily to our cost reduction initiatives and the closing or consolidation of certain branch offices. A portion of these expense reductions were offset by additional depreciation expense related to the replacement of substantially all of our ATMs during 2013 to meet applicable Americans with Disabilities Act requirements.

Communications expense has been relatively unchanged and totaled \$3.0 million, \$2.9 million, and \$2.9 million in 2015, 2014 and 2013, respectively.

Advertising expense totaled \$2.1 million, \$2.2 million, and \$2.4 million in 2015, 2014 and 2013, respectively. The slight decrease in 2015 as compared to 2014 is due primarily to reductions in outdoor (billboard) advertising. The 2014 decline was due to a reduction in direct mail costs.

Legal and professional fees totaled \$2.0 million, \$2.0 million, and \$2.5 million in 2015, 2014 and 2013, respectively. The decrease in 2014 as compared to 2013 was due primarily to declines in consulting fees, legal fees and external audit fees due, in part, to our cost reduction initiatives.

FDIC deposit insurance expense totaled \$1.4 million, \$1.6 million, and \$2.4 million in 2015, 2014 and 2013, respectively. The declines in 2015 and 2014 as compared to 2013 reflect reductions in the Bank’s risk based premium rate due to our improved financial metrics.

Interchange expense primarily represents fees paid to our core information systems processor and debit card licensor related to debit card and ATM transactions. The decrease in this expense in 2015 and 2014 as compared to 2013 is primarily due to the impact of our new seven-year core data processing contract that we executed in March 2014.



Supplies expense has declined over the past two years consistent with our cost reduction initiatives and the smaller size of the organization resulting from the closing or consolidation of branches.

The decline in credit card and bank service fees is primarily due to a decrease in the number of payment plans being administered by Mepco.

The amortization of intangible assets primarily relates to branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$2.3 million and \$2.6 million at December 31, 2015 and 2014, respectively. See note #7 to the Consolidated Financial Statements for a schedule of future amortization of intangible assets.

We record estimated incurred losses associated with Mepco's vehicle service contract payment plan receivables in our provision for loan losses and establish a related allowance for loan losses. (See "Portfolio Loans and asset quality.") We record estimated incurred losses associated with defaults by Mepco's counterparties as "vehicle service contract counterparty contingencies expense," which is included in non-interest expenses in our Consolidated Statements of Operations. Such expenses totaled \$0.1 million, \$0.2 million and \$4.8 million in 2015, 2014 and 2013, respectively. The higher level of expense in 2013 was due to write-downs of or additional reserves on vehicle service contract counterparty receivables. We reached settlements in certain litigation in 2013 to collect these receivables. Given the costs and uncertainty of continued litigation, we determined it was in our best interest to resolve these matters.

Our estimate of probable incurred losses from vehicle service contract counterparty contingencies requires a significant amount of judgment because a number of factors can influence the amount of loss that we may ultimately incur. These factors include our estimate of future cancellations of vehicle service contracts, our evaluation of collateral that may be available to recover funds due from our counterparties, and our assessment of the amount that may ultimately be collected from counterparties in connection with their contractual obligations. We apply a rigorous process, based upon historical payment plan activity and past experience, to estimate probable incurred losses and quantify the necessary reserves for our vehicle service contract counterparty contingencies, but there can be no assurance that our modeling process will successfully identify all such losses. We believe our assumptions regarding the collection of vehicle service contract counterparty receivables are reasonable, and we based them on our good faith judgments using data currently available. We also believe the current amount of reserves we have established and the vehicle service contract counterparty contingencies expense that we have recorded are appropriate given our estimate of probable incurred losses at the applicable Statement of Financial Condition date. However, because of the uncertainty surrounding the numerous and complex assumptions made, actual losses could exceed the charges we have taken to date.

Upon the cancellation of a service contract and the completion of the billing process to the counterparties for amounts due to Mepco, there is a decrease in the amount of "payment plan receivables" and an increase in the amount of "vehicle service contract counterparty receivables" until such time as the amount due from the counterparty is collected. These amounts represent funds due to Mepco from its counterparties for cancelled service contracts. The aggregate amount of such obligations owing to Mepco by counterparties, net of write-downs and reserves made through the recognition of vehicle service contract counterparty contingency expense, totaled \$7.2 million at both December 31, 2015 and 2014.

We face continued risk with respect to certain counterparties defaulting in their contractual obligations to Mepco which could result in additional charges for losses if these counterparties go out of business. Further, Mepco has incurred elevated legal and collection expenses, in general, in dealing with defaults by its counterparties in recent years. In particular, Mepco has had to initiate litigation against certain counterparties to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations. In addition, see note #11 to the Consolidated Financial Statements included within this report for more information about Mepco's business, certain risks and difficulties we currently face with respect to that business, and reserves we have established (through vehicle service contract counterparty contingencies expense) for losses related to the business.

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

The provision for loss reimbursement on sold loans was a credit of \$0.06 million and \$0.5 million in 2015 and 2014, respectively, and an expense of \$2.2 million in 2013. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac and Ginnie Mae). The credit provisions in 2015 and 2014 are due primarily to the reduction or rescission of certain loss reimbursement requests that had been pending and accrued for in earlier periods. Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. Historically, loss reimbursements on mortgage loans sold without recourse were rare. Prior to 2009, we had years in which we incurred no such loss reimbursements. However, our loss reimbursements increased from 2010 to 2013 as Fannie Mae and Freddie Mac, in particular, were doing more reviews of mortgage loans where they had incurred or expected to incur a loss and were more aggressive in pursuing loss reimbursements from the sellers of such mortgage loans. In November 2013, we executed a Resolution Agreement with Fannie Mae to resolve our existing and future repurchase and make whole obligations (collectively “Repurchase Obligations”) related to mortgage loans originated between January 1, 2000 and December 31, 2008 and delivered to them by January 31, 2009. Under the terms of the Resolution Agreement, we paid Fannie Mae approximately \$1.5 million in November 2013 with respect to the Repurchase Obligations. We believe that it was in our best interest to execute the Resolution Agreement in order to bring finality to the loss reimbursement exposure with Fannie Mae for these years and reduce the resources spent on individual file reviews and defending loss reimbursement requests. In addition, we were notified by Freddie Mac in January 2014 that they had completed their review of mortgage loans that we originated between January 1, 2000 and December 31, 2008 and delivered to them. The reserve for loss reimbursements on sold mortgage loans totaled \$0.5 million and \$0.7 million at December 31, 2015 and 2014, respectively. This reserve is included in accrued expenses and other liabilities in our Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at December 31, 2015 and 2014 also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

Net (gains) losses on ORE and repossessed assets represent the gain or loss on the sale or additional write downs on these assets subsequent to the transfer of the asset from our loan portfolio. This transfer occurs at the time we acquire the collateral that secured the loan. At the time of acquisition, the other real estate or repossessed asset is valued at fair value, less estimated costs to sell, which becomes the new basis for the asset. Any write-downs at the time of acquisition are charged to the allowance for loan losses. The net gains of \$0.2 million and \$0.5 million in 2015 and 2014, respectively, as compared to a net loss of \$1.2 million recorded in 2013, primarily reflect greater stability in real estate prices during the last two years, with many markets even experiencing price increases.

Other non-interest expenses have been relatively consistent over the past three years and totaled \$4.9 million in 2015, compared to \$5.1 million in 2014, and \$5.0 million in 2013.

We are subject to an industry-specific tax based on net capital (the Michigan Business Tax [“MBT”]). The MBT is recorded in other non-interest expenses. Our MBT expense was \$0.3 million, \$0.2 million and \$0.2 million in 2015, 2014 and 2013, respectively.

*Income tax expense (benefit).* We recorded an income tax expense of \$9.4 million and \$7.2 million in 2015 and 2014, respectively, as compared to an income tax benefit of \$54.9 million in 2013. Prior to the second quarter of 2013, we had established a deferred tax asset valuation allowance against all of our net deferred tax assets.

We assess whether a valuation allowance on our deferred tax assets is necessary each quarter. Reversing or reducing the valuation allowance requires us to conclude that the realization of the deferred tax assets is “more likely

than not.” The ultimate realization of this asset is primarily based on generating future income. As of June 30, 2013, we concluded that the realization of substantially all of our deferred tax assets was more likely than not. That conclusion was primarily based upon the following factors:

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

The reversal of substantially all of the valuation allowance on our deferred tax assets resulted in our recording an income tax benefit of \$57.6 million in the second quarter of 2013. 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 as more fully discussed in Note #13 to the Consolidated Financial Statements.

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 ten additional profitable quarters since the second quarter of 2013.

The valuation allowance against our deferred tax assets totaled approximately \$1.1 million and \$1.0 million at December 31, 2015 and 2014, respectively. The portion of the valuation allowance on our deferred tax assets that we did not reverse primarily relates to state income taxes at our Mepco segment. In this instance, we determined that the future realization of these particular deferred tax assets was not more likely than not. This conclusion was primarily based on the uncertainty of Mepco’s future earnings attributable to particular states (given the various apportionment criteria) and the significant reduction in the size of Mepco’s business over the past few years.

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

Our actual federal income tax expense (benefit) is different than the amount computed by applying our statutory federal income tax rate to our pre-tax income (loss) primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance and also, for 2013 the impact of changes in the deferred tax asset valuation allowance. In addition, 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 a valuation allowance on a capital loss carryforward that was believed to not be more likely than not to be realized prior to a strategy executed during the second quarter of 2014 that generated capital gains.

The income tax benefit in the Consolidated Statements of Operations also includes income taxes in a variety of other states due primarily to Mepco’s operations. The amounts of such state income taxes were an expense (benefit) of \$(0.014) million, \$0.005 million, and \$(0.2) million in 2015, 2014 and 2013, respectively.

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

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

## BUSINESS SEGMENTS

	Year ended December 31,		
	2015	2014	2013
	(In thousands)		
Independent Bank . . . . .	\$21,727	\$18,550	\$74,313
Mepco . . . . .	(712)	366	(1,801)
Other (1) . . . . .	(936)	(712)	5,092
Elimination . . . . .	(62)	(183)	(95)
Net income . . . . .	<u>\$20,017</u>	<u>\$18,021</u>	<u>\$77,509</u>

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

The substantial change in the Bank's results in 2015 and 2014 compared to 2013 is primarily due to the change in income tax expense (benefit) as 2013 included the reversal of the valuation allowance on deferred tax assets resulting in the recording of a significant income tax benefit that year. In addition, declines in net interest income and non-interest income in 2014 were only partially offset by a decline in non-interest expense. The increase in 2015 as compared to 2014 is primarily due to increases in net interest income and non-interest income as well as a decline in non-interest expense. (See "Net interest income," "Provision for loan losses," "Non-interest income," "Non-interest expense," "Income tax expense (benefit)," and "Portfolio Loans and asset quality.")

The changes in Mepco's results are due primarily to changes in the level of vehicle service contract counterparty contingencies expense (see "Non-interest expense") as well as changes in its level of net interest income. All of Mepco's funding is provided by its parent company (Independent Bank) through an intercompany loan (that is eliminated in consolidation). The rate on this intercompany loan is based on the Prime Rate (currently 3.50%). Mepco might not be able to obtain such favorable funding costs on its own in the open market. Mepco's 2014 results also included a \$0.3 million gain on the sale of ORE and repossessed assets compared to a loss of \$0.5 million in 2013. There was no gain or loss on ORE at our Mepco segment in 2015.

"Other" is essentially our parent company only results. The change between the various periods is primarily due to the change in the amount of income tax benefit recorded in each year, as 2013 included the reversal of the valuation allowance on deferred tax assets resulting in recording a significant income tax benefit at the parent company. (See "Income tax expense (benefit).") Interest expense at the parent company has declined in 2015 and 2014 as compared to 2013 due to the reduction in the balance of subordinated debentures. "Other" in 2014 also includes a \$0.5 million gain on the extinguishment of debt. In addition, 2013 included a \$1.0 million increase (which reduced income before income taxes) in the fair value of the Amended Warrant issued to the UST. (See "Non-interest income.")



## FINANCIAL CONDITION

*Summary.* Our total assets increased to \$2.41 billion at December 31, 2015, compared to \$2.25 billion at December 31, 2014, primarily due to increases in securities available for sale and loans. Loans, excluding loans held for sale (“Portfolio Loans”), totaled \$1.52 billion at December 31, 2015, an increase of 7.5% from \$1.41 billion at December 31, 2014. (See “Portfolio Loans and asset quality”).

Deposits totaled \$2.09 billion at December 31, 2015, compared to \$1.92 billion at December 31, 2014. The increase in deposits during 2015 is primarily due to growth in checking, savings and time account balances.

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

Securities available for sale increased during 2015 due primarily to the purchase of U.S. agency, corporate, and asset-backed securities. The securities were purchased to utilize funds generated from the increase in total deposits. (See “Deposits” and “Liquidity and capital resources.”)

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

We recorded net impairment losses related to other than temporary impairment on securities available for sale of zero, \$0.009 million, and \$0.026 million, in 2015, 2014, and 2013, respectively. These net other than temporary impairment charges are all related to private label residential mortgage-backed securities. In these instances, we believe that the decline in value is directly due to matters other than changes in interest rates, are not expected to be recovered within a reasonable timeframe based upon available information and are therefore other than temporary in nature. (See “Non-interest income” and “Asset/liability management.”)

## SECURITIES

	Amortized Cost	Unrealized		Fair Value
		Gains	Losses	
		(In thousands)		
Securities available for sale				
December 31, 2015.....	\$585,851	\$3,152	\$3,519	\$585,484
December 31, 2014.....	532,930	3,317	3,069	533,178

*Portfolio Loans and asset quality.* In addition to the communities served by our Bank branch network, our principal lending markets also include nearby communities and metropolitan areas. Subject to established underwriting criteria, we also may participate in commercial lending transactions with certain non-affiliated banks and make whole loan purchases from other financial institutions. In December 2015, we purchased \$32.6 million of single-family residential fixed rate jumbo mortgage loans from another Michigan-based financial institution. These mortgage loans were all on properties located in Michigan, had a weighted average interest rate (after a 0.25% servicing fee) of 3.94% and a weighted average remaining contractual maturity of 344 months.

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

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

## LOAN PORTFOLIO COMPOSITION

	December 31,	
	2015	2014
	(In thousands)	
Real estate (1)		
Residential first mortgages . . . . .	\$ 432,215	\$ 411,423
Residential home equity and other junior mortgages . . . . .	106,297	108,162
Construction and land development . . . . .	62,629	54,644
Other (2) . . . . .	498,706	447,837
Consumer . . . . .	193,350	154,591
Commercial . . . . .	180,424	186,875
Payment plan receivables . . . . .	34,599	40,001
Agricultural . . . . .	6,830	6,429
Total loans . . . . .	<u>\$1,515,050</u>	<u>\$1,409,962</u>

(1) Includes both residential and non-residential commercial loans secured by real estate.

(2) Includes loans secured by multi-family residential and non-farm, non-residential property.

Future growth of overall Portfolio Loans is dependent upon a number of competitive and economic factors. Further, it is our desire to reduce or restrict certain loan categories for risk management reasons.

## NON-PERFORMING ASSETS (1)

	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Non-accrual loans . . . . .	\$10,607	\$15,231	\$17,905
Loans 90 days or more past due and still accruing interest . . . . .	116	7	—
Total non-performing loans . . . . .	10,723	15,238	17,905
Other real estate and repossessed assets . . . . .	7,150	6,454	18,282
Total non-performing assets . . . . .	<u>\$17,873</u>	<u>\$21,692</u>	<u>\$36,187</u>
As a percent of Portfolio Loans			
Non-performing loans . . . . .	0.71%	1.08%	1.30%
Allowance for loan losses . . . . .	1.49	1.84	2.35
Non-performing assets to total assets . . . . .	0.74	0.96	1.64
Allowance for loan losses as a percent of non-performing loans . . . . .	210.48	170.56	180.54

(1) Excludes loans classified as “troubled debt restructured” that are performing and vehicle service contract counterparty receivables, net.

## TROUBLED DEBT RESTRUCTURINGS

	December 31, 2015		
	Commercial	Retail	Total
	(In thousands)		
Performing TDR's .....	\$13,318	\$68,194	\$81,512
Non-performing TDR's (1) .....	3,041	3,777 <sup>(2)</sup>	6,818
Total .....	<u>\$16,359</u>	<u>\$71,971</u>	<u>\$88,330</u>

	December 31, 2014		
	Commercial	Retail	Total
	(In thousands)		
Performing TDR's .....	\$29,475	\$73,496	\$102,971
Non-performing TDR's (1) .....	1,978	5,225 <sup>(2)</sup>	7,203
Total .....	<u>\$31,453</u>	<u>\$78,721</u>	<u>\$110,174</u>

(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.

Non-performing loans declined by \$4.5 million, or 29.6%, in 2015 and by \$2.7 million, or 14.9%, in 2014 due principally to declines in non-performing commercial loans and residential mortgage loans. These declines primarily reflect reduced levels of new loan defaults as well as loan charge-offs, pay-offs, negotiated transactions, and the migration of loans into ORE. In general, improving economic conditions in our market areas, as well as our collection and resolution efforts, have resulted in a downward trend in non-performing loans. However, we are still experiencing some loan defaults, particularly related to commercial loans secured by income-producing property and mortgage loans secured by resort/vacation property.

Non-performing loans exclude performing loans that are classified as troubled debt restructurings ("TDRs"). Performing TDRs totaled \$81.5 million, or 5.4% of total Portfolio Loans, and \$103.0 million, or 7.3% of total Portfolio Loans, at December 31, 2015 and 2014, respectively. The decrease in the amount of performing TDRs during 2015 reflects declines in both commercial loan and retail loan TDRs.

ORE and repossessed assets totaled \$7.2 million at December 31, 2015, compared to \$6.5 million at December 31, 2014. The slight increase in ORE during 2015 primarily reflects the migration of some income-producing commercial properties into ORE during the last quarter of the year.

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

## ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES

	December 31,		
	2015	2014	2013
	(In thousands)		
Specific allocations .....	\$10,983	\$13,233	\$15,158
Other adversely rated commercial loans .....	1,053	761	1,358
Historical loss allocations .....	5,262	6,773	9,849
Additional allocations based on subjective factors .....	5,272	5,223	5,960
Total .....	<u>\$22,570</u>	<u>\$25,990</u>	<u>\$32,325</u>

Some loans will not be repaid in full. Therefore, an allowance for loan losses ("AFL") is maintained at a level which represents our best estimate of losses incurred. In determining the AFL and the related provision for loan

losses, we consider four principal elements: (i) specific allocations based upon probable losses identified during the review of the loan portfolio, (ii) allocations established for other adversely rated commercial loans, (iii) allocations based principally on historical loan loss experience, and (iv) additional allowances based on subjective factors, including local and general economic business factors and trends, portfolio concentrations and changes in the size and/or the general terms of the loan portfolios.

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

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

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

Mepco's allowance for losses is determined in a similar manner as discussed above, and primarily takes into account historical loss experience and other subjective factors deemed relevant to Mepco's payment plan business. Estimated incurred losses associated with Mepco's outstanding vehicle service contract payment plans are included in the provision for loan losses. Mepco recorded credits of \$0.009 million, \$0.038 million and \$0.097 million for its provision for loan losses in 2015, 2014 and 2013, respectively, due primarily to declines in the balance of payment plan receivables (\$5.4 million, or 13.5%, \$20.6 million, or 34.0%, and \$24.1 million, or 28.4%, in 2015, 2014 and 2013, respectively). Mepco's allowance for loan losses totaled \$0.063 million and \$0.072 million at December 31, 2015 and 2014, respectively. Mepco has established procedures for vehicle service contract payment plan servicing, administration and collections, including the timely cancellation of the vehicle service contract, in order to protect our position in the event of payment default or voluntary cancellation by the customer. Mepco has also established procedures to attempt to prevent and detect fraud since the payment plan origination activities and initial customer contacts are done entirely through unrelated third parties (vehicle service contract administrators and sellers or automobile dealerships). However, there can be no assurance these risk management policies and procedures will prevent us from incurring significant credit or fraud related losses in this business segment. The estimated incurred losses described in this paragraph should be distinguished from the possible losses we may incur from counterparties failing to pay their obligations to Mepco. (See note #11 to the Consolidated Financial Statements included within this report.)

The AFLL decreased \$3.4 million to \$22.6 million at December 31, 2015 from \$26.0 million at December 31, 2014 and was equal to 1.49% of total Portfolio Loans at December 31, 2015 compared to 1.84% at December 31, 2014. Two of the four components of the allowance for loan losses outlined above declined during 2015. The allowance for loan losses related to specific loans decreased \$2.3 million in 2015 due primarily to a \$24.0 million, or 21.6%, decline in the balance of individually impaired loans as well as charge-offs. The allowance for loan losses related to other adversely rated commercial loans increased \$0.3 million in 2015. Although the total balance of such loans included in this component decreased to \$27.8 million at December 31, 2015, from \$30.6 million at December 31, 2014, the allowance related to such loans increased slightly due to the use of higher loss given default rates. The allowance for loan losses related to historical losses decreased \$1.5 million during 2015 due principally to the use of a lower estimated probability of default for homogenous mortgage and installment loans (resulting from lower loan net charge-offs and reduced levels of new defaults on loans). The allowance for loan losses related to subjective factors was relatively unchanged (increased by just \$0.05 million during 2015).

All four components of the allowance for loan losses outlined above declined during 2014. The allowance for loan losses related to specific loans decreased \$1.9 million in 2014 due primarily to a \$12.5 million, or 10.0%, decline in the balance of individually impaired loans as well as charge-offs. The allowance for loan losses related to other adversely rated commercial loans decreased \$0.6 million in 2014 primarily due to lower expected loss given default rates. The total balance of such loans included in this component also decreased to \$30.6 million at December 31, 2014, from \$39.4 million at December 31, 2013. In addition, the mix improved, with the balance of loans with more adverse ratings declining to \$12.7 million at December 31, 2014, from \$18.1 million at December 31, 2013. The allowance for loan losses related to historical losses decreased \$3.1 million during 2014 due principally to the use of a lower estimated probability of default for homogenous mortgage and installment loans (resulting from lower loan net charge-offs and reduced levels of new defaults on loans). The allowance for loan losses related to subjective factors decreased \$0.7 million during 2014 primarily due to the improvement of various economic indicators used in computing this portion of the allowance.

#### ALLOWANCE FOR LOSSES ON LOANS AND UNFUNDED COMMITMENTS

	2015		2014		2013	
	Loan Losses	Unfunded Commitments	Loan Losses	Unfunded Commitments	Loan Losses	Unfunded Commitments
	(Dollars in thousands)					
Balance at beginning of year . . . . .	\$25,990	\$539	\$ 32,325	\$508	\$ 44,275	\$598
Additions (deductions)						
Provision for loan losses . . . . .	(2,714)	—	(3,136)	—	(3,988)	—
Recoveries credited to allowance . . . . .	5,022	—	7,420	—	8,270	—
Loans charged against the allowance . . . . .	(5,728)	—	(10,619)	—	(16,232)	—
Additions (deductions) included in non- interest expense . . . . .	—	113	—	31	—	(90)
Balance at end of year . . . . .	<u>\$22,570</u>	<u>\$652</u>	<u>\$ 25,990</u>	<u>\$539</u>	<u>\$ 32,325</u>	<u>\$508</u>
Net loans charged against the allowance to average Portfolio Loans . . . . .	0.05%		0.23%		0.58%	

The ratio of loan net charge-offs to average loans was 0.05% in 2015 (or \$0.7 million) compared to 0.23% in 2014 (or \$3.2 million) and 0.58% in 2013 (or \$8.0 million). The decreases in loan net charge-offs occurred across all loan categories. These decreases primarily reflect reduced levels of non-performing loans and improvement in collateral liquidation values.



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

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

Deposits totaled \$2.09 billion and \$1.92 billion at December 31, 2015 and 2014, respectively. The \$161.7 million increase in deposits in 2015 is due to growth in checking, savings and time deposit account balances. Reciprocal deposits totaled \$50.2 million and \$53.7 million at December 31, 2015 and 2014, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network’s Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At December 31, 2015, we had approximately \$492.5 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

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

Other borrowings, comprised almost entirely of advances from the Federal Home Loan Bank (the “FHLB”), totaled \$12.0 million and \$12.5 million at December 31, 2015 and 2014, respectively.

As described above, we utilize wholesale funding, including FHLB borrowings and Brokered CDs to augment our core deposits and fund a portion of our assets. At December 31, 2015, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$62.2 million, or 3.0% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all. Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. We discontinued the active use of derivative financial instruments during 2008. In June 2013, we terminated our last remaining interest-rate swap, which had an aggregate notional amount of \$10.0 million. We have begun to again utilize interest-rate swaps in 2014, relating to our commercial lending activities. During 2015 and 2014, we entered into \$24.3 million and \$3.3 million (aggregate notional amounts), respectively, of interest rate swaps with commercial loan customers, which were offset with interest rate swaps that the Bank entered into with a broker-dealer. We recorded \$0.412 million and \$0.070 million of fee income related to these transactions during 2015 and 2014, respectively.

*Liquidity and capital resources.* Liquidity risk is the risk of being unable to timely meet obligations as they come due at a reasonable funding cost or without incurring unacceptable losses. Our liquidity management involves the measurement and monitoring of a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows

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

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

At December 31, 2015, we had \$302.1 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$1.66 billion of our deposits at December 31, 2015, were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

We also believe that the available cash on hand at the parent company (including time deposits) of approximately \$15.8 million as of December 31, 2015 provides sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures and to pay a cash dividend on our common stock for the foreseeable future.

In the normal course of business, we enter into certain contractual obligations. Such obligations include requirements to make future payments on debt and lease arrangements, contractual commitments for capital expenditures, and service contracts. The table below summarizes our significant contractual obligations at December 31, 2015.

#### CONTRACTUAL COMMITMENTS (1)

	1 Year or Less	1-3 Years	3-5 Years	After 5 Years	Total
	(In thousands)				
Time deposit maturities . . . . .	\$302,136	\$ 93,655	\$27,195	\$ 3,234	\$426,220
Other borrowings . . . . .	2,526	6,629	2,799	—	11,954
Subordinated debentures . . . . .	—	—	—	35,569	35,569
Operating lease obligations . . . . .	1,054	1,671	1,386	253	4,364
Purchase obligations (2) . . . . .	1,385	2,771	2,771	346	7,273
Total . . . . .	<u>\$307,101</u>	<u>\$104,726</u>	<u>\$34,151</u>	<u>\$39,402</u>	<u>\$485,380</u>

(1) Excludes approximately \$0.6 million of accrued tax and interest relative to uncertain tax benefits due to the high degree of uncertainty as to when, or if, those amounts would be paid.

(2) Includes contracts with a minimum annual payment of \$1.0 million and are not cancellable within one year.

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

## CAPITALIZATION

	December 31,	
	2015	2014
	(In thousands)	
Subordinated debentures .....	\$ 35,569	\$ 35,569
Amount not qualifying as regulatory capital .....	(1,069)	(1,069)
Amount qualifying as regulatory capital .....	<u>34,500</u>	<u>34,500</u>
Shareholders' equity		
Common stock .....	339,462	352,462
Accumulated deficit .....	(82,334)	(96,455)
Accumulated other comprehensive loss .....	<u>(6,036)</u>	<u>(5,636)</u>
Total shareholders' equity .....	<u>251,092</u>	<u>250,371</u>
Total capitalization .....	<u>\$285,592</u>	<u>\$284,871</u>

We currently have three special purpose entities that originally issued \$39.5 million of cumulative trust preferred securities. These special purpose entities issued common securities and provided cash to our parent company that in turn issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Consolidated Statements of Financial Condition.

On December 1, 2014, we purchased 5,000 shares of trust preferred securities (liquidation amount of \$1,000 per security, representing a total of \$5.0 million) that were issued by IBC Capital Finance IV. The trust preferred securities have been retired along with certain related common stock issued by IBC Capital Finance IV and subordinated debentures issued by us.

At both December 31, 2015 and 2014, we had \$34.5 million of cumulative trust preferred securities remaining outstanding.

The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at December 31, 2015 and 2014. Although the Dodd-Frank Act further limited Tier 1 treatment for trust preferred securities, those new limits did not apply to our outstanding trust preferred securities. Further, the New Capital Rules grandfathered the treatment of our trust preferred securities as qualifying regulatory capital.

On August 30, 2013, we redeemed the Series B Preferred Stock and the Amended Warrant from the UST and exited TARP by making an \$81.0 million payment to the UST. See note #12 to the Consolidated Financial Statements included within this report for additional information about the Series B Preferred Stock and the Amended Warrant.

Common shareholders' equity increased to \$251.1 million at December 31, 2015 from \$250.4 million at December 31, 2014 due primarily to our net income in 2015 that was substantially offset by share repurchases and dividends paid on our common stock. Our tangible common equity ("TCE") totaled \$248.8 million and \$247.7 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 10.34% and 11.03% at December 31, 2015 and 2014, respectively.

On January 21, 2015, our Board of Directors authorized a share repurchase plan. Under the terms of this share repurchase plan, we were authorized to buy back up to 5% of our outstanding common stock. This repurchase plan expired on December 31, 2015. During 2015, we repurchased 967,199 shares of our common stock pursuant to this plan at an average price of \$13.96 per share.

On January 21, 2016, our Board of Directors authorized another share repurchase plan. Under the terms of the 2016 share repurchase plan, we are authorized to buy back up to 5% of our outstanding common stock. This repurchase plan is authorized to last through December 31, 2016.

We resumed a quarterly cash dividend on our common stock of six cents per share in May 2014 and have continued to pay regular quarterly dividends at that amount through August 2015. In October 2015, our Board of Directors increased the quarterly cash dividend on our common stock to eight cents per share.

Because the Bank currently has negative “undivided profits” (i.e. a retained deficit) of \$10.1 million at December 31, 2015, under Michigan banking regulations, the Bank is not currently permitted to pay a dividend. We can request regulatory approval for a return of capital from the Bank to the parent company. During the first quarter of 2016, we requested regulatory approval for an \$18.0 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on February 24, 2016, and the Bank returned \$18.0 million of capital to the parent company on February 25, 2016. Our banking regulators approved previous return of capital requests totaling \$41.0 million during the three-year period ended December 31, 2015. Also see note #20 to the Consolidated Financial Statements included within this report.

As of December 31, 2015 and 2014, our Bank (and holding company) continued to meet the requirements to be considered “well-capitalized” under federal regulatory standards (also see note #20 to the Consolidated Financial Statements included within this report).

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

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

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

## CHANGES IN MARKET VALUE OF PORTFOLIO EQUITY AND NET INTEREST INCOME

<u>Change in Interest Rates</u>	<u>Market Value of Portfolio Equity (1)</u>	<u>Percent Change</u> (Dollars in thousands)	<u>Net Interest Income (2)</u>	<u>Percent Change</u>
<b>December 31, 2015</b>				
200 basis point rise.....	\$419,600	8.42%	\$80,700	6.32%
100 basis point rise.....	407,300	5.25	78,700	3.69
Base-rate scenario.....	387,000	—	75,900	—
100 basis point decline.....	356,500	(7.88)	72,000	(5.14)
<b>December 31, 2014</b>				
200 basis point rise.....	\$421,700	9.56%	\$75,600	6.03%
100 basis point rise.....	406,800	5.69	73,600	3.23
Base-rate scenario.....	384,900	—	71,300	—
100 basis point decline.....	355,000	(7.77)	69,200	(2.95)

- (1) Simulation analyses calculate the change in the net present value of our assets and liabilities, including debt and related financial derivative instruments, under parallel shifts in interest rates by discounting the estimated future cash flows using a market-based discount rate. Cash flow estimates incorporate anticipated changes in prepayment speeds and other embedded options.
- (2) Simulation analyses calculate the change in net interest income under immediate parallel shifts in interest rates over the next twelve months, based upon a static Statement of Financial Condition, which includes debt and related financial derivative instruments, and do not consider loan fees.

*Accounting Standards Update.* See note #1 to the Consolidated Financial Statements included elsewhere in this report for details on recently issued accounting pronouncements and their impact on our financial statements.

### FAIR VALUATION OF FINANCIAL INSTRUMENTS

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

We utilize fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. FASB ASC topic 820 differentiates between those assets and liabilities required to be carried at fair value at every reporting period (“recurring”) and those assets and liabilities that are only required to be adjusted to fair value under certain circumstances (“nonrecurring”). Trading securities, securities available-for-sale, loans held for sale, and derivatives are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a nonrecurring basis, such as loans held for investment, capitalized mortgage loan servicing rights and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. See note #21 to the Consolidated Financial Statements for a complete discussion on our use of fair valuation of financial instruments and the related measurement techniques.

### LITIGATION MATTERS

We are involved in various litigation matters in the ordinary course of business. At the present time, we do not believe any of these matters will have a significant impact on our consolidated financial position or results of operations. The aggregate amount we have accrued for losses we consider probable as a result of these litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is approximately \$1.0 million. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.



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

## **CRITICAL ACCOUNTING POLICIES**

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for other than temporary impairment of investment securities, the allowance for loan losses, originated mortgage loan servicing rights, vehicle service contract payment plan counterparty contingencies, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our financial position or results of operations.

We are required to assess our investment securities for “other than temporary impairment” on a periodic basis. The determination of other than temporary impairment for an investment security requires judgment as to the cause of the impairment, the likelihood of recovery and the projected timing of the recovery. On January 12, 2009, the FASB issued ASC 325-40-65-1 (formerly Staff Position No. EITF 99-20-1 — “Amendments to the Impairment Guidance of EITF Issue No. 99-20.”) This standard has been applicable to our financial statements since December 31, 2008. In particular, this standard struck the language that required the use of market participant assumptions about future cash flows from previous guidance. This change now permits the use of reasonable management judgment about whether it is probable that all previously projected cash flows will not be collected in determining other than temporary impairment. Our assessment process resulted in recording net other than temporary impairment charges on securities of zero, \$0.009 million, and \$0.03 million, in 2015, 2014 and 2013, respectively. We believe that our assumptions and judgments in assessing other than temporary impairment for our investment securities are reasonable and conform to general industry practices. Prices for investment securities are largely provided by a pricing service. These prices consider benchmark yields, reported trades, broker / dealer quotes and issuer spreads. Furthermore, prices for mortgage-backed securities consider: TBA prices, monthly payment information and collateral performance. At December 31, 2015 and 2014, the estimated fair value of our investment securities classified as available for sale was (less than)/exceeded their cost basis at that same date by \$(0.4) million and \$0.2 million, respectively. These amounts are included in the accumulated other comprehensive loss section of shareholders’ equity.

Our methodology for determining the allowance and related provision for loan losses is described above in “Portfolio Loans and asset quality.” In particular, this area of accounting requires a significant amount of judgment because a multitude of factors can influence the ultimate collection of a loan or other type of credit. It is extremely difficult to precisely measure the amount of probable incurred losses in our loan portfolio. We use a rigorous process to attempt to accurately quantify the necessary allowance and related provision for loan losses, but there can be no assurance that our modeling process will successfully identify all of the probable incurred losses in our loan portfolio. As a result, we could record future provisions for loan losses that may be significantly different than the levels that we recorded in prior periods.

At December 31, 2015 and 2014, we had approximately \$12.4 million and \$12.1 million, respectively, of mortgage loan servicing rights capitalized on our Consolidated Statements of Financial Condition. There are several critical assumptions involved in establishing the value of this asset including estimated future prepayment speeds on the underlying mortgage loans, the interest rate used to discount the net cash flows from the mortgage loan servicing, the estimated amount of ancillary income that will be received in the future (such as late fees) and the estimated cost to service the mortgage loans. We believe the assumptions that we utilize in our valuation are reasonable based upon accepted industry practices for valuing mortgage loan servicing rights and represent neither the most conservative or aggressive assumptions. We recorded an increase in the valuation allowance on capitalized mortgage loan servicing rights of \$0.9 million in 2014 compared to decreases of \$0.5 million and \$3.2 million in 2015 and 2013, respectively.

Mepco purchases payment plans from companies (which we refer to as Mepco's "counterparties") that provide vehicle service contracts and similar products to consumers. The payment plans (which are classified as payment plan receivables in our Consolidated Statements of Financial Condition) permit a consumer to purchase a 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 does not have recourse against the consumer for nonpayment of a payment plan and therefore does not evaluate the creditworthiness of the individual customer. When consumers stop making payments or exercise their right to voluntarily cancel the contract, the remaining unpaid balance of the payment plan is normally recouped by Mepco from the counterparties that sold the contract and provided the coverage. The refund obligations of these counterparties are not fully secured. We record losses in vehicle service contract counterparty contingencies expense, included in non-interest expenses, for estimated defaults by these counterparties in their obligations to Mepco. These losses (which totaled \$0.1 million, \$0.2 million and \$4.8 million in 2015, 2014 and 2013, respectively) are titled "vehicle service contract counterparty contingencies" in our Consolidated Statements of Operations. This area of accounting requires a significant amount of judgment because a number of factors can influence the amount of loss that we may ultimately incur. These factors include our estimate of future cancellations of vehicle service contracts, our evaluation of collateral that may be available to recover funds due from our counterparties, and our assessment of the amount that may ultimately be collected from counterparties in connection with their contractual obligations. We apply a rigorous process, based upon historical payment plan activity and past experience, to estimate probable incurred losses and quantify the necessary reserves for our vehicle service contract counterparty contingencies, but there can be no assurance that our modeling process will successfully identify all such losses. As a result, we could record future losses associated with vehicle service contract counterparty contingencies that may be materially different than the levels that we recorded in prior periods.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with net operating loss carryforwards and differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. At December 31, 2015 we had gross deferred tax assets of \$45.5 million, gross deferred tax liabilities of \$4.8 million and a valuation allowance of \$1.1 million. This compares to gross deferred tax assets of \$54.6 million, gross deferred tax liabilities of \$4.9 million and a valuation allowance of \$1.0 million at December 31, 2014. We are required to assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In 2008, we first established a valuation allowance against substantially all of our net deferred tax assets due to a number of factors, including our then declining operating performance, overall negative trends in the banking industry and our expectation that our operating results would continue to be negatively affected by the overall economic environment. During 2012, 2011, 2010 and 2009, we concluded that we needed to continue to carry a valuation allowance based on similar factors. However, at June 30, 2013, we concluded that the realization of substantially all of our deferred tax assets was more likely than not. Subsequent to June 30, 2013, we concluded that the realization of substantially all of our deferred tax assets continues to be more likely than not [see "Income tax expense (benefit)."]. We will continue to evaluate the realization of our net deferred tax assets in future periods. In making such judgments, significant weight will be given to evidence that can be objectively verified. We will analyze changes in near-term market conditions and consider both positive and negative evidence as well as other factors which may impact future operating results in making any decision to adjust our valuation allowance. In addition, changes in tax laws and changes in tax rates as well as our future level of earnings can impact the ultimate realization of our net deferred tax asset as well as the valuation allowance that we have established.

## MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

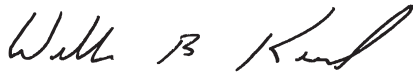
The management of Independent Bank Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to us and the board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We assessed the effectiveness of our internal control over financial reporting as of December 31, 2015. In making this assessment, we used the criteria established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment, management has concluded that as of December 31, 2015, the Company's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

There were no changes in our internal control over financial reporting during the quarter ended December 31, 2015, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Our independent registered public accounting firm has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2015. Their report immediately follows our report.



William B. Kessel  
President and  
Chief Executive Officer

Independent Bank Corporation  
March 7, 2016



Robert N. Shuster  
Executive Vice President  
and Chief Financial Officer

Board of Directors and Shareholders  
Independent Bank Corporation  
Grand Rapids, Michigan

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Rowe Hirsch LLP

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## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	December 31,	
	2015	2014
	(In thousands, except share amounts)	
ASSETS		
Cash and due from banks . . . . .	\$ 54,260	\$ 48,326
Interest bearing deposits. . . . .	31,523	25,690
Cash and Cash Equivalents . . . . .	85,783	74,016
Interest bearing deposits - time . . . . .	11,866	13,561
Trading securities . . . . .	148	203
Securities available for sale . . . . .	585,484	533,178
Federal Home Loan Bank and Federal Reserve Bank stock, at cost. . . . .	15,471	19,919
Loans held for sale, carried at fair value . . . . .	27,866	23,662
Loans		
Commercial. . . . .	748,398	690,955
Mortgage. . . . .	500,454	472,628
Installment . . . . .	231,599	206,378
Payment plan receivables. . . . .	34,599	40,001
Total Loans . . . . .	1,515,050	1,409,962
Allowance for loan losses . . . . .	(22,570)	(25,990)
Net Loans . . . . .	1,492,480	1,383,972
Other real estate and repossessed assets . . . . .	7,150	6,454
Property and equipment, net . . . . .	43,103	45,948
Bank-owned life insurance. . . . .	54,402	53,625
Deferred tax assets, net . . . . .	39,635	48,632
Capitalized mortgage loan servicing rights. . . . .	12,436	12,106
Vehicle service contract counterparty receivables, net . . . . .	7,229	7,237
Other intangibles . . . . .	2,280	2,627
Accrued income and other assets . . . . .	23,733	23,590
Total Assets. . . . .	<u>\$2,409,066</u>	<u>\$2,248,730</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Non-interest bearing. . . . .	\$ 659,793	\$ 576,882
Savings and interest-bearing checking . . . . .	988,174	943,734
Reciprocal . . . . .	50,207	53,668
Time . . . . .	387,789	350,018
Total Deposits. . . . .	2,085,963	1,924,302
Other borrowings . . . . .	11,954	12,470
Subordinated debentures . . . . .	35,569	35,569
Vehicle service contract counterparty payables. . . . .	797	1,977
Accrued expenses and other liabilities . . . . .	23,691	24,041
Total Liabilities. . . . .	<u>2,157,974</u>	<u>1,998,359</u>
Commitments and contingent liabilities		
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: 22,251,373 shares at December 31, 2015 and 22,957,323 shares at December 31, 2014. . . . .	339,462	352,462
Accumulated deficit . . . . .	(82,334)	(96,455)
Accumulated other comprehensive loss . . . . .	(6,036)	(5,636)
Total Shareholders' Equity. . . . .	<u>251,092</u>	<u>250,371</u>
Total Liabilities and Shareholders' Equity . . . . .	<u>\$2,409,066</u>	<u>\$2,248,730</u>

See accompanying notes to consolidated financial statements



## CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2015	2014	2013
	(In thousands, except per share amounts)		
INTEREST INCOME			
Interest and fees on loans . . . . .	\$70,930	\$71,823	\$ 80,664
Interest on securities			
Taxable . . . . .	7,805	6,341	4,059
Tax-exempt . . . . .	907	991	1,101
Other investments . . . . .	1,200	1,400	1,297
Total Interest Income . . . . .	<u>80,842</u>	<u>80,555</u>	<u>87,121</u>
INTEREST EXPENSE			
Deposits . . . . .	4,009	4,967	5,706
Other borrowings . . . . .	1,847	2,332	3,456
Total Interest Expense . . . . .	<u>5,856</u>	<u>7,299</u>	<u>9,162</u>
Net Interest Income . . . . .	74,986	73,256	77,959
Provision for loan losses . . . . .	(2,714)	(3,136)	(3,988)
Net Interest Income After Provision for Loan Losses . . . . .	<u>77,700</u>	<u>76,392</u>	<u>81,947</u>
NON-INTEREST INCOME			
Service charges on deposit accounts . . . . .	12,389	13,446	14,076
Interchange income . . . . .	8,481	8,164	7,362
Net gains (losses) on assets			
Mortgage loans . . . . .	7,448	5,628	10,022
Securities . . . . .	20	329	395
Other than temporary impairment loss on securities			
Total impairment loss . . . . .	—	(9)	(26)
Loss recognized in other comprehensive income (loss) . . . . .	—	—	—
Net impairment loss recognized in earnings . . . . .	—	(9)	(26)
Mortgage loan servicing, net . . . . .	1,751	791	3,806
Title insurance fees . . . . .	1,156	995	1,682
Net gain on branch sale . . . . .	1,193	—	—
Gain on extinguishment of debt . . . . .	—	500	—
Increase in fair value of U.S. Treasury warrant . . . . .	—	—	(1,025)
Other . . . . .	7,692	8,931	8,537
Total Non-interest Income . . . . .	<u>40,130</u>	<u>38,775</u>	<u>44,829</u>
NON-INTEREST EXPENSE			
Compensation and employee benefits . . . . .	48,186	47,221	47,924
Occupancy, net . . . . .	8,369	8,912	8,845
Data processing . . . . .	7,944	7,532	8,019
Furniture, fixtures and equipment . . . . .	3,892	4,137	4,293
Loan and collection . . . . .	3,609	5,392	6,886
Communications . . . . .	2,957	2,926	2,919
Advertising . . . . .	2,121	2,193	2,433
Legal and professional . . . . .	2,013	1,969	2,459
FDIC deposit insurance . . . . .	1,366	1,567	2,435
Interchange expense . . . . .	1,125	1,291	1,645
Credit card and bank service fees . . . . .	797	946	1,263
Vehicle service contract counterparty contingencies . . . . .	119	199	4,837
Costs (recoveries) related to unfunded lending commitments . . . . .	113	31	(90)
Provision for loss reimbursement on sold loans . . . . .	(59)	(466)	2,152
Net (gains) losses on other real estate and repossessed assets . . . . .	(180)	(500)	1,237
Other . . . . .	6,078	6,601	6,861
Total Non-interest Expense . . . . .	<u>88,450</u>	<u>89,951</u>	<u>104,118</u>
Income Before Income Tax . . . . .	29,380	25,216	22,658
Income tax expense (benefit) . . . . .	9,363	7,195	(54,851)
Net Income . . . . .	<u>\$20,017</u>	<u>\$18,021</u>	<u>\$ 77,509</u>
Preferred stock dividends and discount accretion . . . . .	—	—	(3,001)
Preferred stock discount . . . . .	—	—	7,554
Net Income Applicable to Common Stock . . . . .	<u>\$20,017</u>	<u>\$18,021</u>	<u>\$ 82,062</u>
Net income per common share			
Basic . . . . .	<u>\$ 0.88</u>	<u>\$ 0.79</u>	<u>\$ 5.87</u>
Diluted . . . . .	<u>\$ 0.86</u>	<u>\$ 0.77</u>	<u>\$ 3.55</u>
Cash dividends declared per common share . . . . .	<u>\$ 0.26</u>	<u>\$ 0.18</u>	<u>\$ —</u>

See accompanying notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,		
	2015	2014	2013
	(In thousands)		
Net income . . . . .	\$20,017	\$18,021	\$77,509
Other comprehensive income (loss)			
Securities available for sale			
Unrealized gain (loss) arising during period . . . . .	(540)	5,095	(4,698)
Change in unrealized losses for which a portion of other than temporary impairment has been recognized in earnings . . . . .	—	398	270
Reclassification adjustment for other than temporary impairment included in earnings . . . . .	—	9	26
Reclassification adjustments for gains included in earnings . . . . .	(75)	(329)	(7)
Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale . . . . .	(615)	5,173	(4,409)
Income tax expense (benefit) . . . . .	(215)	1,811	(1,544)
Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale, net of tax . . . . .	(400)	3,362	(2,865)
Derivative instruments			
Unrealized loss arising during period . . . . .	—	—	(37)
Reclassification adjustment for expense recognized in earnings . . . . .	—	—	208
Reclassification adjustment for accretion on settled derivatives . . . . .	—	380	189
Unrealized gains recognized in other comprehensive income (loss) on derivative instruments . . . . .	—	380	360
Income tax expense (benefit) . . . . .	—	133	(1,318)
Unrealized gains recognized in other comprehensive income (loss) on derivative instruments, net of tax . . . . .	—	247	1,678
Other comprehensive income (loss) . . . . .	(400)	3,609	(1,187)
Comprehensive income . . . . .	<u>\$19,617</u>	<u>\$21,630</u>	<u>\$76,322</u>

See accompanying notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Preferred Stock	Common Stock	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	(In thousands)				
Balances at January 1, 2013 .....	\$ 84,204	\$251,237	\$(192,408)	\$(8,058)	\$134,975
Net income for 2013 .....	—	—	77,509	—	77,509
Dividends on Preferred, 5% .....	2,856	—	(2,856)	—	—
Issuance of 13,604,963 shares of common stock ..	—	99,075	—	—	99,075
Share based compensation (issuance of 175,789 shares of common stock) .....	—	1,238	—	—	1,238
Share based compensation withholding obligation (withholding of 55,348 shares of common stock) .....	—	(513)	—	—	(513)
Accretion of preferred stock discount .....	146	—	(146)	—	—
Common stock warrant .....	—	1,484	—	—	1,484
Redemption of convertible preferred stock and common stock warrant .....	(87,206)	(1,348)	7,554	—	(81,000)
Other comprehensive loss .....	—	—	—	(1,187)	(1,187)
Balances at December 31, 2013 .....	—	351,173	(110,347)	(9,245)	231,581
Net income for 2014 .....	—	—	18,021	—	18,021
Cash dividends declared, \$.18 per share .....	—	—	(4,129)	—	(4,129)
Issuance of 30,828 shares of common stock .....	—	97	—	—	97
Share based compensation (issuance of 107,359 shares of common stock) .....	—	1,192	—	—	1,192
Other comprehensive income .....	—	—	—	3,609	3,609
Balances at December 31, 2014 .....	—	352,462	(96,455)	(5,636)	250,371
Net income for 2015 .....	—	—	20,017	—	20,017
Cash dividends declared, \$.26 per share .....	—	—	(5,896)	—	(5,896)
Repurchase of 967,199 shares of common stock ..	—	(13,498)	—	—	(13,498)
Issuance of 39,610 shares of common stock .....	—	112	—	—	112
Share based compensation (issuance of 299,263 shares of common stock) .....	—	1,477	—	—	1,477
Share based compensation withholding obligation (withholding of 77,624 shares of common stock) .....	—	(1,091)	—	—	(1,091)
Other comprehensive loss .....	—	—	—	(400)	(400)
Balances at December 31, 2015 .....	<u>\$ —</u>	<u>\$339,462</u>	<u>\$ (82,334)</u>	<u>\$(6,036)</u>	<u>\$251,092</u>

See accompanying notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2015	2014	2013
	(In thousands)		
Net Income . . . . .	\$ 20,017	\$ 18,021	\$ 77,509
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH FROM OPERATING ACTIVITIES			
Proceeds from sales of loans held for sale . . . . .	288,852	228,906	415,442
Disbursements for loans held for sale . . . . .	(285,608)	(226,550)	(378,323)
Provision for loan losses . . . . .	(2,714)	(3,136)	(3,988)
Deferred federal income tax expense (benefit) . . . . .	8,997	8,918	(57,550)
Deferred loan fees . . . . .	(1,234)	(753)	17
Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities, loans and interest bearing deposits - time . . . . .	4,553	3,014	(2,197)
Net gains on mortgage loans . . . . .	(7,448)	(5,628)	(10,022)
Net gains on securities . . . . .	(20)	(329)	(395)
Securities impairment recognized in earnings . . . . .	—	9	26
Net (gains) losses on other real estate and repossessed assets . . . . .	(180)	(500)	1,237
Vehicle service contract counterparty contingencies . . . . .	119	199	4,837
Share based compensation . . . . .	1,477	1,192	1,238
Net gain on branch sale . . . . .	(1,193)	—	—
Gain on extinguishment of debt . . . . .	—	(500)	—
(Increase) decrease in accrued income and other assets . . . . .	(1,387)	(2,579)	7,747
Decrease in accrued expenses and other liabilities . . . . .	(196)	(7,213)	(3,508)
Total Adjustments . . . . .	4,018	(4,950)	(25,439)
Net Cash From Operating Activities . . . . .	24,035	13,071	52,070
CASH FLOW USED IN INVESTING ACTIVITIES			
Proceeds from the sale of securities available for sale . . . . .	12,037	14,633	2,940
Proceeds from the maturity of securities available for sale . . . . .	36,808	58,220	29,866
Principal payments received on securities available for sale . . . . .	130,232	84,487	43,702
Purchases of securities available for sale . . . . .	(234,693)	(224,946)	(332,060)
Purchases of interest bearing deposits - time . . . . .	(4,595)	(2,401)	(20,260)
Proceeds from the maturity of interest bearing deposits - time . . . . .	6,222	6,719	2,142
Redemption of Federal Home Loan Bank and Federal Reserve Bank stock . . . . .	4,906	3,814	—
Purchase of Federal Reserve Bank stock . . . . .	(458)	(314)	(2,581)
Net (increase) decrease in portfolio loans (loans originated, net of principal payments) . . . . .	(74,343)	(37,195)	33,192
Purchase of portfolio loans . . . . .	(32,872)	—	—
Net proceeds from sale of watch, substandard and non-performing loans . . . . .	—	—	6,721
Net cash from (paid for) branch sale . . . . .	(7,229)	—	3,292
Proceeds from the collection of vehicle service contract counterparty receivables . . . . .	1,092	385	6,751
Proceeds from the sale of other real estate and repossessed assets . . . . .	6,179	18,471	13,546
Proceeds from the sale of property and equipment . . . . .	555	309	52
Capital expenditures . . . . .	(4,354)	(4,298)	(8,371)
Net Cash Used in Investing Activities . . . . .	(160,513)	(82,116)	(221,068)
CASH FLOW FROM FINANCING ACTIVITIES			
Net increase in total deposits . . . . .	170,314	39,496	105,269
Net increase (decrease) in other borrowings . . . . .	(1)	(1)	4
Proceeds from Federal Home Loan Bank advances . . . . .	100	100	100
Payments of Federal Home Loan Bank advances . . . . .	(615)	(4,817)	(541)
Net decrease in vehicle service contract counterparty payables . . . . .	(1,180)	(2,112)	(3,636)
Dividends paid . . . . .	(5,896)	(4,129)	—
Proceeds from issuance of common stock . . . . .	112	97	98,066
Repurchase of common stock . . . . .	(13,498)	—	—
Share based compensation withholding obligation . . . . .	(1,091)	—	(513)
Redemption of subordinated debt . . . . .	—	(4,654)	(9,452)
Redemption of convertible preferred stock and common stock warrant . . . . .	—	—	(81,000)
Net Cash From Financing Activities . . . . .	148,245	23,980	108,297
Net Increase (Decrease) in Cash and Cash Equivalents . . . . .	11,767	(45,065)	(60,701)
Cash and Cash Equivalents at Beginning of Year . . . . .	74,016	119,081	179,782
Cash and Cash Equivalents at End of Year . . . . .	\$ 85,783	\$ 74,016	\$ 119,081
Cash paid during the year for			
Interest . . . . .	\$ 5,769	\$ 7,365	\$ 15,914
Income taxes . . . . .	295	216	43
Transfers to other real estate and repossessed assets . . . . .	6,694	6,143	6,932
Transfer of payment plan receivables to vehicle service contract counterparty receivables . . . . .	1,203	180	792
Purchase of securities available for sale and interest bearing deposits - time not yet settled . . . . .	—	265	4,146

See accompanying notes to consolidated financial statements

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 – ACCOUNTING POLICIES

The accounting and reporting policies and practices of Independent Bank Corporation and subsidiaries conform to accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. 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. We are required to make material estimates and assumptions that are particularly susceptible to changes in the near term as we prepare the consolidated financial statements and report amounts for each of these items. Actual results may vary from these estimates.

Our subsidiary Independent Bank (“Bank”) transacts business in the single industry of commercial banking. Our Bank’s activities cover traditional phases of commercial banking, including checking and savings accounts, commercial lending, direct and indirect consumer financing and mortgage lending. Our principal markets are the rural and suburban communities across Lower Michigan that are served by our Bank’s branches and loan production offices. We also purchase payment plans from companies (which we refer to as “counterparties”) that provide vehicle service contracts and similar products to consumers, through our wholly owned subsidiary, Mepco Finance Corporation (“Mepco”). At December 31, 2015, 72.6% of our Bank’s loan portfolio was secured by real estate.

**PRINCIPLES OF CONSOLIDATION** — The consolidated financial statements include the accounts of Independent Bank Corporation and its subsidiaries. The income, expenses, assets and liabilities of the subsidiaries are included in the respective accounts of the consolidated financial statements, after elimination of all material intercompany accounts and transactions.

**STATEMENTS OF CASH FLOWS** — For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest bearing deposits and federal funds sold. Generally, federal funds are sold for one-day periods. We report net cash flows for customer loan and deposit transactions, for short-term borrowings and for vehicle service contract counterparty payables.

**INTEREST BEARING DEPOSITS** — Interest bearing deposits consist of overnight deposits with the Federal Reserve Bank.

**INTEREST BEARING DEPOSITS - TIME** — Interest bearing deposits - time consist of deposits with original maturities of 3 months or more.

**LOANS HELD FOR SALE** — Mortgage loans originated and intended for sale in the secondary market are carried at fair value. Fair value adjustments, as well as realized gains and losses, are recorded in current earnings.

**MORTGAGE LOAN SERVICING RIGHTS** — We recognize as separate assets the rights to service mortgage loans for others. The fair value of originated mortgage loan servicing rights has been determined based upon fair value indications for similar servicing. The mortgage loan servicing rights are amortized in proportion to and over the period of estimated net loan servicing income. We assess mortgage loan servicing rights for impairment based on the fair value of those rights. For purposes of measuring impairment, the characteristics used include interest rate, term and type. Amortization of and changes in the impairment reserve on originated mortgage loan servicing rights are included in mortgage loan servicing, net in the Consolidated Statements of Operations. The fair values of mortgage loan servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses. Mortgage loan servicing income is recorded for fees earned for servicing loans previously sold. The fees are generally based on a contractual percentage of the outstanding principal and are recorded as income when earned. Mortgage loan servicing fees, excluding amortization of and changes in the impairment reserve on originated mortgage loan servicing rights, totaled \$4.1 million, \$4.2 million and \$4.3 million for the years ended December 31, 2015, 2014 and 2013, respectively. Late fees and ancillary fees related to loan servicing are not material.

**TRANSFERS OF FINANCIAL ASSETS** — Transfers of financial assets are accounted for as sales when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

have been isolated from us, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and we do not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**SECURITIES** — We classify our securities as trading, held to maturity or available for sale. Trading securities are bought and held principally for the purpose of selling them in the near term and are reported at fair value with realized and unrealized gains and losses included in earnings. Securities held to maturity represent those securities for which we have the positive intent and ability to hold until maturity and are reported at cost, adjusted for amortization of premiums and accretion of discounts computed on the level-yield method. We did not have any securities held to maturity at December 31, 2015 and 2014. Securities available for sale represent those securities not classified as trading or held to maturity and are reported at fair value with unrealized gains and losses, net of applicable income taxes reported in other comprehensive income (loss).

We evaluate securities for OTTI at least on a quarterly basis and more frequently when economic or market conditions warrant such an evaluation. In performing this evaluation, 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 (loss). The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

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.

**FEDERAL HOME LOAN BANK (“FHLB”) STOCK** — Our Bank subsidiary is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income in interest income-other investments on the Consolidated Statements of Operations.

**FEDERAL RESERVE BANK (“FRB”) STOCK** — Our Bank subsidiary is a member of its regional Federal Reserve Bank. FRB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income in interest income-other investments on the Consolidated Statements of Operations.

**LOAN REVENUE RECOGNITION** — Interest on loans is accrued based on the principal amounts outstanding. In general, the accrual of interest income is discontinued when a loan becomes 90 days past due for commercial loans and installment loans and when a loan misses four consecutive payments for mortgage loans and the borrower’s capacity to repay the loan and collateral values appear insufficient for each loan class. However, loans may be placed on non-accrual status regardless of whether or not such loans are considered past due if, in management’s opinion, the borrower is unable to meet payment obligations as they become due or as required by regulatory provisions. All interest accrued but not received for all loans placed on non-accrual is reversed from interest income. Payments on such loans are generally applied to the principal balance until qualifying to be returned to accrual status. A non-accrual loan may be restored to accrual status when interest and principal payments are current and the loan appears otherwise collectible. Delinquency status for all classes in the commercial and installment loan segments is based on the actual number of days past due as required by the contractual terms of the loan agreement while delinquency status for mortgage loan segment classes is based on the number of payments past due.

Certain loan fees and direct loan origination costs are deferred and recognized as an adjustment of yield generally over the contractual life of the related loan. Fees received in connection with loan commitments are deferred until the loan is advanced and are then recognized generally over the contractual life of the loan as an adjustment of yield. Fees on commitments that expire unused are recognized at expiration. Fees received for letters of credit are recognized as revenue over the life of the commitment.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**PAYMENT PLAN RECEIVABLE REVENUE RECOGNITION** — Payment plan receivables are acquired by our Mepco segment at a discount and reported net of this discount in the Consolidated Statements of Financial Condition. This discount is accreted into interest and fees on loans over the life of the receivable computed on a level-yield method. All classes of payment plan receivables that have been canceled and are 90 days or more past due as required by the contractual terms of the payment plan are classified as non-accrual.

**ALLOWANCE FOR LOAN LOSSES** — Portfolios are disaggregated into segments for purposes of determining the allowance for loan losses (“AFL”) which include commercial, mortgage and installment loans and payment plan receivables. These segments are further disaggregated into classes for purposes of monitoring and assessing credit quality based on certain risk characteristics. Classes within the commercial loan segment include (i) income producing – real estate, (ii) land, land development and construction – real estate and (iii) commercial and industrial. Classes within the mortgage loan segment include (i) 1-4 family, (ii) resort lending, (iii) home equity – 1st lien, (iv) home equity – 2nd lien and beginning in 2015 (v) purchased loans. Classes within the installment loan segment include (i) home equity – 1st lien, (ii) home equity – 2nd lien, (iii) loans not secured by real estate and (iv) other. Classes within the payment plan receivables segment include (i) full refund, (ii) partial refund and (iii) other. Commercial loans are subject to adverse market conditions which may impact the borrower’s ability to make repayment on the loan or could cause a decline in the value of the collateral that secures the loan. Mortgage and installment loans and payment plan receivables are subject to adverse employment conditions in the local economy which could increase default rates. In addition, mortgage loans and real estate based installment loans are subject to adverse market conditions which could cause a decline in the value of collateral that secures the loan. For an analysis of the AFL by portfolio segment and credit quality information by class, see note #4.

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

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

Increases in the AFL are recorded by a provision for loan losses charged to expense. Although we periodically allocate portions of the AFL to specific loans and loan portfolios, the entire AFL is available for incurred losses.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

We generally charge-off commercial, homogenous residential mortgage and installment loans and payment plan receivables when they are deemed uncollectible or reach a predetermined number of days past due based on loan product, industry practice and other factors. Collection efforts may continue and recoveries may occur after a loan is charged against the AFLL.

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

A loan is impaired when full payment under the loan terms is not expected. Generally, those loans included in each commercial loan class that are rated substandard, classified as non-performing or were classified as non-performing in the preceding quarter, are evaluated for impairment. Those loans included in each mortgage loan or installment class whose terms have been modified and considered a troubled debt restructuring are also impaired. Loans which have been modified resulting in a concession, and which the borrower is experiencing financial difficulties, are considered troubled debt restructurings (“TDR”) and classified as 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. Large groups of smaller balance homogeneous loans, such as those loans included in each installment and mortgage loan class and each payment plan receivable class, are collectively evaluated for impairment and accordingly, they are not separately identified for impairment disclosures. TDR loans are measured at the present value of estimated future cash flows using the loan’s effective interest rate at inception of the loan. If a TDR is considered to be a collateral dependent loan, the loan is reported net, at the fair value of collateral. A loan can be removed from TDR status if it is subsequently restructured and the borrower is no longer experiencing financial difficulties and the newly restructured agreement does not contain any concessions to the borrower. The new agreement must specify market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, and other terms no less favorable to us than those we would offer for similar new debt.

**PROPERTY AND EQUIPMENT** — Property and equipment is stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed using both straight-line and accelerated methods over the estimated useful lives of the related assets. Buildings are generally depreciated over a period not exceeding 39 years and equipment is generally depreciated over periods not exceeding 7 years. Leasehold improvements are depreciated over the shorter of their estimated useful life or lease period.

**BANK OWNED LIFE INSURANCE** — We have purchased a group flexible premium non-participating variable life insurance contract on approximately 270 lives (who were salaried employees at the time we purchased the contract) in order to recover the cost of providing certain employee benefits. Bank owned life insurance is recorded at its cash surrender value or the amount that can be currently realized.

**OTHER REAL ESTATE AND REPOSSESSED ASSETS** — Other real estate at the time of acquisition is recorded at fair value, less estimated costs to sell, which becomes the property’s new basis. Fair value is typically determined by a third party appraisal of the property. Any write-downs at date of acquisition are charged to the allowance for loan losses. Expense incurred in maintaining other real estate and subsequent write-downs to reflect declines in value and gains or losses on the sale of other real estate are recorded in the Consolidated Statements of Operations. Non-real estate repossessed assets are treated in a similar manner.

**OTHER INTANGIBLE ASSETS** — Other intangible assets consist of core deposits. They are initially measured at fair value and then are amortized on both straight-line and accelerated methods over their estimated useful lives, which range from 10 to 15 years.

**VEHICLE SERVICE CONTRACT COUNTERPARTY RECEIVABLES, NET** — These amounts represent funds due to Mepco from its counterparties for cancelled service contracts. Upon the cancellation of a service contract and the completion of the billing process to the counterparties for amounts due to Mepco, there is a decrease in the amount of “payment plan receivables” and an increase in the amount of “vehicle service contract counterparty receivables” until such time as the amount due from the counterparty is collected.

**INCOME TAXES** — We employ the asset and liability method of accounting for income taxes. This method establishes deferred tax assets and liabilities for the temporary differences between the financial reporting basis and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the tax basis of our assets and liabilities at tax rates expected to be in effect when such amounts are realized or settled. Under this method, the effect of a change in tax rates is recognized in the period that includes the enactment date. The deferred tax asset is subject to a valuation allowance for that portion of the asset for which it is more likely than not that it will not be realized.

A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination.

We recognize interest and/or penalties related to income tax matters in income tax expense.

We file a consolidated federal income tax return. Intercompany tax liabilities are settled as if each subsidiary filed a separate return.

**VEHICLE SERVICE CONTRACT COUNTERPARTY PAYABLES** — Vehicle service contract counterparty payables represent amounts owed to insurance companies or other counterparties for vehicle service contract payment plans purchased by us. The vehicle service contract counterparty payable becomes due in accordance with the terms of the specific contract between Mepco and the counterparty. Typically these terms require payment after Mepco has received one or two payments from the consumer on the payment plan receivable.

**COMMITMENTS TO EXTEND CREDIT AND RELATED FINANCIAL INSTRUMENTS** — Financial instruments may include commitments to extend credit and standby letters of credit. Financial instruments involve varying degrees of credit and interest-rate risk in excess of amounts reflected in the Consolidated Statements of Financial Condition. Exposure to credit risk in the event of non-performance by the counterparties to the financial instruments for loan commitments to extend credit and letters of credit is represented by the contractual amounts of those instruments. In general, we use a similar methodology to estimate our liability for these off-balance sheet credit exposures as we do for our allowance for loan losses. For commercial related commitments, we estimate liability using our loan rating system and for mortgage and installment commitments we estimate liability principally upon historical loss experience. Our estimated liability for off balance sheet commitments is included in accrued expenses and other liabilities in our Consolidated Statements of Financial Condition and any charge or recovery is recorded in non-interest expenses in our Consolidated Statements of Operations.

**DERIVATIVE FINANCIAL INSTRUMENTS** — We record derivatives on our 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.

At the inception of the derivative we designate the derivative as one of three types based on our intention and belief as to likely effectiveness as a hedge. These three types are (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (“Fair Value Hedge”), (2) a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (“Cash Flow Hedge”), or (3) an instrument with no hedging designation. For a Fair Value Hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item, are recognized in current earnings as fair values change. For a Cash Flow Hedge, the gain or loss on the derivative is reported in other comprehensive income (loss) and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. We did not have any Fair Value Hedges or Cash Flow Hedges at December 31, 2015 or 2014. For both types of hedges, changes in the fair value of derivatives that are not highly effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings. For instruments with no hedging designation, the gain or loss on the derivative is reported in earnings. These free standing instruments currently consist of (i) mortgage banking related derivatives and include rate-lock loan commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and mandatory forward commitments for the future delivery of these mortgage loans, (ii) certain pay-fixed and pay-variable interest rate swap agreements related to commercial loan customers and (iii) certain purchased and written options related to a time deposit product. Fair values of the mortgage derivatives are estimated based on mortgage backed security pricing for comparable assets. We enter into mandatory forward commitments for the future delivery of mortgage loans generally when interest rate locks are entered into in order

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

to hedge the change in interest rates resulting from our commitments to fund the loans. Changes in the fair values of these derivatives are included in net gains on mortgage loans. Fair values of the pay-fixed and pay-variable interest rate swap agreements are based on discounted cash flow analyses and are included in net interest income. Fair values of the purchased and written options are based on prices of financial instruments with similar characteristics and are included in net interest income.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest expense. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in non-interest income (mortgage banking related derivatives) or net interest income (interest rate swap agreements and options). Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

We formally document the relationship between derivatives and hedged items, as well as the risk- management objective and the strategy for undertaking hedge transactions, at the inception of the hedging relationship. This documentation includes linking Fair Value or Cash Flow Hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. We also assess, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. We discontinue hedge accounting when it is determined that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded in earnings. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive loss are amortized into earnings over the same periods which the hedged transactions will affect earnings.

**COMPREHENSIVE INCOME** — Comprehensive income consists of net income, unrealized gains and losses on securities available for sale and derivative instruments classified as cash flow hedges.

**INCOME PER COMMON SHARE** — Basic income per common share is computed by dividing net income applicable to common stock by the weighted average number of common shares outstanding during the period and participating share awards. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. For diluted income per common share, net income is divided by the weighted average number of common shares outstanding during the period plus the dilutive effects of the assumed conversion of convertible preferred stock, assumed exercise of common stock warrants, assumed exercise of stock options, restricted stock units and stock units for a deferred compensation plan for non-employee directors.

**SHARE BASED COMPENSATION** — Cost is recognized for stock options and non-vested share awards issued to employees based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, a simulation analysis which considers potential outcomes for a large number of independent scenarios is utilized to estimate the fair value of performance share units and the market price of our common stock at the date of grant is used for other non-vested share awards. Cost is recognized over the required service period, generally defined as the vesting period. Cost is also recognized for salary stock issued to employees and stock issued to non-employee directors. These shares vest immediately and cost is recognized during the period they are issued.

**COMMON STOCK** — At December 31, 2015, 0.1 million shares of common stock were reserved for issuance under the dividend reinvestment plan and 0.5 million shares of common stock were reserved for issuance under our long-term incentive plans.

**RECLASSIFICATION** — Certain amounts in the 2014 and 2013 consolidated financial statements have been reclassified to conform to the 2015 presentation.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**ADOPTION OF NEW ACCOUNTING STANDARDS** — In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-04, “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure”. The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. This amendment is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014, with early adoption and retrospective or prospective application permitted. This amended guidance became effective for us on January 1, 2015, 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, 2018, and is not expected to have a material impact on our consolidated operating results or financial condition.

In June 2014, the FASB issued ASU 2014-12, “Compensation – Stock Compensation (Topic 718) – Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period”. This ASU amends existing guidance related to the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. These amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. This amended guidance is effective for us on January 1, 2016, and is not expected to have a material impact on our consolidated operating results or financial condition.

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

### NOTE 2 – RESTRICTIONS ON CASH AND DUE FROM BANKS

Our Bank is required to maintain reserve balances in the form of vault cash and non-interest earning balances with the FRB. The average reserve balances to be maintained during 2015 and 2014 were \$3.2 million and \$15.3 million, respectively. We do not maintain compensating balances with correspondent banks. We are also required to maintain reserve balances related primarily to our merchant payment processing operations and for certain investment security transactions. These balances are held at unrelated financial institutions and totaled \$2.5 million and \$2.8 million at December 31, 2015 and 2014, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

## NOTE 3 – SECURITIES

Securities available for sale consist of the following at December 31:

	Amortized Cost	Unrealized Gains      Losses		Fair Value
		(In thousands)		
2015				
U.S. agency .....	\$ 47,283	\$ 309	\$ 80	\$ 47,512
U.S. agency residential mortgage-backed .....	195,055	1,584	583	196,056
U.S. agency commercial mortgage-backed .....	34,017	94	83	34,028
Private label residential mortgage-backed .....	5,061	161	319	4,903
Other asset backed .....	117,431	54	581	116,904
Obligations of states and political subdivisions .....	145,193	941	1,150	144,984
Corporate .....	38,895	9	290	38,614
Trust preferred .....	2,916	—	433	2,483
Total .....	<u>\$585,851</u>	<u>\$3,152</u>	<u>\$3,519</u>	<u>\$585,484</u>
2014				
U.S. agency .....	\$ 34,936	\$ 133	\$ 63	\$ 35,006
U.S. agency residential mortgage-backed .....	256,387	1,838	667	257,558
U.S. agency commercial mortgage-backed .....	33,779	68	119	33,728
Private label residential mortgage-backed .....	6,216	187	390	6,013
Other asset backed .....	32,314	77	38	32,353
Obligations of states and political subdivisions .....	143,698	961	1,244	143,415
Corporate .....	22,690	53	79	22,664
Trust preferred .....	2,910	—	469	2,441
Total .....	<u>\$532,930</u>	<u>\$3,317</u>	<u>\$3,069</u>	<u>\$533,178</u>

Total OTTI recognized in accumulated other comprehensive loss for securities available for sale was zero at both December 31, 2015 and 2014, respectively.

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, at December 31 follows:

	Less Than Twelve Months		Twelve Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
2015						
U.S. agency .....	\$ 12,164	\$ 47	\$ 6,746	\$ 33	\$ 18,910	\$ 80
U.S. agency residential mortgage-backed .....	57,538	316	23,340	267	80,878	583
U.S. agency commercial mortgage-backed .....	16,747	60	2,247	23	18,994	83
Private label residential mortgage-backed .....	—	—	3,393	319	3,393	319
Other asset backed .....	102,660	434	5,189	147	107,849	581
Obligations of states and political subdivisions .....	52,493	597	12,240	553	64,733	1,150
Corporate .....	30,550	290	—	—	30,550	290
Trust preferred .....	—	—	2,483	433	2,483	433
Total .....	<u>\$272,152</u>	<u>\$1,744</u>	<u>\$55,638</u>	<u>\$1,775</u>	<u>\$327,790</u>	<u>\$3,519</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Less Than Twelve Months		Twelve Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
2014						
U.S. agency . . . . .	\$ 12,851	\$ 58	\$ 606	\$ 5	\$ 13,457	\$ 63
U.S. agency residential mortgage-backed . . . . .	89,547	531	15,793	136	105,340	667
U.S. agency commercial mortgage-backed . . . . .	21,325	119	—	—	21,325	119
Private label residential mortgage-backed . . . . .	208	1	4,013	389	4,221	390
Other asset backed . . . . .	2,960	15	8,729	23	11,689	38
Obligations of states and political subdivisions . . . . .	28,114	106	37,540	1,138	65,654	1,244
Corporate . . . . .	8,660	79	—	—	8,660	79
Trust preferred . . . . .	—	—	2,441	469	2,441	469
Total . . . . .	<u>\$163,665</u>	<u>\$909</u>	<u>\$69,122</u>	<u>\$2,160</u>	<u>\$232,787</u>	<u>\$3,069</u>

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

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at December 31, 2015, we had 39 U.S. agency, 108 U.S. agency residential mortgage-backed and 18 U.S. agency commercial mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to increases in interest rates since acquisition and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label residential mortgage backed securities — at December 31, 2015, we had five of this type of security whose fair value is less than amortized cost. Two of the five issues are rated by a major rating agency as investment grade, two are rated below investment grade and one is split rated. Two of these bonds have an impairment in excess of 10% and all five 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.

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. 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. Our cash flow analysis forecasts complete recovery of our cost basis for four of the five securities whose fair value is less than amortized cost while the fifth security had credit related OTTI recognized in prior years and is discussed in further detail below.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

Other asset backed — at December 31, 2015, we had 129 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at December 31, 2015, we had 79 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at December 31, 2015, we had 27 corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at December 31, 2015, we had three trust preferred securities whose fair value is less than amortized cost. All of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities has suffered from credit spread widening.

One of the three securities is rated by two major rating agencies as investment grade, while one (a Bank of America issuance) is rated below investment grade by two major rating agencies and the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.8 million as of December 31, 2015, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of December 31:

	<b>2015</b>		<b>2014</b>	
	<b>Fair Value</b>	<b>Net Unrealized Loss</b>	<b>Fair Value</b>	<b>Net Unrealized Loss</b>
	<b>(In thousands)</b>			
Trust preferred securities				
Rated issues . . . . .	\$1,690	\$(226)	\$1,643	\$(267)
Unrated issues . . . . .	793	(207)	798	(202)

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.

During 2015, 2014 and 2013, we recorded in earnings credit related OTTI charges on securities available for sale of zero, \$0.01 million and \$0.03 million, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

At December 31, 2015, three private label residential mortgage-backed securities had credit related OTTI and are summarized as follows:

	<u>Senior Security</u>	<u>Super Senior Security</u>	<u>Senior Support Security</u>	<u>Total</u>
	(In thousands)			
As of December 31, 2015				
Fair value . . . . .	\$1,616	\$1,331	\$ 79	\$3,026
Amortized cost . . . . .	1,635	1,249	—	2,884
Non-credit unrealized loss . . . . .	19	—	—	19
Unrealized gain . . . . .	—	82	79	161
Cumulative credit related OTTI . . . . .	757	457	380	1,594

Credit related OTTI recognized in our Consolidated  
Statements of Operations

For the years ended December 31,

2015 . . . . .	\$ —	\$ —	\$ —	\$ —
2014 . . . . .	9	—	—	9
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 December 31, 2015. 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 (loss) during those same periods.

A roll forward of credit losses recognized in earnings on securities available for sale for the years ending December 31 follow:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Balance at beginning of year . . . . .	\$1,844	\$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 . . . . .	—	9	26
Total . . . . .	<u>\$1,844</u>	<u>\$1,844</u>	<u>\$1,835</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The amortized cost and fair value of securities available for sale at December 31, 2015, by contractual maturity, follow:

	<u>Amortized Cost</u>	<u>Fair Value</u>
	(In thousands)	
Maturing within one year .....	\$ 34,565	\$ 34,591
Maturing after one year but within five years .....	69,976	69,916
Maturing after five years but within ten years .....	46,512	46,641
Maturing after ten years .....	<u>83,234</u>	<u>82,445</u>
	234,287	233,593
U.S. agency residential mortgage-backed .....	195,055	196,056
U.S. agency commercial mortgage-backed .....	34,017	34,028
Private label residential mortgage-backed .....	5,061	4,903
Other asset backed .....	<u>117,431</u>	<u>116,904</u>
Total .....	<u>\$585,851</u>	<u>\$585,484</u>

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.

A summary of proceeds from the sale of securities available for sale and gains and losses for the years ended December 31 follow:

	<u>Proceeds</u>	<u>Realized Gains (1)</u>	<u>Losses (2)</u>
	(In thousands)		
2015 .....	\$12,037	\$ 75	\$—
2014 .....	14,633	329	—
2013 .....	2,940	15	8

(1) Gains in 2014 exclude \$0.3 million of realized gain related to a U.S. Treasury short position.

(2) Losses in 2014 and 2013 exclude \$0.01 million and \$0.03 million, respectively of credit related OTTI recognized in earnings.

During 2015, 2014 and 2013, our trading securities consisted of various preferred stocks. During each of those years, we recognized gains (losses) on trading securities of \$(0.06) million, \$(0.30) million and \$0.39 million, respectively, that are included in net gains on securities in the Consolidated Statements of Operations. All of these amounts relate to gains (losses) recognized on trading securities still held at December 31, 2015 and 2014.

Securities with a book value of \$1.1 million at both December 31, 2015 and 2014, respectively, were pledged to secure borrowings, derivatives, public deposits and for other purposes as required by law. There were no investment obligations of state and political subdivisions that were payable from or secured by the same source of revenue or taxing authority that exceeded 10% of consolidated shareholders' equity at December 31, 2015 or 2014.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**NOTE 4 – LOANS AND PAYMENT PLAN RECEIVABLES**

Our loan portfolios at December 31 follow:

	<u>2015</u>	<u>2014</u>
	<u>(In thousands)</u>	
Real estate (1)		
Residential first mortgages . . . . .	\$ 432,215	\$ 411,423
Residential home equity and other junior mortgages . . . . .	106,297	108,162
Construction and land development . . . . .	62,629	54,644
Other (2) . . . . .	498,706	447,837
Consumer . . . . .	193,350	154,591
Commercial . . . . .	180,424	186,875
Payment plan receivables . . . . .	34,599	40,001
Agricultural . . . . .	6,830	6,429
Total loans . . . . .	<u>\$1,515,050</u>	<u>\$1,409,962</u>

(1) Includes both residential and non-residential commercial loans secured by real estate.

(2) Includes loans secured by multi-family residential and non-farm, non-residential property.

Loans include net deferred loan costs of \$2.2 million and \$1.0 million at December 31, 2015 and 2014, respectively. Payment plan receivables totaling \$36.9 million and \$42.6 million at December 31, 2015 and 2014, respectively, are presented net of unamortized discount of \$2.3 million and \$2.6 million at December 31, 2015 and 2014, respectively. These payment plan receivables had effective yields of 13% and 14% at December 31, 2015 and 2014, respectively. These receivables have various due dates through January 2018.

In December 2015, we purchased \$32.6 million of single-family residential fixed rate jumbo mortgage loans from another Michigan-based financial institution. These mortgage loans were all on properties located in Michigan, had a weighted average interest rate (after a 0.25% servicing fee) of 3.94% and a weighted average remaining contractual maturity of 344 months.

An analysis of the allowance for loan losses by portfolio segment for the years ended December 31 follows:

	<u>Commercial</u>	<u>Mortgage</u>	<u>Installment</u>	<u>Payment Plan Receivables</u>	<u>Subjective Allocation</u>	<u>Total</u>
	<u>(In thousands)</u>					
2015						
Balance at beginning of period . . . . .	\$ 5,445	\$13,444	\$ 1,814	\$ 64	\$5,223	\$ 25,990
Additions (deductions)						
Provision for loan losses . . . . .	(737)	(1,744)	(274)	(8)	49	(2,714)
Recoveries credited to allowance . . . . .	2,656	1,258	1,108	—	—	5,022
Loans charged against the allowance . . . . .	<u>(1,694)</u>	<u>(2,567)</u>	<u>(1,467)</u>	<u>—</u>	<u>—</u>	<u>(5,728)</u>
Balance at end of period . . . . .	<u>\$ 5,670</u>	<u>\$10,391</u>	<u>\$ 1,811</u>	<u>\$ 56</u>	<u>\$5,272</u>	<u>\$ 22,570</u>
2014						
Balance at beginning of period . . . . .	\$ 6,827	\$17,195	\$ 2,246	\$ 97	\$5,960	\$ 32,325
Additions (deductions)						
Provision for loan losses . . . . .	(1,683)	(1,029)	349	(36)	(737)	(3,136)
Recoveries credited to allowance . . . . .	4,914	1,397	1,104	5	—	7,420
Loans charged against the allowance . . . . .	<u>(4,613)</u>	<u>(4,119)</u>	<u>(1,885)</u>	<u>(2)</u>	<u>—</u>	<u>(10,619)</u>
Balance at end of period . . . . .	<u>\$ 5,445</u>	<u>\$13,444</u>	<u>\$ 1,814</u>	<u>\$ 64</u>	<u>\$5,223</u>	<u>\$ 25,990</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	<u>Commercial</u>	<u>Mortgage</u>	<u>Installment</u>	<u>Payment Plan Receivables</u>	<u>Subjective Allocation</u>	<u>Total</u>
	(In thousands)					
2013						
Balance at beginning of period . . . . .	\$11,402	\$21,447	\$ 3,378	\$144	\$ 7,904	\$ 44,275
Additions (deductions)						
Provision for loan losses . . . . .	(2,336)	71	314	(93)	(1,944)	(3,988)
Recoveries credited to allowance . . .	5,119	1,996	1,074	81	—	8,270
Loans charged against the allowance . . . . .	<u>(7,358)</u>	<u>(6,319)</u>	<u>(2,520)</u>	<u>(35)</u>	<u>—</u>	<u>(16,232)</u>
Balance at end of period . . . . .	<u>\$ 6,827</u>	<u>\$17,195</u>	<u>\$ 2,246</u>	<u>\$ 97</u>	<u>\$ 5,960</u>	<u>\$ 32,325</u>

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

	<u>Commercial</u>	<u>Mortgage</u>	<u>Installment</u>	<u>Payment Plan Receivables</u>	<u>Subjective Allocation</u>	<u>Total</u>
	(In thousands)					
2015						
Allowance for loan losses:						
Individually evaluated for						
impairment . . . . .	\$ 2,708	\$ 7,818	\$ 457	\$ —	\$ —	\$ 10,983
Collectively evaluated for						
impairment . . . . .	<u>2,962</u>	<u>2,573</u>	<u>724</u>	<u>56</u>	<u>5,272</u>	<u>11,587</u>
Total ending allowance balance . . . . .	<u>\$ 5,670</u>	<u>\$ 10,391</u>	<u>\$ 1,181</u>	<u>\$ 56</u>	<u>\$5,272</u>	<u>\$ 22,570</u>
Loans						
Individually evaluated for						
impairment . . . . .	\$ 16,868	\$ 66,375	\$ 5,888	\$ —		\$ 89,131
Collectively evaluated for						
impairment . . . . .	<u>733,399</u>	<u>436,349</u>	<u>226,409</u>	<u>34,599</u>		<u>1,430,756</u>
Total loans recorded investment . . . . .	<u>750,267</u>	<u>502,724</u>	<u>232,297</u>	<u>34,599</u>		<u>1,519,887</u>
Accrued interest included in recorded						
investment . . . . .	<u>1,869</u>	<u>2,270</u>	<u>698</u>	<u>—</u>		<u>4,837</u>
Total loans . . . . .	<u>\$748,398</u>	<u>\$500,454</u>	<u>\$231,599</u>	<u>\$34,599</u>		<u>\$1,515,050</u>
2014						
Allowance for loan losses:						
Individually evaluated for						
impairment . . . . .	\$ 3,194	\$ 9,311	\$ 728	\$ —	\$ —	\$ 13,233
Collectively evaluated for						
impairment . . . . .	<u>2,251</u>	<u>4,133</u>	<u>1,086</u>	<u>64</u>	<u>5,223</u>	<u>12,757</u>
Total ending allowance balance . . . . .	<u>\$ 5,445</u>	<u>\$ 13,444</u>	<u>\$ 1,814</u>	<u>\$ 64</u>	<u>\$5,223</u>	<u>\$ 25,990</u>
Loans						
Individually evaluated for						
impairment . . . . .	\$ 34,147	\$ 72,340	\$ 6,679	\$ —		\$ 113,166
Collectively evaluated for						
impairment . . . . .	<u>658,423</u>	<u>402,458</u>	<u>200,368</u>	<u>40,001</u>		<u>1,301,250</u>
Total loans recorded investment . . . . .	<u>692,570</u>	<u>474,798</u>	<u>207,047</u>	<u>40,001</u>		<u>1,414,416</u>
Accrued interest included in recorded						
investment . . . . .	<u>1,615</u>	<u>2,170</u>	<u>669</u>	<u>—</u>		<u>4,454</u>
Total loans . . . . .	<u>\$690,955</u>	<u>\$472,628</u>	<u>\$206,378</u>	<u>\$40,001</u>		<u>\$1,409,962</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Non-performing loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. If these loans had continued to accrue interest in accordance with their original terms, approximately \$0.6 million, \$0.8 million and \$1.2 million of interest income would have been recognized in 2015, 2014 and 2013, respectively. Interest income recorded on these loans was approximately zero during the years ended 2015 and 2014 and \$0.1 million in 2013.

Loans on non-accrual status and past due more than 90 days (“Non-performing Loans”) at December 31 follow:

	<u>90+ and Still Accruing</u>	<u>Non- Accrual</u>	<u>Total Non- Performing Loans</u>
	(In thousands)		
2015			
Commercial			
Income producing - real estate . . . . .	\$ —	\$ 1,027	\$ 1,027
Land, land development and construction - real estate . . . . .	49	401	450
Commercial and industrial . . . . .	69	2,028	2,097
Mortgage			
1-4 family . . . . .	—	4,744	4,744
Resort lending . . . . .	—	1,094	1,094
Home equity - 1st lien . . . . .	—	187	187
Home equity - 2nd lien . . . . .	—	147	147
Purchased loans . . . . .	—	2	2
Installment			
Home equity - 1st lien . . . . .	—	106	106
Home equity - 2nd lien . . . . .	—	443	443
Loans not secured by real estate . . . . .	—	421	421
Other . . . . .	—	2	2
Payment plan receivables			
Full refund . . . . .	—	2	2
Partial refund . . . . .	—	2	2
Other . . . . .	—	1	1
Total recorded investment . . . . .	<u>\$118</u>	<u>\$10,607</u>	<u>\$10,725</u>
Accrued interest included in recorded investment . . . . .	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 2</u>
2014			
Commercial			
Income producing - real estate . . . . .	\$ —	\$ 1,233	\$ 1,233
Land, land development and construction - real estate . . . . .	—	594	594
Commercial and industrial . . . . .	—	2,746	2,746
Mortgage			
1-4 family . . . . .	7	5,945	5,952
Resort lending . . . . .	—	2,168	2,168
Home equity - 1st lien . . . . .	—	331	331
Home equity - 2nd lien . . . . .	—	605	605
Installment			
Home equity - 1st lien . . . . .	—	576	576
Home equity - 2nd lien . . . . .	—	517	517
Loans not secured by real estate . . . . .	—	454	454
Other . . . . .	—	48	48
Payment plan receivables			
Full refund . . . . .	—	2	2
Partial refund . . . . .	—	12	12
Other . . . . .	—	—	—
Total recorded investment . . . . .	<u>\$ 7</u>	<u>\$15,231</u>	<u>\$15,238</u>
Accrued interest included in recorded investment . . . . .	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

An aging analysis of loans by class at December 31 follows:

	Loans Past Due				Loans not Past Due	Total Loans
	30-59 days	60-89 days	90+ days	Total		
	(In thousands)					
2015						
Commercial						
Income producing - real estate . . . . .	\$ 203	\$ 209	\$ 647	\$ 1,059	\$ 305,155	\$ 306,214
Land, land development and construction - real estate . . . . .	—	—	252	252	44,231	44,483
Commercial and industrial . . . . .	785	16	151	952	398,618	399,570
Mortgage						
1-4 family . . . . .	1,943	640	4,744	7,327	272,298	279,625
Resort lending . . . . .	307	—	1,094	1,401	114,619	116,020
Home equity - 1st lien . . . . .	50	—	187	237	22,327	22,564
Home equity - 2nd lien . . . . .	439	54	147	640	50,618	51,258
Purchased loans . . . . .	9	1	2	12	33,245	33,257
Installment						
Home equity - 1st lien . . . . .	315	107	106	528	16,707	17,235
Home equity - 2nd lien . . . . .	231	149	443	823	19,727	20,550
Loans not secured by real estate . . . . .	567	83	421	1,071	191,262	192,333
Other . . . . .	15	3	2	20	2,159	2,179
Payment plan receivables						
Full refund . . . . .	492	62	2	556	21,294	21,850
Partial refund . . . . .	415	228	2	645	5,834	6,479
Other . . . . .	110	3	1	114	6,156	6,270
Total recorded investment . . . . .	<u>\$5,881</u>	<u>\$1,555</u>	<u>\$ 8,201</u>	<u>\$15,637</u>	<u>\$1,504,250</u>	<u>\$1,519,887</u>
Accrued interest included in recorded investment . . . . .	<u>\$ 53</u>	<u>\$ 17</u>	<u>\$ 2</u>	<u>\$ 72</u>	<u>\$ 4,765</u>	<u>\$ 4,837</u>
2014						
Commercial						
Income producing - real estate . . . . .	\$ 89	\$ —	\$ 214	\$ 303	\$ 252,763	\$ 253,066
Land, land development and construction - real estate . . . . .	131	—	223	354	33,984	34,338
Commercial and industrial . . . . .	2,391	279	209	2,879	402,287	405,166
Mortgage						
1-4 family . . . . .	1,877	1,638	5,952	9,467	269,719	279,186
Resort lending . . . . .	226	—	2,168	2,394	126,342	128,736
Home equity - 1st lien . . . . .	39	50	331	420	19,782	20,202
Home equity - 2nd lien . . . . .	711	89	605	1,405	45,269	46,674
Installment						
Home equity - 1st lien . . . . .	466	37	576	1,079	20,995	22,074
Home equity - 2nd lien . . . . .	369	81	517	967	28,125	29,092
Loans not secured by real estate . . . . .	589	231	454	1,274	152,115	153,389
Other . . . . .	15	3	48	66	2,426	2,492
Payment plan receivables						
Full refund . . . . .	838	214	2	1,054	26,799	27,853
Partial refund . . . . .	409	123	12	544	6,550	7,094
Other . . . . .	96	24	—	120	4,934	5,054
Total recorded investment . . . . .	<u>\$8,246</u>	<u>\$2,769</u>	<u>\$11,311</u>	<u>\$22,326</u>	<u>\$1,392,090</u>	<u>\$1,414,416</u>
Accrued interest included in recorded investment . . . . .	<u>\$ 55</u>	<u>\$ 29</u>	<u>\$ —</u>	<u>\$ 84</u>	<u>\$ 4,370</u>	<u>\$ 4,454</u>

# **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Impaired loans are as follows:

	<u>December 31,</u>	
	<u>2015</u>	<u>2014</u>
	<u>(In thousands)</u>	
Impaired loans with no allocated allowance		
TDR .....	\$ 2,518	\$ 9,325
Non - TDR .....	203	299
Impaired loans with an allocated allowance		
TDR - allowance based on collateral .....	4,810	5,879
TDR - allowance based on present value cash flow .....	81,002	94,970
Non - TDR - allowance based on collateral .....	260	2,296
Non - TDR - allowance based on present value cash flow .....	<u>—</u>	<u>—</u>
Total impaired loans .....	<u>\$88,793</u>	<u>\$112,769</u>
Amount of allowance for loan losses allocated		
TDR - allowance based on collateral .....	\$ 2,436	\$ 2,025
TDR - allowance based on present value cash flow .....	8,471	10,188
Non - TDR - allowance based on collateral .....	76	1,020
Non - TDR - allowance based on present value cash flow .....	<u>—</u>	<u>—</u>
Total amount of allowance for loan losses allocated .....	<u>\$10,983</u>	<u>\$ 13,233</u>



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Impaired loans by class as of December 31 are as follows (1):

	2015			2014		
	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 . . . . .	\$ 641	\$ 851	\$ —	\$ 5,868	\$ 6,077	\$ —
Land, land development & construction-real estate . . . . .	818	1,393	—	1,051	1,606	—
Commercial and industrial . . . . .	1,245	1,241	—	2,685	2,667	—
Mortgage						
1-4 family . . . . .	23	183	—	—	49	—
Resort lending . . . . .	—	—	—	48	397	—
Home equity - 1st lien . . . . .	—	—	—	—	—	—
Home equity - 2nd lien . . . . .	—	—	—	—	—	—
Installment						
Home equity - 1st lien . . . . .	—	76	—	—	40	—
Home equity - 2nd lien . . . . .	—	—	—	—	—	—
Loans not secured by real estate . . . . .	—	—	—	—	—	—
Other . . . . .	—	—	—	—	—	—
	<u>2,727</u>	<u>3,744</u>	<u>—</u>	<u>9,652</u>	<u>10,836</u>	<u>—</u>
With an allowance recorded:						
Commercial						
Income producing - real estate . . . . .	8,377	9,232	516	12,836	13,797	689
Land, land development & construction-real estate . . . . .	1,690	1,778	296	3,456	3,528	499
Commercial and industrial . . . . .	4,097	4,439	1,896	8,251	8,486	2,006
Mortgage						
1-4 family . . . . .	47,792	49,808	5,132	53,206	56,063	6,195
Resort lending . . . . .	18,148	18,319	2,662	18,799	18,963	3,075
Home equity - 1st lien . . . . .	168	172	9	162	177	14
Home equity - 2nd lien . . . . .	244	325	15	125	205	27
Installment						
Home equity - 1st lien . . . . .	2,364	2,492	143	2,744	2,930	219
Home equity - 2nd lien . . . . .	2,929	2,951	271	3,212	3,215	419
Loans not secured by real estate . . . . .	587	658	42	711	835	89
Other . . . . .	8	8	1	12	12	1
	<u>86,404</u>	<u>90,182</u>	<u>10,983</u>	<u>103,514</u>	<u>108,211</u>	<u>13,233</u>
Total						
Commercial						
Income producing - real estate . . . . .	9,018	10,083	516	18,704	19,874	689
Land, land development & construction-real estate . . . . .	2,508	3,171	296	4,507	5,134	499
Commercial and industrial . . . . .	5,342	5,680	1,896	10,936	11,153	2,006
Mortgage						
1-4 family . . . . .	47,815	49,991	5,132	53,206	56,112	6,195
Resort lending . . . . .	18,148	18,319	2,662	18,847	19,360	3,075
Home equity - 1st lien . . . . .	168	172	9	162	177	14
Home equity - 2nd lien . . . . .	244	325	15	125	205	27
Installment						
Home equity - 1st lien . . . . .	2,364	2,568	143	2,744	2,970	219
Home equity - 2nd lien . . . . .	2,929	2,951	271	3,212	3,215	419
Loans not secured by real estate . . . . .	587	658	42	711	835	89
Other . . . . .	8	8	1	12	12	1
Total . . . . .	<u>\$89,131</u>	<u>\$93,926</u>	<u>\$10,983</u>	<u>\$113,166</u>	<u>\$119,047</u>	<u>\$13,233</u>
Accrued interest included in recorded investment . .	\$ 338			\$ 397		

(1) There were no impaired payment plan receivables or purchased mortgage loans at December 31, 2015 or 2014.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Average recorded investment in and interest income earned on impaired loans by class for the years ended December 31 follows (1):

	2015		2014		2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)					
<b>With no related allowance recorded:</b>						
Commercial						
Income producing - real estate . . . . .	\$ 4,520	\$ 387	\$ 7,660	\$ 250	\$ 5,765	\$ 340
Land, land development & construction-real estate . . . . .	952	79	1,145	64	3,092	240
Commercial and industrial . . . . .	2,125	257	3,351	152	3,980	226
Mortgage						
1-4 family . . . . .	19	11	29	—	5	11
Resort lending . . . . .	12	—	40	1	28	—
Home equity - 1st lien . . . . .	—	—	—	—	—	—
Home equity - 2nd lien . . . . .	—	—	—	—	—	—
Installment						
Home equity - 1st lien . . . . .	—	5	—	2	1,604	83
Home equity - 2nd lien . . . . .	—	—	—	—	1,841	96
Loans not secured by real estate . . . . .	—	—	—	—	470	23
Other . . . . .	—	—	—	—	15	1
	<u>7,628</u>	<u>739</u>	<u>12,225</u>	<u>469</u>	<u>16,800</u>	<u>1,020</u>
<b>With an allowance recorded:</b>						
Commercial						
Income producing - real estate . . . . .	12,677	439	12,772	677	18,164	587
Land, land development & construction-real estate . . . . .	2,219	54	3,939	149	6,186	149
Commercial and industrial . . . . .	6,663	104	8,500	294	11,795	457
Mortgage						
1-4 family . . . . .	50,421	2,140	55,877	2,286	60,858	2,622
Resort lending . . . . .	18,448	670	19,458	753	21,708	836
Home equity - 1st lien . . . . .	161	8	160	6	136	4
Home equity - 2nd lien . . . . .	172	13	57	2	42	2
Installment						
Home equity - 1st lien . . . . .	2,539	176	2,837	174	1,448	85
Home equity - 2nd lien . . . . .	3,055	193	3,359	188	1,546	86
Loans not secured by real estate . . . . .	653	37	719	35	314	17
Other . . . . .	10	1	14	1	3	1
	<u>97,018</u>	<u>3,835</u>	<u>107,692</u>	<u>4,565</u>	<u>122,200</u>	<u>4,846</u>
<b>Total</b>						
Commercial						
Income producing - real estate . . . . .	17,197	826	20,432	927	23,929	927
Land, land development & construction-real estate . . . . .	3,171	133	5,084	213	9,278	389
Commercial and industrial . . . . .	8,788	361	11,851	446	15,775	683
Mortgage						
1-4 family . . . . .	50,440	2,151	55,906	2,286	60,863	2,633
Resort lending . . . . .	18,460	670	19,498	754	21,736	836
Home equity - 1st lien . . . . .	161	8	160	6	136	4
Home equity - 2nd lien . . . . .	172	13	57	2	42	2
Installment						
Home equity - 1st lien . . . . .	2,539	181	2,837	176	3,052	168
Home equity - 2nd lien . . . . .	3,055	193	3,359	188	3,387	182
Loans not secured by real estate . . . . .	653	37	719	35	784	40
Other . . . . .	10	1	14	1	18	2
Total . . . . .	<u>\$104,646</u>	<u>\$4,574</u>	<u>\$119,917</u>	<u>\$5,034</u>	<u>\$139,000</u>	<u>\$5,866</u>

(1) There were no impaired payment plan receivables or purchased mortgage loans during the years ending December 31, 2015, 2014 and 2013.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Our average investment in impaired loans was approximately \$104.6 million, \$119.9 million and \$139.0 million in 2015, 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 was approximately \$4.6 million, \$5.0 million and \$5.9 million in 2015, 2014 and 2013, respectively, of which the majority of these amounts were received in cash.

Troubled debt restructurings at December 31 follow:

	2015		
	Commercial	Retail	Total
	(In thousands)		
Performing TDR's .....	\$13,318	\$68,194	\$81,512
Non-performing TDR's (1) .....	<u>3,041</u>	<u>3,777<sup>(2)</sup></u>	<u>6,818</u>
Total .....	<u>\$16,359</u>	<u>\$71,971</u>	<u>\$88,330</u>

	2014		
	Commercial	Retail	Total
	(In thousands)		
Performing TDR's .....	\$29,475	\$73,496	\$102,971
Non-performing TDR's (1) .....	<u>1,978</u>	<u>5,225<sup>(2)</sup></u>	<u>7,203</u>
Total .....	<u>\$31,453</u>	<u>\$78,721</u>	<u>\$110,174</u>

(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 have allocated \$10.9 million and \$12.2 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2015 and 2014, respectively. We have committed to lend additional amounts totaling up to \$0.04 million at both December 31, 2015 and 2014, respectively, to customers with outstanding loans that are classified as troubled debt restructurings.

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

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Loans that have been classified as troubled debt restructurings during the years ended December 31 follow:

	<u>Number of Contracts</u>	<u>Pre-modification Recorded Balance</u>	<u>Post-modification Recorded Balance</u>
		(Dollars in thousands)	
2015			
Commercial			
Income producing - real estate . . . . .	2	\$ 229	\$ 227
Land, land development & construction-real estate . . . . .	—	—	—
Commercial and industrial . . . . .	17	3,188	2,960
Mortgage			
1-4 family . . . . .	8	1,345	1,128
Resort lending . . . . .	1	313	307
Home equity - 1st lien . . . . .	1	20	20
Home equity - 2nd lien . . . . .	1	27	27
Purchased loans . . . . .	—	—	—
Installment			
Home equity - 1st lien . . . . .	6	220	186
Home equity - 2nd lien . . . . .	8	228	217
Loans not secured by real estate . . . . .	2	19	25
Other . . . . .	—	—	—
Total . . . . .	<u>46</u>	<u>\$ 5,589</u>	<u>\$ 5,097</u>
2014			
Commercial			
Income producing - real estate . . . . .	4	\$ 426	\$ 389
Land, land development & construction-real estate . . . . .	2	55	44
Commercial and industrial . . . . .	13	2,236	1,606
Mortgage			
1-4 family . . . . .	15	1,576	1,570
Resort lending . . . . .	6	1,583	1,572
Home equity - 1st lien . . . . .	1	17	14
Home equity - 2nd lien . . . . .	1	85	84
Installment			
Home equity - 1st lien . . . . .	13	631	523
Home equity - 2nd lien . . . . .	9	400	400
Loans not secured by real estate . . . . .	6	114	106
Other . . . . .	—	—	—
Total . . . . .	<u>70</u>	<u>\$ 7,123</u>	<u>\$ 6,308</u>
2013			
Commercial			
Income producing - real estate . . . . .	6	\$ 4,798	\$ 3,869
Land, land development & construction-real estate . . . . .	1	16	—
Commercial and industrial . . . . .	23	2,522	1,901
Mortgage			
1-4 family . . . . .	20	1,968	1,995
Resort lending . . . . .	5	1,240	1,231
Home equity - 1st lien . . . . .	1	95	97
Home equity - 2nd lien . . . . .	—	—	—
Installment			
Home equity - 1st lien . . . . .	25	659	657
Home equity - 2nd lien . . . . .	16	508	508
Loans not secured by real estate . . . . .	5	149	110
Other . . . . .	—	—	—
Total . . . . .	<u>102</u>	<u>\$11,955</u>	<u>\$10,368</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The troubled debt restructurings described above increased (decreased) the allowance for loan losses by \$0.4 million, \$0.2 million and \$(0.3) million during the years ended December 31, 2015, 2014 and 2013, respectively and resulted in charge offs of \$0.16 million, \$0.04 million and \$0.5 million during the years ended December 31, 2015, 2014 and 2013, respectively.

Loans that have been classified as troubled debt restructured during the past twelve months and that have subsequently defaulted during the years ended December 31 follows:

	<u>Number of Contracts</u>	<u>Recorded Balance</u>
	(Dollars in thousands)	
2015		
Commercial		
Income producing - real estate . . . . .	—	\$ —
Land, land development & construction-real estate . . . . .	—	—
Commercial and industrial . . . . .	2	157
Mortgage		
1-4 family . . . . .	2	73
Resort lending . . . . .	—	—
Home equity - 1st lien . . . . .	—	—
Home equity - 2nd lien . . . . .	—	—
Purchased loans . . . . .	—	—
Installment		
Home equity - 1st lien . . . . .	—	—
Home equity - 2nd lien . . . . .	—	—
Loans not secured by real estate . . . . .	1	4
Other . . . . .	—	—
Total . . . . .	<u>5</u>	<u>\$234</u>
2014		
Commercial		
Income producing - real estate . . . . .	—	\$ —
Land, land development & construction-real estate . . . . .	—	—
Commercial and industrial . . . . .	2	319
Mortgage		
1-4 family . . . . .	1	125
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 . . . . .	—	—
Total . . . . .	<u>3</u>	<u>\$444</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	<u>Number of Contracts</u>	<u>Recorded Balance</u>
	(Dollars in thousands)	
2013		
Commercial		
Income producing - real estate	1	\$ 693
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	2	32
Home equity - 2nd lien	1	22
Loans not secured by real estate	—	—
Other	—	—
Total	<u>9</u>	<u>\$1,486</u>

A loan is generally considered to be in payment default once it is 90 days contractually past due under the modified terms for commercial loans and installment loans and when four consecutive payments are missed for mortgage loans.

The troubled debt restructurings that subsequently defaulted described above increased (decreased) the allowance for loan losses by \$(0.03) million, \$0.02 million and zero during the years ended December 31, 2015, 2014 and 2013, respectively and resulted in charge offs of zero, zero and \$0.2 million during the years ended December 31, 2015, 2014 and 2013, respectively.

The terms of certain other loans were modified during the years ending December 31, 2015, 2014 and 2013 that did not meet the definition of a troubled debt restructuring. The modification of these loans could have included modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

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 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) financial performance 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.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**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.

The following table summarizes loan ratings by loan class for our commercial loan segment at December 31:

	Commercial				
	Non-watch 1-6	Watch 7-8	Substandard Accrual 9	Non- Accrual 10-11	Total
	(In thousands)				
2015					
Income producing - real estate . . . . .	\$296,898	\$ 6,866	\$1,423	\$1,027	\$306,214
Land, land development and construction - real estate . .	40,844	2,995	243	401	44,483
Commercial and industrial . . . . .	<u>371,357</u>	<u>19,502</u>	<u>6,683</u>	<u>2,028</u>	<u>399,570</u>
Total . . . . .	<u>\$709,099</u>	<u>\$29,363</u>	<u>\$8,349</u>	<u>\$3,456</u>	<u>\$750,267</u>
Accrued interest included in total . . . . .	<u>\$ 1,729</u>	<u>\$ 108</u>	<u>\$ 32</u>	<u>\$ —</u>	<u>\$ 1,869</u>
2014					
Income producing - real estate . . . . .	\$241,266	\$ 8,649	\$1,918	\$1,233	\$253,066
Land, land development and construction - real estate . .	30,869	2,485	390	594	34,338
Commercial and industrial . . . . .	<u>372,947</u>	<u>23,475</u>	<u>5,998</u>	<u>2,746</u>	<u>405,166</u>
Total . . . . .	<u>\$645,082</u>	<u>\$34,609</u>	<u>\$8,306</u>	<u>\$4,573</u>	<u>\$692,570</u>
Accrued interest included in total . . . . .	<u>\$ 1,479</u>	<u>\$ 111</u>	<u>\$ 25</u>	<u>\$ —</u>	<u>\$ 1,615</u>

For each of our mortgage and installment segment classes we generally monitor credit quality based on the credit scores of the borrowers. These credit scores are generally updated semi-annually. The following tables summarize credit scores by loan class for our mortgage and installment loan segments at December 31:

	Mortgage (1)					
			Home Equity 1st Lien	Home Equity 2nd Lien	Purchased Loans	Total
	1-4 Family	Resort Lending				
	(In thousands)					
2015						
800 and above	\$ 28,760	\$ 13,943	\$ 4,374	\$ 7,696	\$ 2,310	\$ 57,083
750-799	78,802	40,888	7,137	17,405	23,283	167,515
700-749	56,519	31,980	4,341	11,022	6,940	110,802
650-699	51,813	17,433	3,203	7,691	—	80,140
600-649	27,966	4,991	1,467	3,684	—	38,108
550-599	16,714	3,070	1,027	1,918	—	22,729
500-549	10,610	1,051	572	1,295	—	13,528
Under 500	4,708	554	244	265	—	5,771
Unknown	3,733	2,110	199	282	724	7,048
Total	<u>\$279,625</u>	<u>\$116,020</u>	<u>\$22,564</u>	<u>\$51,258</u>	<u>\$33,257</u>	<u>\$502,724</u>
Accrued interest included in total	\$ 1,396	\$ 477	\$ 87	\$ 196	\$ 114	\$ 2,270

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Mortgage (1)						
	1-4 Family	Resort Lending	Home Equity 1st Lien	Home Equity 2nd Lien	Purchased Loans	Total
	(In thousands)					
2014						
800 and above	\$ 27,918	\$ 14,484	\$ 3,863	\$ 6,225	\$—	\$ 52,490
750-799	72,674	45,950	6,128	14,323	—	139,075
700-749	52,843	32,660	3,054	9,642	—	98,199
650-699	51,664	20,250	3,257	8,194	—	83,365
600-649	27,770	6,538	1,704	3,862	—	39,874
550-599	21,361	3,639	994	1,721	—	27,715
500-549	14,575	2,156	699	1,401	—	18,831
Under 500	6,306	875	261	632	—	8,074
Unknown	4,075	2,184	242	674	—	7,175
Total	<u>\$279,186</u>	<u>\$128,736</u>	<u>\$20,202</u>	<u>\$46,674</u>	<u>\$—</u>	<u>\$474,798</u>
Accrued interest included in total	<u>\$ 1,311</u>	<u>\$ 562</u>	<u>\$ 88</u>	<u>\$ 209</u>	<u>\$—</u>	<u>\$ 2,170</u>

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

Installment (1)					
	Home Equity 1st Lien	Home Equity 2nd Lien	Loans not Secured by Real Estate	Other	Total
	(In thousands)				
2015					
800 and above	\$ 1,792	\$ 1,782	\$ 44,254	\$ 58	\$ 47,886
750-799	4,117	5,931	86,800	531	97,379
700-749	2,507	3,899	34,789	694	41,889
650-699	3,508	4,182	16,456	499	24,645
600-649	2,173	2,153	4,979	200	9,505
550-599	1,800	1,346	1,997	109	5,252
500-549	1,056	855	1,170	61	3,142
Under 500	223	370	385	23	1,001
Unknown	59	32	1,503	4	1,598
Total	<u>\$17,235</u>	<u>\$20,550</u>	<u>\$192,333</u>	<u>\$2,179</u>	<u>\$232,297</u>
Accrued interest included in total	<u>\$ 78</u>	<u>\$ 83</u>	<u>\$ 520</u>	<u>\$ 17</u>	<u>\$ 698</u>
2014					
800 and above	\$ 2,272	\$ 2,835	\$ 31,507	\$ 60	\$ 36,674
750-799	5,677	8,557	66,558	583	81,375
700-749	3,111	6,358	28,179	689	38,337
650-699	3,963	5,477	16,152	615	26,207
600-649	3,434	2,408	5,128	255	11,225
550-599	2,019	1,913	1,896	134	5,962
500-549	1,128	1,036	1,672	84	3,920
Under 500	393	427	455	28	1,303
Unknown	77	81	1,842	44	2,044
Total	<u>\$22,074</u>	<u>\$29,092</u>	<u>\$153,389</u>	<u>\$2,492</u>	<u>\$207,047</u>
Accrued interest included in total	<u>\$ 93</u>	<u>\$ 112</u>	<u>\$ 445</u>	<u>\$ 19</u>	<u>\$ 669</u>

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Mepco is a wholly-owned subsidiary of our Bank that operates a vehicle service contract payment plan business throughout the United States. See note #11 for more information about Mepco's business. As of December 31, 2015, approximately 63.2% 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 18.7% of Mepco's outstanding payment plan receivables as of December 31, 2015, 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.

The following table summarizes credit ratings of insurer or risk retention group counterparties by class of payment plan receivable at December 31:

<b>Payment Plan Receivables</b>				
	<b>Full Refund</b>	<b>Partial Refund</b>	<b>Other</b>	<b>Total</b>
	(In thousands)			
<b>2015</b>				
AM Best rating				
A+ .....	\$ —	\$ 6	\$ —	\$ 6
A .....	2,712	5,203	—	7,915
A- .....	3,418	1,177	6,265	10,860
Not rated .....	15,720	93	5	15,818
Total .....	<u>\$21,850</u>	<u>\$6,479</u>	<u>\$6,270</u>	<u>\$34,599</u>
<b>2014</b>				
AM Best rating				
A+ .....	\$ —	\$ 43	\$ —	\$ 43
A .....	10,007	6,190	—	16,197
A- .....	1,989	685	5,054	7,728
Not rated .....	15,857	176	—	16,033
Total .....	<u>\$27,853</u>	<u>\$7,094</u>	<u>\$5,054</u>	<u>\$40,001</u>

Although Mepco has contractual recourse against various counterparties for refunds owing upon cancellation of vehicle service contracts, see Note #11 below regarding certain risks and difficulties associated with collecting these refunds.

Mortgage loans serviced for others are not reported as assets on the Consolidated Statements of Financial Condition. The principal balances of these loans at December 31 follow:

	<b>2015</b>	<b>2014</b>
	(In thousands)	
Mortgage loans serviced for:		
Fannie Mae .....	\$ 898,443	\$ 913,863
Freddie Mac .....	707,891	748,833
Ginnie Mae .....	37,884	—
Other .....	107	104
Total .....	<u>\$1,644,325</u>	<u>\$1,662,800</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Custodial deposit accounts maintained in connection with mortgage loans serviced for others totaled \$21.8 million and \$20.9 million, at December 31, 2015 and 2014, respectively.

If we do not remain well capitalized for regulatory purposes (see note #20), meet certain minimum capital levels or certain profitability requirements or if we incur a rapid decline in net worth, we could lose our ability to sell and/or service loans to these investors. This could impact our ability to generate gains on the sale of loans and generate servicing income. A forced liquidation of our servicing portfolio could also impact the value that could be recovered on this asset. Fannie Mae has the most stringent eligibility requirements covering capital levels, profitability and decline in net worth. Fannie Mae requires seller/servicers to be well capitalized for regulatory purposes. For the profitability requirement, we cannot record four or more consecutive quarterly losses and experience a 30% decline in net worth over the same period. Finally, our net worth cannot decline by more than 25% in one quarter or more than 40% over two consecutive quarters. The highest level of capital we are required to maintain is at least \$2.5 million plus 0.25% of loans serviced for Freddie Mac.

An analysis of capitalized mortgage loan servicing rights for the years ended December 31 follows:

	2015	2014	2013
		(In thousands)	
Balance at beginning of year . . . . .	\$ 12,106	\$ 13,710	\$ 11,013
Originated servicing rights capitalized . . . . .	2,697	1,823	3,210
Amortization . . . . .	(2,868)	(2,509)	(3,745)
Change in valuation allowance . . . . .	501	(918)	3,232
Balance at end of year . . . . .	<u>\$ 12,436</u>	<u>\$ 12,106</u>	<u>\$ 13,710</u>
Valuation allowance . . . . .	<u>\$ 3,272</u>	<u>\$ 3,773</u>	<u>\$ 2,855</u>
Loans sold and serviced that have had servicing rights capitalized . . . . .	<u>\$1,643,086</u>	<u>\$1,661,269</u>	<u>\$1,732,476</u>

The fair value of capitalized mortgage loan servicing rights was \$12.9 million and \$12.6 million at December 31, 2015 and 2014, respectively. Fair value was determined using an average coupon rate of 4.32%, average servicing fee of 0.254%, average discount rate of 10.04% and an average Public Securities Association (“PSA”) prepayment rate of 203 for December 31, 2015; and an average coupon rate of 4.44%, average servicing fee of 0.253%, average discount rate of 10.07% and an average PSA prepayment rate of 200 for December 31, 2014.

### NOTE 5 – OTHER REAL ESTATE OWNED

A summary of other real estate owned activity for the years ended December 31 follows (1):

	2015	2014	2013
		(In thousands)	
Balance at beginning of year, net of valuation allowance . . .	\$ 6,370	\$ 18,088	\$ 25,748
Loans transferred to other real estate owned . . . . .	6,694	6,143	6,932
Sales of other real estate owned . . . . .	(5,502)	(17,198)	(11,994)
Additions to valuation allowance charged to expense . . . .	(492)	(663)	(2,598)
Balance at end of year, net of valuation allowance . . . . .	<u>\$ 7,070</u>	<u>\$ 6,370</u>	<u>\$ 18,088</u>

(1) Table excludes other repossessed assets totaling \$0.08 million at both December 31, 2015 and 2014, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

We periodically review our real estate owned properties and establish valuation allowances on these properties if values have declined since the date of acquisition. An analysis of our valuation allowance for other real estate owned follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
		(In thousands)	
Balance at beginning of year . . . . .	\$ 2,511	\$ 4,047	\$ 5,958
Additions charged to expense . . . . .	492	663	2,598
Direct write-downs upon sale . . . . .	<u>(1,311)</u>	<u>(2,199)</u>	<u>(4,509)</u>
Balance at end of year . . . . .	<u>\$ 1,692</u>	<u>\$ 2,511</u>	<u>\$ 4,047</u>

At December 31, 2015 and 2014, the balance of other real estate owned includes \$2.8 million and \$2.9 million of foreclosed residential real estate properties. Retail mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements totaled \$1.1 million and \$2.5 million at December 31, 2015 and 2014, respectively.

Other real estate and repossessed assets totaling \$7.2 million and \$6.5 million at December 31, 2015 and 2014, respectively, are presented net of the valuation allowance on the Consolidated Statements of Financial Condition.

### NOTE 6 – PROPERTY AND EQUIPMENT

A summary of property and equipment at December 31 follows:

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Land . . . . .	\$ 15,152	\$ 14,904
Buildings . . . . .	57,638	59,486
Equipment . . . . .	<u>79,842</u>	<u>79,809</u>
	152,632	154,199
Accumulated depreciation and amortization . . . . .	<u>(109,529)</u>	<u>(108,251)</u>
Property and equipment, net . . . . .	<u>\$ 43,103</u>	<u>\$ 45,948</u>

Depreciation expense was \$6.6 million, \$6.7 million and \$6.7 million in 2015, 2014 and 2013, respectively.

### NOTE 7 – INTANGIBLE ASSETS

Intangible assets, net of amortization, at December 31 follows:

	<u>2015</u>	<u>2014</u>
	Gross Carrying Amount	Gross Carrying Amount
	Accumulated Amortization	Accumulated Amortization
	(In thousands)	
Amortized intangible assets - core deposits . . . . .	<u>\$6,118</u>	<u>\$3,838</u>
	<u>\$6,118</u>	<u>\$3,491</u>

Intangible amortization expense was \$0.3 million, \$0.5 million and \$0.8 million in 2015, 2014 and 2013, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

A summary of estimated core deposit intangible amortization at December 31, 2015, follows:

	(In thousands)
2016 .....	\$ 347
2017 .....	346
2018 .....	346
2019 .....	346
2020 .....	346
2021 and thereafter .....	<u>549</u>
Total .....	<u>\$2,280</u>

### NOTE 8 – DEPOSITS

A summary of interest expense on deposits for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Savings and interest bearing checking .....	\$1,056	\$1,064	\$1,131
Time deposits under \$100,000 .....	1,586	2,467	2,995
Time deposits of \$100,000 or more .....	<u>1,367</u>	<u>1,436</u>	<u>1,580</u>
Total .....	<u>\$4,009</u>	<u>\$4,967</u>	<u>\$5,706</u>

Aggregate time deposits in denominations of \$250,000 or more amounted to \$110.4 million and \$42.8 million at December 31, 2015 and 2014, respectively.

A summary of the maturity of time deposits at December 31, 2015, follows:

	(In thousands)
2016 .....	\$302,136
2017 .....	66,288
2018 .....	27,367
2019 .....	15,432
2020 .....	11,763
2021 and thereafter .....	<u>3,234</u>
Total .....	<u>\$426,220</u>

Time deposits acquired through broker relationships totaled zero and \$11.3 million at December 31, 2015 and 2014, respectively.

Reciprocal deposits totaled \$50.2 million and \$53.7 million at December 31, 2015 and 2014, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network's Insured Cash Sweep® service and Certificate of Deposit Account Registry Service®. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum.

A summary of reciprocal deposits at December 31 follows:

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Demand .....	\$ 3,436	\$ 5,867
Money market .....	8,340	7,692
Time .....	<u>38,431</u>	<u>40,109</u>
Total .....	<u>\$50,207</u>	<u>\$53,668</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 9 – OTHER BORROWINGS

A summary of other borrowings at December 31 follows:

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Advances from the FHLB .....	\$11,949	\$12,464
Other .....	<u>5</u>	<u>6</u>
Total .....	<u>\$11,954</u>	<u>\$12,470</u>

Advances from the FHLB are secured by unencumbered qualifying mortgage and home equity loans with a market value equal to at least 135% to 174%, respectively, of outstanding advances. Advances are also secured by FHLB stock that we own, which totaled \$7.8 million at December 31, 2015. Unused borrowing capacity with the FHLB (subject to the FHLB's credit requirements and policies) was \$179.6 million at December 31, 2015. Interest expense on advances amounted to \$0.8 million, \$0.9 million and \$1.1 million for the years ended December 31, 2015, 2014 and 2013, respectively. No FHLB advances were terminated during 2015, 2014 or 2013.

As a member of the FHLB, we must own FHLB stock equal to the greater of 1.0% of the unpaid principal balance of residential mortgage loans or 5.0% of our outstanding advances. At December 31, 2015, we were in compliance with the FHLB stock ownership requirements.

The maturity dates and weighted average interest rates of FHLB advances at December 31 follow:

	<u>2015</u>		<u>2014</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
	(Dollars in thousands)			
Fixed-rate advances				
2016 .....	\$ 2,089	6.55%	\$ 2,205	6.55%
2017 .....	1,258	7.04	1,320	7.04
2018 .....	5,437	5.99	5,671	5.99
2019 .....	—		—	
2020 .....	<u>3,165</u>	7.49	<u>3,268</u>	7.49
Total advances .....	<u>\$11,949</u>	6.59%	<u>\$12,464</u>	6.59%

A summary of contractually required repayments of FHLB Advances at December 31, 2015, follows:

	(In thousands)
2016 .....	\$ 2,521
2017 .....	1,587
2018 .....	5,042
2019 .....	143
2020 .....	<u>2,656</u>
Total .....	<u>\$11,949</u>

We had no borrowings outstanding with the FRB during the years ended or at December 31, 2015, 2014 or 2013. We had unused borrowing capacity with the FRB (subject to the FRB's credit requirements and policies) of \$307.7 million at December 31, 2015. Collateral for FRB borrowings are certain commercial loans.

Assets, consisting of FHLB stock and loans, pledged to secure other borrowings and unused borrowing capacity totaled \$781.8 million at December 31, 2015.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 10 – SUBORDINATED DEBENTURES

We have formed various special purpose entities (the “trusts”) for the purpose of issuing trust preferred securities in either public or pooled offerings or in private placements. Independent Bank Corporation owns all of the common stock of each trust and has issued subordinated debentures to each trust in exchange for all of the proceeds from the issuance of the common stock and the trust preferred securities. Trust preferred securities totaling \$34.5 million at both December 31, 2015 and 2014, respectively, qualified as Tier 1 regulatory capital.

These trusts are not consolidated with Independent Bank Corporation and accordingly, we report the common securities of the trusts held by us in accrued income and other assets and the subordinated debentures that we have issued to the trusts in the liability section of our Consolidated Statements of Financial Condition.

Summary information regarding subordinated debentures as of December 31 follows:

		2015 and 2014		
Entity Name	Issue Date	Subordinated Debentures	Trust Preferred Securities	Common Stock Issued
			Issued	
(In thousands)				
IBC Capital Finance III .....	May 2007	\$12,372	\$12,000	\$ 372
IBC Capital Finance IV .....	September 2007	15,465	15,000	465
Midwest Guaranty Trust I .....	November 2002	<u>7,732</u>	<u>7,500</u>	<u>232</u>
		<u>\$35,569</u>	<u>\$34,500</u>	<u>\$1,069</u>

Other key terms for the subordinated debentures and trust preferred securities that were outstanding at December 31, 2015 and 2014 follow:

Entity Name	Maturity Date	Interest Rate	First Permitted Redemption Date
IBC Capital Finance III	July 30, 2037	3 month LIBOR plus 1.60%	July 30, 2012
IBC Capital Finance IV	September 15, 2037	3 month LIBOR plus 2.85%	September 15, 2012
Midwest Guaranty Trust I	November 7, 2032	3 month LIBOR plus 3.45%	November 7, 2007

The subordinated debentures and trust preferred securities are cumulative and have a feature that permits us to defer distributions (payment of interest) from time to time for a period not to exceed 20 consecutive quarters. Interest is payable quarterly on each of the subordinated debentures and trust preferred securities and no distributions were deferred at December 31, 2015 and 2014.

We have the right to redeem the subordinated debentures and trust preferred securities (at par) in whole or in part from time to time on or after the first permitted redemption date specified above or upon the occurrence of specific events defined within the trust indenture agreements. During 2014, we redeemed trust preferred securities issued by IBC Capital Finance IV with a par value of \$5.0 million. These trust preferred securities were redeemed at a discount of \$0.5 million and we recognized a gain on extinguishment of debt in our Consolidated Statements of Operations for this same amount.

Issuance costs have been capitalized and are being amortized on a straight-line basis over a period not exceeding 30 years and are included in interest expense in the Consolidated Statements of Operations. Distributions (payment of interest) on the trust preferred securities are also included in interest expense in the Consolidated Statements of Operations.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 11 – COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business, we enter into financial instruments with off-balance sheet risk to meet the financing needs of customers or to reduce exposure to fluctuations in interest rates. These financial instruments may include commitments to extend credit and standby letters of credit. Financial instruments involve varying degrees of credit and interest-rate risk in excess of amounts reflected in the Consolidated Statements of Financial Condition. Exposure to credit risk in the event of non-performance by the counterparties to the financial instruments for loan commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. We do not, however, anticipate material losses as a result of these financial instruments.

A summary of financial instruments with off-balance sheet risk at December 31 follows:

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Financial instruments whose risk is represented by contract amounts		
Commitments to extend credit .....	\$243,458	\$204,827
Standby letters of credit .....	3,582	2,757

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and generally require payment of a fee. Since commitments may expire without being drawn upon, the commitment amounts do not represent future cash requirements. Commitments are issued subject to similar underwriting standards, including collateral requirements, as are generally involved in the extension of credit facilities.

Standby letters of credit are written conditional commitments issued to guarantee the performance of a customer to a third party. The credit risk involved in such transactions is essentially the same as that involved in extending loan facilities and, accordingly, standby letters of credit are issued subject to similar underwriting standards, including collateral requirements, as are generally involved in the extension of credit facilities. The majority of the standby letters of credit are to corporations, have variable rates that range from 2.75% to 8.25% and mature through 2018.

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 \$1.0 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 Condensed Consolidated Statements of Financial Condition) permits a consumer to purchase a vehicle service contract by making installment payments, generally for a term of 12 to 24 months, to the sellers of those contracts (one of the "counterparties"). Mepco thereafter collects the payments from consumers. In acquiring the payment plan, Mepco generally funds a portion of the cost to the seller of the service contract and a portion of the cost to the administrator of the service contract. The administrator, in turn, pays the necessary contractual liability insurance policy ("CLIP") premium to the insurer or risk retention group.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Consumers are allowed to voluntarily cancel the service contract at any time and are generally entitled to receive a refund from the administrator of the unearned portion of the service contract at the time of cancellation. As a result, while Mepco does not owe any refund to the consumer, it also does not have any recourse against the consumer for nonpayment of a payment plan and therefore does not evaluate the creditworthiness of the individual consumer. If a consumer stops making payments on a payment plan or exercises the right to voluntarily cancel the service contract, the service contract seller and administrator are each obligated to refund to Mepco the amount necessary to make Mepco whole as a result of its funding of the service contract. In addition, the insurer or risk retention group that issued the CLIP for the service contract often guarantees all or a portion of the refund to Mepco. See note #4 above for a breakdown of Mepco's payment plan receivables by the level of recourse Mepco has against various counterparties.

Upon the cancellation of a service contract and the completion of the billing process to the counterparties for amounts due to Mepco, there is a decrease in the amount of "payment plan receivables" and an increase in the amount of "vehicle service contract counterparty receivables" until such time as the amount due from the counterparty is collected. These amounts represent funds actually due to Mepco from its counterparties for cancelled service contracts. At both December 31, 2015 and 2014, the aggregate amount of such obligations owing to Mepco by counterparties, net of write-downs and reserves made through the recognition of vehicle service contract counterparty contingencies expense, totaled \$7.2 million. Mepco is currently in the process of working to recover these receivables, primarily through litigation against counterparties.

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

When counterparties do not honor their contractual obligations to Mepco to repay funds, we recognize estimated losses. Mepco pursues collection (including commencing legal action if necessary) of funds due to it under its various contracts with counterparties. Mepco has had to initiate litigation against certain counterparties, including third party insurers, to collect amounts owed to Mepco as a result of those parties' dispute of their contractual obligations to Mepco. For 2015, 2014 and 2013, non-interest expenses include \$0.1 million, \$0.2 million and \$4.8 million, respectively, of charges related to estimated losses for vehicle service contract counterparty contingencies. The significant decrease in this expense in 2014 (from 2013) is due to 2013 including write-downs of vehicle service contract counterparty receivables related to settlements of certain litigation to collect these receivables. Given the costs and uncertainty of continued litigation, we determined it was in our best interest to resolve these matters. These charges are being classified in non-interest expense because they are associated with a default or potential default of a contractual obligation under our counterparty contracts as opposed to loss on the administration of the payment plan itself.

Our estimate of probable incurred losses from vehicle service contract counterparty contingencies requires a significant amount of judgment because a number of factors can influence the amount of loss that we may ultimately incur. These factors include our estimate of future cancellations of vehicle service contracts, our evaluation of collateral that may be available to recover funds due from our counterparties, and our assessment of the amount that may ultimately be collected from counterparties in connection with their contractual obligations. We apply a rigorous process, based upon historical payment plan activity and past experience, to estimate probable incurred losses and quantify the necessary reserves for our vehicle service contract counterparty contingencies, but there can be no assurance that our modeling process will successfully identify all such losses.

We believe our assumptions regarding the collection of vehicle service contract counterparty receivables are reasonable, and we based them on our good faith judgments using data currently available. We also believe the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

current amount of reserves we have established and the vehicle service contract counterparty contingencies expense that we have recorded are appropriate given our estimate of probable incurred losses at the applicable Consolidated Statement of Financial Condition date. However, because of the uncertainty surrounding the numerous and complex assumptions made, actual losses could exceed the charges we have taken to date.

An analysis of our vehicle service contract counterparty receivable, net follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Balance at beginning of year, net of reserve .....	\$ 7,237	\$7,716	\$18,449
Transfers in from payment plan receivables .....	1,203	180	792
Reserves established and charge-offs recorded to expense .....	(119)	(199)	(4,837)
Transferred to (from) contingency reserves .....	—	(75)	63
Cash received .....	<u>(1,092)</u>	<u>(385)</u>	<u>(6,751)</u>
Balance at end of year, net of reserve .....	<u>\$ 7,229</u>	<u>\$7,237</u>	<u>\$ 7,716</u>
Reserve at end of year .....	<u>\$ 56</u>	<u>\$1,370</u>	<u>\$ 1,300</u>

An analysis of our vehicle service contract counterparty reserve follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Balance at beginning of year .....	\$ 1,370	\$1,375	\$ 2,012
Additions charged to expense .....	119	199	4,837
Charge-offs, net .....	<u>(1,433)</u>	<u>(204)</u>	<u>(5,474)</u>
Balance at end of year .....	<u>\$ 56</u>	<u>\$1,370</u>	<u>\$ 1,375</u>
Reserves recorded in VSC counterparty receivables, net .....	\$ 56	\$1,370	\$ 1,300
Reserves recorded in accrued expenses and other liabilities .....	—	—	75
Total at end of year .....	<u>\$ 56</u>	<u>\$1,370</u>	<u>\$ 1,375</u>

The provision for loss reimbursement on sold loans represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac and Ginnie Mae). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. In November 2013, we executed a Resolution Agreement with Fannie Mae to resolve our existing and future repurchase and make whole obligations (collectively “Repurchase Obligations”) related to mortgage loans originated between January 1, 2000 and December 31, 2008 and delivered to them by January 31, 2009. Under the terms of the Resolution Agreement, we paid Fannie Mae approximately \$1.5 million in November 2013 with respect to the Repurchase Obligations. We believe that it was in our best interest to execute the Resolution Agreement in order to bring finality to the loss reimbursement exposure with Fannie Mae for these years and reduce the resources spent on individual file reviews and defending loss reimbursement requests. In addition, we were notified by Freddie Mac in January 2014 that they had completed their review of mortgage loans that we originated between January 1, 2000 and December 31, 2008 and delivered to them. The reserve for loss reimbursements on sold mortgage loans totaled \$0.5 million and \$0.7 million at December 31, 2015 and 2014, respectively. This reserve is included in accrued expenses and other liabilities in our Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. The reserve levels at December 31, 2015 and 2014 also reflect the resolution of the mortgage loan origination years of 2000 to 2008 with Fannie Mae and Freddie Mac. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 12 – SHAREHOLDERS' EQUITY AND INCOME PER COMMON SHARE

On January 21, 2015, our Board of Directors authorized a share repurchase plan (the “Repurchase Plan”) to buy back up to 5% of our outstanding common stock through December 31, 2015. The repurchases were made through open market transactions and totaled 967,199 shares of common stock for an aggregate purchase price of \$13.5 million.

On July 26, 2013, we executed a Securities Purchase Agreement (“SPA”) with the U.S. Department of the Treasury (“UST”). Under the terms of the SPA, we agreed to purchase from the UST for \$81.0 million in cash consideration: (i) 74,426 shares of our Series B Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, with an original liquidation preference of \$1,000 per share (“Series B Preferred Stock”), including all accrued and unpaid dividends; and (ii) the Amended and Restated Warrant to purchase 346,154 shares of our common stock at an exercise price of \$7.234 per share and expiring on December 12, 2018 (the “Amended Warrant”). On August 30, 2013, we closed the SPA transaction with the UST and we exited the Troubled Asset Relief Program (“TARP”). On that date, the Series B Preferred Stock and Amended Warrant had book balances of \$87.2 million (including accrued dividends) and \$1.5 million, respectively. This transaction resulted in a discount of \$7.7 million, of which \$7.6 million was allocated to the Series B Preferred Stock and included in net income applicable to common stock and \$0.1 million was allocated to the Amended Warrant and recorded to common stock.

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

On November 15, 2011, we entered into a Tax Benefits Preservation Plan (the “Preservation Plan”) with our stock transfer agent, American Stock Transfer & Trust Company. Our Board of Directors adopted the Preservation Plan in an effort to protect the value to our shareholders of our ability to use deferred tax assets, such as net operating loss carry forwards, to reduce potential future federal income tax obligations. Under federal tax rules, this value could be lost in the event we experienced an “ownership change,” as defined in Section 382 of the federal Internal Revenue Code. The Preservation Plan attempts to protect this value by reducing the likelihood that we will experience such an ownership change by discouraging any person who is not already a 5% shareholder from becoming a 5% shareholder (with certain limited exceptions).

On November 15, 2011, our Board of Directors declared a dividend of one preferred share purchase right (a “Right”) for each outstanding share of our common stock under the terms of the Preservation Plan. The dividend is payable to the holders of common stock outstanding as of the close of business on November 15, 2011, or outstanding at any time thereafter but before the earlier of a “Distribution Date” and the date the Preservation Plan terminates. Each Right entitles the registered holder to purchase from us 1/1000 of a share of our Series C Junior Participating Preferred Stock, no par value per share (“Series C Preferred Stock”). Each 1/1000 of a share of Series C Preferred Stock has economic and voting terms similar to those of one whole share of common stock. The Rights are not exercisable and generally do not become exercisable until a person or group has acquired, subject to certain exceptions and conditions, beneficial ownership of 4.99% or more of the outstanding shares of common stock. At that time, each Right will generally entitle its holder to purchase securities of the Company at a discount of 50% to the current market price of the common stock. However, the Rights owned by the person acquiring beneficial ownership of 4.99% or more of the outstanding shares of common stock would automatically be void. The significant dilution that would result is expected to deter any person from acquiring beneficial ownership of 4.99% or more and thereby triggering the Rights.

To date, none of the Rights have been exercised or have become exercisable because no unpermitted 4.99% or more change in the beneficial ownership of the outstanding common stock has occurred. The Rights will generally expire on the earlier to occur of the close of business on November 15, 2016 and certain other events described in the Preservation Plan, including such date as our Board of Directors determines that the Preservation Plan is no longer necessary for its intended purposes.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

A reconciliation of basic and diluted net income per common share for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands, except per share amounts)		
Net income applicable to common stock .....	\$20,017	\$18,021	\$82,062
Convertible preferred stock dividends .....	—	—	3,001
Preferred stock discount .....	—	—	(7,554)
Net income applicable to common stock for calculation of diluted earnings per share .....	<u>\$20,017</u>	<u>\$18,021</u>	<u>\$77,509</u>
Weighted average shares outstanding (1) .....	22,716	22,927	13,970
Restricted stock units .....	233	306	363
Effect of stock options .....	119	124	92
Stock units for deferred compensation plan for non-employee directors .....	112	114	125
Effect of convertible preferred stock .....	—	—	7,314
Weighted average shares outstanding for calculation of diluted earnings per share .....	<u>23,180</u>	<u>23,471</u>	<u>21,864</u>
Net income per common share			
Basic (1) .....	<u>\$ 0.88</u>	<u>\$ 0.79</u>	<u>\$ 5.87</u>
Diluted .....	<u>\$ 0.86</u>	<u>\$ 0.77</u>	<u>\$ 3.55</u>

(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 common share because they were anti-dilutive totaled 0.03 million, 0.03 million and 0.1 million for 2015, 2014 and 2013, respectively. The Amended Warrant issued to the UST to purchase 346,154 shares of our common stock was also not considered in computing the diluted net income per common share in 2013 as it was anti-dilutive.

### NOTE 13 – INCOME TAX

The composition of income tax expense (benefit) for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Current .....	\$ 200	\$ (359)	\$ (277)
Deferred .....	9,128	7,672	—
Disproportionate tax effect .....	—	—	1,444
Valuation allowance - change in estimate .....	<u>35</u>	<u>(118)</u>	<u>(56,018)</u>
Income tax expense (benefit) .....	<u>\$9,363</u>	<u>\$7,195</u>	<u>\$(54,851)</u>

Income tax expense (benefit) was \$9.4 million, \$7.2 million and \$(54.9) million during the years ended December 31, 2015, 2014 and 2013. 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 (loss) and credited to income tax expense (benefit) due to our valuation allowance on deferred tax assets as more fully discussed in note #24. 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The income tax expense (benefit) in the Consolidated Statements of Operations also includes income taxes in a variety of other states due primarily to Mepco's operations. The amounts of such state income taxes were an expense (benefit) of \$(0.1) million, zero and \$(0.2) million in 2015, 2014 and 2013, respectively.

The deferred income tax expense of \$9.1 million and \$7.7 million during 2015 and 2014 can be primarily attributed to tax effects of temporary differences. The deferred income tax benefit of \$56.0 million during 2013 is attributed to the reversal of our deferred tax valuation allowance on primarily all of our deferred tax assets.

A reconciliation of income tax expense (benefit) to the amount computed by applying the statutory federal income tax rate of 35% in each year presented to the income before income tax for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Statutory rate applied to income before income tax .....	\$10,283	\$8,826	\$ 7,930
Bank owned life insurance .....	(449)	(480)	(477)
Tax-exempt income .....	(434)	(522)	(402)
Unrecognized tax benefit .....	(135)	(595)	(186)
Non-deductible meals, entertainment and memberships .....	43	53	55
Net change in valuation allowance .....	35	(118)	(63,980)
Disproportionate tax effect .....	—	—	1,444
U.S. Treasury warrant .....	—	—	359
Share-based compensation .....	—	—	8
Other, net .....	20	31	398
Income tax expense (benefit) .....	<u>\$ 9,363</u>	<u>\$7,195</u>	<u>\$(54,851)</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31 follow:

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Deferred tax assets		
Loss carryforwards .....	\$25,516	\$32,933
Allowance for loan losses .....	7,901	9,099
Alternative minimum tax credit carry forward .....	3,427	3,037
Property and equipment .....	3,369	3,239
Purchase premiums, net .....	1,755	2,050
Share based payments .....	786	684
Valuation allowance on other real estate .....	592	879
Unrealized loss on trading securities .....	578	559
Deferred compensation .....	404	448
Other than temporary impairment charge on securities available for sale ...	382	436
Non accrual loan interest income .....	232	244
Reserve for unfunded lending commitments .....	228	189
Loss reimbursement on sold loans reserve .....	186	242
Unrealized loss on securities available for sale .....	128	—
Vehicle service contract counterparty contingency reserve .....	21	521
Gross deferred tax assets .....	45,505	54,560
Valuation allowance .....	(1,054)	(1,019)
Total net deferred tax assets .....	44,451	53,541

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	<u>2015</u>	<u>2014</u>
	(In thousands)	
Deferred tax liabilities		
Capitalized mortgage loan servicing rights .....	4,353	4,237
Deferred loan fees .....	256	260
Federal Home Loan Bank stock .....	45	196
Unrealized gain on securities available for sale .....	—	87
Other .....	<u>162</u>	<u>129</u>
Gross deferred tax liabilities .....	<u>4,816</u>	<u>4,909</u>
Net deferred tax assets .....	<u>\$39,635</u>	<u>\$48,632</u>

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 10 additional profitable quarters since June 30, 2013.

The valuation allowance against our deferred tax assets totaled \$1.1 million and \$1.0 million at December 31, 2015 and 2014, respectively. The valuation allowance against our deferred tax assets at December 31, 2015 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.

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

At December 31, 2015, we had federal net operating loss (“NOL”) carryforwards of approximately \$73.4 million which, if not used against taxable income, will expire as follows:

	(In thousands)
2030 .....	\$18,496
2031 .....	17,170
2032 .....	<u>37,739</u>
Total .....	<u>\$73,405</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

\$3.4 million of NOL carryforwards in the table above relate to unrealized excess benefits on share based compensation for which a benefit will be recorded to additional paid in capital (common stock) when realized. We also had a minor amount of state NOL carryforwards in certain states where Mepco operates. In addition, we had \$3.4 million of alternative minimum tax credit carryforwards with indefinite lives at December 31, 2015.

Changes in unrecognized tax benefits for the years ended December 31 follow:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Balance at beginning of year .....	\$1,091	\$1,672	\$1,871
Additions based on tax positions related to the current year .....	20	18	11
Reductions due to the statute of limitations .....	(135)	(595)	(186)
Reductions due to settlements .....	<u>—</u>	<u>(4)</u>	<u>(24)</u>
Balance at end of year .....	<u>\$ 976</u>	<u>\$1,091</u>	<u>\$1,672</u>

If recognized, the entire amount of unrecognized tax benefits, net of \$0.3 million of federal tax on state benefits, would affect our effective tax rate. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. No amounts were expensed for interest and penalties for the years ended December 31, 2015, 2014 and 2013. No amounts were accrued for interest and penalties at December 31, 2015, 2014 or 2013. At December 31, 2015, U.S. Federal tax years 2012 through the present remain open to examination.

### NOTE 14 – SHARE BASED COMPENSATION AND BENEFIT PLANS

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 0.3 million shares of common stock as of December 31, 2015. The non-employee director stock purchase plan permits the grant of additional share based payments for up to 0.2 million shares of common stock as of December 31, 2015. 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 2015 and 2014, pursuant to our long-term incentive plan, we granted in each year 0.07 million, shares of restricted stock and 0.03 million performance stock units (“PSUs”) to certain officers. The shares of restricted stock issued during 2015 cliff vest after a period of three years, the shares of restricted stock issued during 2014 vest ratably over three years and the PSUs issued in both years 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 2013, we issued 0.1 million restricted stock units to certain of our executive officers. These restricted stock units cliff vest after a period of three years. We used the market value of the common stock on the date of grant to measure compensation cost for these non-vested share awards.

During 2013, pursuant to our performance-based compensation plans, we granted 0.1 million stock options to certain officers. 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 0.01 million shares, 0.01 million shares and 0.06 million shares to directors during 2015, 2014 and 2013, respectively, and expensed their value during those same periods.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

During 2013, a portion of our president's annual salary was paid in the form of common stock. The amount paid in common stock (also referred to as "salary stock") was \$0.020 million. These shares were issued each pay period and vested immediately. No salary stock was paid during 2015 and 2014.

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$1.4 million, \$1.0 million and \$0.9 million in 2015, 2014 and 2013, respectively. The corresponding tax benefit relating to this expense was \$0.5 million, \$0.4 million and zero in 2015, 2014 and 2013, respectively. Total expense recognized for non-employee director share based payments was \$0.1 million, \$0.2 million and \$0.3 million in 2015, 2014 and 2013, respectively. The corresponding tax benefit relating to this expense was \$0.03 million, \$0.1 million and zero in 2015, 2014 and 2013, respectively.

At December 31, 2015, the total expected compensation cost related to non-vested stock options, restricted stock, PSUs and restricted stock unit awards not yet recognized was \$1.5 million. The weighted-average period over which this amount will be recognized is 1.6 years.

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

	<u>Number of Shares</u>	<u>Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term (Years)</u>	<u>Aggregated Intrinsic Value</u>  (In thousands)
Outstanding at January 1, 2015 .....	281,820	\$4.69		
Granted .....	—			
Exercised .....	(42,204)	3.25		
Forfeited .....	(2,096)	4.77		
Expired .....	(1,924)	6.79		
Outstanding at December 31, 2015 .....	<u>235,596</u>	<u>\$4.94</u>	<u>6.12</u>	<u>\$2,443</u>
Vested and expected to vest at December 31, 2015 .....	<u>234,949</u>	<u>\$4.93</u>	<u>6.11</u>	<u>\$2,437</u>
Exercisable at December 31, 2015 .....	<u>213,154</u>	<u>\$4.78</u>	<u>5.98</u>	<u>\$2,245</u>

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

	<u>Number of Shares</u>	<u>Weighted- Average Grant Date Fair Value</u>
Outstanding at January 1, 2015 .....	407,130	\$ 6.31
Granted .....	108,761	13.07
Vested .....	(249,526)	3.92
Forfeited .....	(4,384)	12.88
Outstanding at December 31, 2015 .....	<u>261,981</u>	<u>\$11.29</u>

A summary of the weighted-average assumptions used in the Black-Scholes option pricing model for grants of stock options follows (no stock options were granted in 2015 and 2014):

	<u>2013</u>
Expected dividend yield .....	0.31%
Risk-free interest rate .....	1.12
Expected life (in years) .....	6.00
Expected volatility .....	101.30%
Per share weighted-average grant date fair value .....	\$ 4.98

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life was obtained using a simplified method that, in general, averaged the vesting term and original contractual term of the stock option. This method was used as relevant historical data of actual exercise activity was very limited. The expected volatility was based on historical volatility of our common stock.

Certain information regarding options exercised during the periods ending December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Intrinsic value .....	<u>\$444</u>	<u>\$321</u>	<u>\$117</u>
Cash proceeds received .....	<u>\$137</u>	<u>\$ 96</u>	<u>\$ 39</u>
Tax benefit realized .....	<u>\$155</u>	<u>\$112</u>	<u>\$ —</u>

We maintain 401(k) and employee stock ownership plans covering substantially all of our full-time employees. During 2015 we matched 50% of employee contributions to the 401(k) plan up to a maximum of 4% of participating employees' eligible wages. During 2014 and 2013 we matched 100% of employee contributions up to a maximum of 2% and 1%, respectively of participating employees' eligible wages. Contributions to the employee stock ownership plan are determined annually and require approval of our Board of Directors. The maximum contribution is 6% of employees' eligible wages. Contributions to the employee stock ownership plan were 2% for 2015 and 2014 and 3% for 2013. Amounts expensed for these retirement plans were \$1.2 million, \$1.0 million, and \$1.2 million in 2015, 2014 and 2013, respectively.

Our officers participate in various performance-based compensation plans. Amounts expensed for all incentive plans totaled \$5.7 million, \$4.2 million and \$5.0 million, in 2015, 2014 and 2013, respectively.

We also provide certain health care and life insurance programs to substantially all full-time employees. Amounts expensed for these programs totaled \$3.6 million, \$3.9 million and \$3.8 million in 2015, 2014 and 2013 respectively. These insurance programs are also available to retired employees at their own expense.

### NOTE 15 – OTHER NON-INTEREST INCOME

Other non-interest income for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(In thousands)		
Investment and insurance commissions .....	\$1,827	\$1,814	\$1,709
ATM fees .....	1,551	1,599	1,661
Bank owned life insurance .....	1,282	1,371	1,363
Other real estate rental income .....	128	1,295	1,471
Other .....	<u>2,904</u>	<u>2,852</u>	<u>2,333</u>
Total other non-interest income .....	<u>\$7,692</u>	<u>\$8,931</u>	<u>\$8,537</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 16 – DERIVATIVE FINANCIAL INSTRUMENTS

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

Our derivative financial instruments according to the type of hedge in which they are designated at December 31 follow:

	2015		
	Notional Amount	Average Maturity (years)	Fair Value
	(Dollars in thousands)		
No hedge designation			
Rate-lock mortgage loan commitments .....	\$ 20,581	0.1	\$ 550
Mandatory commitments to sell mortgage loans .....	46,320	0.1	69
Pay-fixed interest rate swap agreements .....	27,587	8.0	(497)
Pay-variable interest rate swap agreements .....	27,587	8.0	497
Purchased options .....	2,098	5.7	122
Written options .....	2,098	5.7	(122)
Total .....	<u>\$126,271</u>	3.7	<u>\$ 619</u>
	2014		
	Notional Amount	Average Maturity (years)	Fair Value
	(Dollars in thousands)		
No hedge designation			
Rate-lock mortgage loan commitments .....	\$16,759	0.1	\$ 437
Mandatory commitments to sell mortgage loans .....	38,600	0.1	(184)
Pay-fixed interest rate swap agreements .....	3,300	9.4	(182)
Pay-variable interest rate swap agreements .....	3,300	9.4	182
Total .....	<u>\$61,959</u>	1.1	<u>\$ 253</u>

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. The remaining unrealized loss on the terminated pay-fixed interest rate swap which was equal to this termination fee was included as a component of accumulated other comprehensive loss and was amortized into earnings through December 31, 2014, the original remaining life of the pay-fixed interest rate swap.

Certain derivative financial instruments have not been designated as hedges. The fair value of these derivative financial instruments has been recorded on our 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 2015, we began offering to our deposit customers an equity linked time deposit product (“Altitude CD”). The Altitude CD is a time deposit that provides the customer a guaranteed return of principal at maturity plus a potential equity return (a written option), while we receive a like stream of funds based on the equity return (a purchased option). The written and purchased options will generally move in opposite directions resulting in little or no net impact on our Consolidated Statements of Operations. All of the written and purchased options in the table above relate to this Altitude CD product.

During 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 Consolidated Statements of Operations. All of the interest rate swap agreements in the table above relate to this program.

During the second quarter of 2014, we completed a securities trade in which we shorted a \$13 million UST security. This UST short was terminated during the fourth quarter of 2014 and the change in the fair value of the short position from the inception date to the termination date has been recorded in net gains on securities in our Consolidated Statements of Operations.

During 2010, we entered into an amended and restated warrant with the UST that would allow them to purchase our common stock at a fixed price (see Note #12). 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 non-interest income in our 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 on our Consolidated Statements of Financial Condition 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 #12).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

### Fair Values of Derivative Instruments

				Asset Derivatives		Liability Derivatives					
				December 31,		December 31,					
				2015		2014		2015		2014	
				Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
(In thousands)											
Derivatives not designated as hedging instruments											
Rate-lock mortgage loan commitments . . . . .	Other assets	\$ 550	Other assets	\$437	Other liabilities	\$ —	Other liabilities	\$ —			
Mandatory commitments to sell mortgage loans . .	Other assets	69	Other assets	—	Other liabilities	—	Other liabilities	184			
Pay-fixed interest rate swap agreements . . . . .	Other assets	—	Other assets	—	Other liabilities	497	Other liabilities	182			
Pay-variable interest rate swap agreements . . . . .	Other assets	497	Other assets	182	Other liabilities	—	Other liabilities	—			
Purchased options . . . . .	Other assets	122	Other assets	—	Other liabilities	—	Other liabilities	—			
Written options . . . . .	Other assets	—	Other assets	—	Other liabilities	122	Other liabilities	—			
Total derivatives . . . . .		\$1,238		\$619		\$619		\$366			

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

Year Ended December 31,										
Loss Recognized in Other Comprehensive Income (Loss) (Effective Portion)			Location of Loss Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion)	Loss Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion)			Location of Gain (Loss) Recognized in Income (1)	Gain (Loss) Recognized in Income (1)		
2015	2014	2013		2015	2014	2013		2015	2014	2013
(In thousands)										
Cash Flow Hedges										
Pay-fixed interest rate swap agreements . . . . .	\$—	\$—	\$(37)	Interest expense	\$—	\$(380)	\$(397)	Interest expense	\$ —	\$ —
Total . . . . .	<u>\$—</u>	<u>\$—</u>	<u>\$(37)</u>		<u>\$—</u>	<u>\$(380)</u>	<u>\$(397)</u>		<u>\$ —</u>	<u>\$ —</u>
No hedge designation										
Rate-lock mortgage loan commitments . . . . .							Net gains on mortgage loans	\$ 113	\$ 71	\$(1,002)
Mandatory commitments to sell mortgage loans . . .							Net gains on mortgage loans	253	(312)	250
Pay-fixed interest rate swap agreements . . . . .							Interest income	(315)	(182)	—
Pay-variable interest rate swap agreements . . . . .							Interest income	315	182	—
Purchased options . . . . .							Interest expense	122	—	—
Written options . . . . .							Interest expense	(122)	—	—
UST short position . . . . .							Gain on securities	—	295	—
							Increase in fair value of U.S. Treasury warrant	—	—	(1,025)
Amended Warrant . . . . .								<u>\$ 366</u>	<u>\$ 54</u>	<u>\$(1,777)</u>
Total . . . . .										

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 17 – RELATED PARTY TRANSACTIONS

Certain of our directors and executive officers, including companies in which they are officers or have significant ownership, were loan and deposit customers during 2015 and 2014.

A summary of loans to our directors and executive officers whose borrowing relationship (which includes loans to entities in which the individual owns a 10% or more voting interest) exceeds \$60,000 for the years ended December 31 follows:

	<u>2015</u>	<u>2014</u>
	<u>(In thousands)</u>	
Balance at beginning of year . . . . .	\$216	\$ 351
New loans and advances . . . . .	—	—
Repayments . . . . .	<u>(26)</u>	<u>(135)</u>
Balance at end of year . . . . .	<u>\$190</u>	<u>\$ 216</u>

Deposits held by us for directors and executive officers totaled \$1.3 million and \$1.0 million at December 31, 2015 and 2014, respectively.

### NOTE 18 – LEASES

We have non-cancelable operating leases for certain office facilities, some of which include renewal options and escalation clauses.

A summary of future minimum lease payments under non-cancelable operating leases at December 31, 2015, follows:

	<u>(In thousands)</u>
2016 . . . . .	\$1,054
2017 . . . . .	862
2018 . . . . .	809
2019 . . . . .	720
2020 . . . . .	666
2021 and thereafter . . . . .	<u>253</u>
Total . . . . .	<u>\$4,364</u>

Rental expense on operating leases totaled \$1.2 million, \$1.3 million and \$1.2 million in 2015, 2014 and 2013, respectively.

### NOTE 19 – CONCENTRATIONS OF CREDIT RISK

Credit risk is the risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with our organization or otherwise fail to perform as agreed. Credit risk can occur outside of our traditional lending activities and can exist in any activity where success depends on counterparty, issuer or borrower performance. Concentrations of credit risk (whether on- or off-balance sheet) arising from financial instruments can exist in relation to individual borrowers or groups of borrowers, certain types of collateral, certain types of industries or certain geographic regions. Credit risk associated with these concentrations could arise when a significant amount of loans or other financial instruments, related by similar characteristics, are simultaneously impacted by changes in economic or other conditions that cause their probability of repayment or other type of settlement to be adversely affected. Our major concentrations of credit risk arise by collateral type and by industry. The significant concentrations by collateral type at December 31, 2015, include \$538.5 million of loans secured by residential real estate and \$62.6 million of construction and development loans. In addition, we have a concentration of credit within the vehicle service contract industry. At December 31, 2015, we had \$34.6 million of payment plan receivables. Our recourse for nonpayment of these payment plan receivables is against our counterparties operating within the vehicle service contract industry.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Additionally, within our commercial real estate and commercial loan portfolio, we had significant standard industry classification concentrations in the following categories as of December 31, 2015: Lessors of Nonresidential Real Estate (\$259.1 million); Lessors of Residential Real Estate (\$82.1 million); Health Care and Social Assistance (\$67.8 million) and Construction General Contractors and Land Development (\$54.4 million). A geographic concentration arises because we primarily conduct our lending activities in the State of Michigan.

Our concentration of credit within the vehicle service contract industry relates to the business operated by our subsidiary, Mepco. This business and certain risks associated with this business are described in note #11 above. In addition, see note #4 above for a breakdown of Mepco's payment plan receivables by the level of recourse Mepco has against various counterparties. Mepco monitors counterparty concentrations in order to attempt to manage our exposure for contractual obligations from its counterparties. In addition, even where an insurance company or risk retention group does not have a guarantee obligation to Mepco, the failure of the insurance company or risk retention group could result in a mass cancellation of the vehicle service contracts (and the related payment plans) insured by such entity. Such a mass cancellation would trigger and accelerate the contractual obligations of the counterparties that did have such obligations to Mepco. The counterparty concentration levels are managed based on the AM Best rating and statutory surplus level for an insurance company and on other factors including financial evaluation, collateral, funding holdbacks, guarantees, and distribution of concentrations for vehicle service contract administrators and vehicle service contract sellers/dealers.

The five largest concentrations by insurance company, risk retention group or other party backing the service contract represents approximately 42.4%, 24.0%, 15.0%, 7.8% and 3.7%, respectively, of Mepco's payment plan receivables at December 31, 2015. These companies have provided the insurance coverage for the vehicle service contracts underlying the payment plan receivables; however, these companies are not all obligated to Mepco for the repayment of the payment plan receivables upon cancellation of the underlying vehicle service contracts and payment plans. Mepco has varying levels of recourse against such companies. Still, the failure of any insurer backing service contracts related to Mepco's payment plan receivables could have an adverse effect on Mepco's collection of those receivables.

The top five vehicle service contract sellers from which Mepco purchases payment plans represent approximately 62.2%, 11.7%, 9.4%, 5.4% and 3.8%, respectively of Mepco's payment plan receivables at December 31, 2015. See note #11 for additional information on Mepco counterparties.

### NOTE 20 – 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 December 31, 2015, the Bank had negative undivided profits of \$10.1 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. During January of 2015, we requested regulatory approval for an additional \$18.5 million return of capital from the Bank to the parent company. This return of capital request was approved by our banking regulators on February 13, 2015, and the Bank returned \$18.5 million of capital to the parent company on February 17, 2015. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total, Tier 1, and common equity Tier 1 (as of January 1, 2015) capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can result in certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of December 31, 2015 and 2014, 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On July 2, 2013, the Federal Reserve approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity Tier 1 capital, the most loss-absorbing form of capital, and implement strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. The New Capital Rules became effective for us on January 1, 2015.

Our actual capital amounts and ratios at December 31 follow:

	Actual		Minimum for Adequately Capitalized Institutions		Minimum for Well-Capitalized Institutions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
2015						
Total capital to risk-weighted assets						
Consolidated . . . . .	\$278,170	16.65%	\$133,668	8.00%	NA	NA
Independent Bank . . . . .	261,894	15.69	133,514	8.00	\$166,893	10.00%
Tier 1 capital to risk-weighted assets						
Consolidated . . . . .	\$257,050	15.38%	\$100,251	6.00%	NA	NA
Independent Bank . . . . .	240,867	14.43	100,136	6.00	\$133,514	8.00%
Common equity tier 1 capital to risk-weighted assets						
Consolidated . . . . .	\$239,271	14.32%	\$ 75,188	4.50%	NA	NA
Independent Bank . . . . .	240,867	14.43	75,102	4.50	\$108,480	6.50%
Tier 1 capital to average assets						
Consolidated . . . . .	\$257,050	10.91%	\$ 94,217	4.00%	NA	NA
Independent Bank . . . . .	240,867	10.23	94,145	4.00	\$117,682	5.00%
2014						
Total capital to risk-weighted assets						
Consolidated . . . . .	\$265,163	18.06%	\$117,427	8.00%	NA	NA
Independent Bank . . . . .	247,883	16.90	117,374	8.00	\$146,718	10.00%
Tier 1 capital to risk-weighted assets						
Consolidated . . . . .	\$246,628	16.80%	\$ 58,714	4.00%	NA	NA
Independent Bank . . . . .	229,361	15.63	58,687	4.00	\$ 88,031	6.00%
Tier 1 capital to average assets						
Consolidated . . . . .	\$246,628	11.18%	\$ 88,206	4.00%	NA	NA
Independent Bank . . . . .	229,361	10.46	87,687	4.00	\$109,609	5.00%

NA — Not applicable



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The components of our regulatory capital are as follows:

	Consolidated		Independent Bank	
	December 31,		December 31,	
	2015	2014	2015	2014
	(In thousands)			
Total shareholders' equity .....	\$251,092	\$250,371	\$259,947	\$257,832
Add (deduct)				
Accumulated other comprehensive loss for regulatory purposes .....	238	5,636	238	5,636
Intangible assets .....	(912)	(2,627)	(912)	(2,627)
Disallowed deferred tax assets .....	(11,147)	(40,500)	(18,406)	(30,728)
Disallowed capitalized mortgage loan servicing rights ..	—	(752)	—	(752)
Common equity tier 1 capital .....	239,271	212,128	240,867	229,361
Qualifying trust preferred securities .....	34,500	34,500	—	—
Disallowed deferred tax assets .....	(16,721)	—	—	—
Tier 1 capital .....	257,050	246,628	240,867	229,361
Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets .....	21,120	18,535	21,027	18,522
Total risk-based capital .....	<u>\$278,170</u>	<u>\$265,163</u>	<u>\$261,894</u>	<u>\$247,883</u>

### NOTE 21 – 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.

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 securities, private label residential mortgage-backed securities, other asset backed securities, municipal securities, trust preferred securities and corporate securities.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

*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 December 31, 2015 and 2014, 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 net (gains) losses on other real estate and repossessed assets in the 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.

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.

*Capitalized mortgage loan servicing rights:* The fair value of capitalized mortgage loan servicing rights is based on a valuation model used by an independent third party that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Certain model assumptions are generally unobservable and are based upon the best information available including data relating to our own servicing portfolio, reviews of mortgage servicing assumption and valuation surveys and input from various mortgage servicers and, therefore, are recorded as 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 purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management (recurring Level 2).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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)
		Fair Value Measurements	(In thousands)	
December 31, 2015:				
Measured at Fair Value on a Recurring Basis:				
Assets				
Trading securities . . . . .	\$ 148	\$148	\$ —	\$ —
Securities available for sale				
U.S. agency . . . . .	47,512	—	47,512	—
U.S. agency residential mortgage-backed . . . . .	196,056	—	196,056	—
U.S. agency commercial mortgage-backed . . . . .	34,028	—	34,028	—
Private label residential mortgage-backed . . . . .	4,903	—	4,903	—
Other asset backed . . . . .	116,904	—	116,904	—
Obligations of states and political subdivisions . . . . .	144,984	—	144,984	—
Corporate . . . . .	38,614	—	38,614	—
Trust preferred . . . . .	2,483	—	2,483	—
Loans held for sale . . . . .	27,866	—	27,866	—
Derivatives (1) . . . . .	1,238	—	1,238	—
Liabilities				
Derivatives (2) . . . . .	619	—	619	—
Measured at Fair Value on a Non-recurring basis:				
Assets				
Capitalized mortgage loan servicing rights (3) . . . . .	8,481	—	—	8,481
Impaired loans (4)				
Commercial				
Income producing - real estate . . . . .	711	—	—	711
Land, land development & construction-real estate . . . . .	40	—	—	40
Commercial and industrial . . . . .	1,257	—	—	1,257
Mortgage				
1-4 Family . . . . .	421	—	—	421
Resort lending . . . . .	129	—	—	129
Other real estate (5)				
Commercial				
Land, land development & construction-real estate . . . . .	639	—	—	639
Commercial and industrial . . . . .	165	—	—	165
Mortgage				
1-4 Family . . . . .	26	—	—	26
Resort lending . . . . .	107	—	—	107
Home equity - 1st lien . . . . .	14	—	—	14
Installment				
Home equity - 1st lien . . . . .	36	—	—	36

(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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

		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)
	Fair Value Measurements	(In thousands)		
December 31, 2014:				
Measured at Fair Value on a Recurring Basis:				
Assets				
Trading securities . . . . .	\$ 203	\$203	\$ —	\$ —
Securities available for sale				
U.S. agency . . . . .	35,006	—	35,006	—
U.S. agency residential mortgage-backed . . . . .	257,558	—	257,558	—
U.S. agency commercial mortgage-backed . . . . .	33,728	—	33,728	—
Private label residential mortgage-backed . . . . .	6,013	—	6,013	—
Other asset backed . . . . .	32,353	—	32,353	—
Obligations of states and political subdivisions. . . . .	143,415	—	143,415	—
Corporate . . . . .	22,664	—	22,664	—
Trust preferred. . . . .	2,441	—	2,441	—
Loans held for sale . . . . .	23,662	—	23,662	—
Derivatives (1). . . . .	619	—	619	—
Liabilities				
Derivatives (2). . . . .	366	—	366	—
Measured at Fair Value on a Non-recurring basis:				
Assets				
Capitalized mortgage loan servicing rights (3) . . . . .	9,197	—	—	9,197
Impaired loans (4)				
Commercial				
Income producing - real estate . . . . .	869	—	—	869
Land, land development & construction-real estate . . .	354	—	—	354
Commercial and industrial . . . . .	2,601	—	—	2,601
Mortgage				
1-4 Family . . . . .	1,306	—	—	1,306
Other real estate (5)				
Commercial				
Income producing - real estate . . . . .	479	—	—	479
Land, land development & construction-real estate . . .	737	—	—	737
Mortgage				
1-4 Family . . . . .	102	—	—	102
Resort lending . . . . .	575	—	—	575
Installment				
Home equity - 1st lien . . . . .	13	—	—	13

(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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

There were no transfers between Level 1 and Level 2 during the years ended December 31, 2015 and 2014.

Changes in fair values of financial assets for which we have elected the fair value option for the years ended December 31 were as follows:

	Net Gains (Losses) on Assets		Total Change in Fair Values Included in Current Period Earnings
	Securities	Loans	
	(In thousands)		
2015			
Trading securities .....	\$ (55)	\$ —	\$ (55)
Loans held for sale .....	—	90	90
2014			
Trading securities .....	\$(295)	\$ —	\$ (295)
Loans held for sale .....	—	258	258
2013			
Trading securities .....	\$ 388	\$ —	\$ 388
Loans held for sale .....	—	(1,477)	(1,477)

For those items measured at fair value pursuant to our election of the fair value option, interest income is recorded within the 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 years ended December 31, 2015, 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 \$8.5 million, which is net of a valuation allowance of \$3.3 million, at December 31, 2015, and had a carrying amount of \$9.2 million, which is net of a valuation allowance of \$3.8 million, at December 31, 2014. A recovery (charge) of \$0.5 million, \$(0.9) million and \$3.2 million was included in our results of operations for the years ending December 31, 2015, 2014 and 2013, respectively.
- Loans which are measured for impairment using the fair value of collateral for collateral dependent loans had a carrying amount of \$5.1 million, with a valuation allowance of \$2.5 million at December 31, 2015, and had a carrying amount of \$8.2 million, with a valuation allowance of \$3.1 million at December 31, 2014. An additional provision for loan losses relating to impaired loans of \$1.1 million, \$2.1 million and \$1.5 million was included in our results of operations for the years ending December 31, 2015, 2014 and 2013, respectively.
- Other real estate, which is measured using the fair value of the property, had a carrying amount of \$1.0 million which is net of a valuation allowance of \$1.7 million at December 31, 2015, and a carrying amount of \$1.9 million, which is net of a valuation allowance of \$2.5 million, at December 31, 2014. An additional charge relating to other real estate measured at fair value of \$0.3 million, \$0.3 million and \$1.6 million was included in our results of operations during the years ended December 31, 2015, 2014 and 2013, respectively.

We had no assets or liabilities measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) during the years ended December 31, 2015 and 2014.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

	Asset Fair Value  (In thousands)	Valuation Technique	Unobservable Inputs	Weighted Average
2015				
Capitalized mortgage loan servicing rights . . . . .	\$8,481	Present value of net servicing revenue	Discount rate Cost to service Ancillary income Float rate	10.04% \$ 80 24 1.73%
Impaired loans				
Commercial (1) . . . . .	1,605	Sales comparison approach	Adjustment for differences between comparable sales	(2.1)%
		Income approach	Capitalization rate	9.3
Mortgage . . . . .	550	Sales comparison approach	Adjustment for differences between comparable sales	0.7
Other real estate				
Commercial . . . . .	804	Sales comparison approach	Adjustment for differences between comparable sales	(3.9)
Mortgage and installment . . .	183	Sales comparison approach	Adjustment for differences between comparable sales	75.6
2014				
Capitalized mortgage loan servicing rights . . . . .	\$9,197	Present value of net servicing revenue	Discount rate Cost to service Ancillary income Float rate	10.07% \$ 82 25 1.77%
Impaired loans				
Commercial (1) . . . . .	2,751	Sales comparison approach	Adjustment for differences between comparable sales	(3.8)%
		Income approach	Capitalization rate	9.3
Mortgage . . . . .	1,306	Sales comparison approach	Adjustment for differences between comparable sales	8.6
Other real estate				
Commercial . . . . .	1,216	Sales comparison approach	Adjustment for differences between comparable sales	(9.0)
Mortgage and installment . . .	690	Sales comparison approach	Adjustment for differences between comparable sales	34.3

- (1) In addition to the valuation techniques and unobservable inputs discussed above, at December 31, 2015 and 2014, we had an impaired collateral dependent commercial relationship that totaled \$0.4 million and \$1.1 million, respectively that was primarily secured by collateral other than real estate. Collateral securing this relationship primarily included machinery and equipment and inventory at December 31, 2015 and 2014 and also included accounts receivable at December 31, 2014. Valuation techniques at December 31, 2015, included appraisals and discounting restructuring firm valuations based on estimates of value recovery of each particular asset type. Discount rates used ranged from 0% to 100% of stated values. Valuation techniques at December 31, 2014, included discounting cost and financial statement value approaches based on estimates of value recovery of each particular asset type. Discount rates used ranged from 35% to 100% of stated values.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 at December 31.

	<u>Aggregate Fair Value</u>	<u>Difference</u> (In thousands)	<u>Contractual Principal</u>
Loans held for sale			
2015 .....	\$27,866	\$714	\$27,152
2014 .....	23,662	624	23,038
2013 .....	20,390	366	20,024

### NOTE 22 – FAIR VALUES OF FINANCIAL INSTRUMENTS

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

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

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

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

*Securities:* Financial instrument assets actively traded in a secondary market have been valued using quoted market prices. Trading securities are classified as Level 1 while securities available for sale are classified as Level 2 as described in note #21.

*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 #21. Loans held for sale are classified as Level 2 as described in Note #21.

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

*Derivative financial instruments:* The fair value of rate-lock mortgage loan commitments and mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets, the fair value of interest rate swap agreements is based on a discounted cash flow analysis whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management and the fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management. Each of these instruments has been classified as Level 2 as described in note #21.

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

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

The estimated recorded book balances and fair values at December 31 follow:

		Fair Value Using			
	Recorded Book Balance	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)					
2015					
Assets					
Cash and due from banks . . . . .	\$ 54,260	\$ 54,260	\$ 54,260	\$ —	\$ —
Interest bearing deposits . . . . .	31,523	31,523	31,523	—	—
Interest bearing deposits - time . . . . .	11,866	11,858	—	11,858	—
Trading securities . . . . .	148	148	148	—	—
Securities available for sale . . . . .	585,484	585,484	—	585,484	—
Federal Home Loan Bank and Federal Reserve Bank Stock . . . . .	15,471	NA	NA	NA	NA
Net loans and loans held for sale . . . . .	1,520,346	1,472,613	—	27,866	1,444,747
Accrued interest receivable . . . . .	6,565	6,565	5	1,969	4,591
Derivative financial instruments . . . . .	1,238	1,238	—	1,238	—
Liabilities					
Deposits with no stated maturity (1) . . . . .	\$1,659,743	\$1,659,743	\$1,659,743	\$ —	\$ —
Deposits with stated maturity (1) . . . . .	426,220	423,776	—	423,776	—
Other borrowings . . . . .	11,954	13,448	—	13,448	—
Subordinated debentures . . . . .	35,569	23,069	—	23,069	—
Accrued interest payable . . . . .	466	466	21	445	—
Derivative financial instruments . . . . .	619	619	—	619	—
2014					
Assets					
Cash and due from banks . . . . .	\$ 48,326	\$ 48,326	\$ 48,326	\$ —	\$ —
Interest bearing deposits . . . . .	25,690	25,690	25,690	—	—
Interest bearing deposits - time . . . . .	13,561	13,585	—	13,585	—
Trading securities . . . . .	203	203	203	—	—
Securities available for sale . . . . .	533,178	533,178	—	533,178	—
Federal Home Loan Bank and Federal Reserve Bank Stock . . . . .	19,919	NA	NA	NA	NA
Net loans and loans held for sale . . . . .	1,407,634	1,394,424	—	23,662	1,370,762
Accrued interest receivable . . . . .	5,995	5,995	2	1,599	4,394
Derivative financial instruments . . . . .	619	619	—	619	—
Liabilities					
Deposits with no stated maturity (1) . . . . .	\$1,534,175	\$1,534,175	\$1,534,175	\$ —	\$ —
Deposits with stated maturity (1) . . . . .	390,127	389,139	—	389,139	—
Other borrowings . . . . .	12,470	14,560	—	14,560	—
Subordinated debentures . . . . .	35,569	23,328	—	23,328	—
Accrued interest payable . . . . .	380	380	21	359	—
Derivative financial instruments . . . . .	366	366	—	366	—

- (1) Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$11.8 million and \$13.6 million at December 31, 2015 and 2014, respectively. Deposits with a stated maturity include reciprocal deposits with a recorded book balance of \$38.4 million and \$40.1 million at December 31, 2015 and 2014, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

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

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

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

### NOTE 23 – OPERATING 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.

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

	<u>IB</u>	<u>Mepco</u>	<u>Other (1)(2)</u>	<u>Elimination (3)</u>	<u>Total</u>
	(In thousands)				
<b>2015</b>					
Total assets . . . . .	\$2,340,566	\$57,208	\$286,936	\$(275,644)	\$2,409,066
Interest income . . . . .	75,552	5,290	72	(72)	80,842
Net interest income . . . . .	71,448	4,487	(949)	—	74,986
Provision for loan losses . . . . .	(2,705)	(9)	—	—	(2,714)
Income (loss) before income tax . . . . .	32,136	(1,183)	(1,478)	(95)	29,380
Net income (loss) . . . . .	21,727	(712)	(936)	(62)	20,017
<b>2014</b>					
Total assets . . . . .	\$2,174,536	\$63,378	\$286,158	\$(275,342)	\$2,248,730
Interest income . . . . .	73,551	7,004	64	(64)	80,555
Net interest income . . . . .	68,948	5,706	(1,398)	—	73,256
Provision for loan losses . . . . .	(3,098)	(38)	—	—	(3,136)
Income (loss) before income tax . . . . .	25,845	561	(1,095)	(95)	25,216
Net income (loss) . . . . .	18,550	366	(712)	(183)	18,021
<b>2013</b>					
Total assets . . . . .	\$2,104,550	\$94,648	\$272,348	\$(261,603)	\$2,209,943
Interest income . . . . .	76,018	11,103	—	—	87,121
Net interest income . . . . .	71,496	8,780	(2,317)	—	77,959
Provision for loan losses . . . . .	(3,891)	(97)	—	—	(3,988)
Income (loss) before income tax . . . . .	29,605	(2,891)	(3,961)	(95)	22,658
Net income (loss) . . . . .	74,313	(1,801)	5,092	(95)	77,509

- (1) During 2013 IB and Other (parent company) include \$47.1 million and \$9.0 million, respectively of income tax benefit related to the reversal of the valuation allowance on our net deferred tax assets (see note #13).
- (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.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

## NOTE 24 – ACCUMULATED OTHER COMPREHENSIVE LOSS

A summary of changes in accumulated other comprehensive loss (“AOCL”), net of tax during the years ended December 31 follows:

	Unrealized Losses on Available for Sale Securities	Disproportionate Tax Effects from Securities Available for Sale	Unrealized Losses on Cash Flow Hedges	Unrealized Losses on Settled Derivatives	Disproportionate Tax Effects from Cash Flow Hedges	Total
	(In thousands)					
2015						
Balances at beginning of period . . . . .	\$ 162	\$(5,798)	\$ —	\$ —	\$ —	\$(5,636)
Other comprehensive loss before reclassifications . . . . .	(351)	—	—	—	—	(351)
Amounts reclassified from AOCL . . . . .	(49)	—	—	—	—	(49)
Net current period other comprehensive loss . . . . .	(400)	—	—	—	—	(400)
Balances at end of period . . . . .	<u>\$ (238)</u>	<u>\$(5,798)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$(6,036)</u>
2014						
Balances at beginning of period . . . . .	\$(3,200)	\$(5,798)	\$ —	\$(247)	\$ —	\$(9,245)
Other comprehensive income before reclassifications . . . . .	3,570	—	—	—	—	3,570
Amounts reclassified from AOCL . . . . .	(208)	—	—	247	—	39
Net current period other comprehensive income . . . . .	3,362	—	—	247	—	3,609
Balances at end of period . . . . .	<u>\$ 162</u>	<u>\$(5,798)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$(5,636)</u>
2013						
Balances at beginning of period . . . . .	\$ (516)	\$(5,617)	\$(739)	\$ —	\$(1,186)	\$(8,058)
Income tax . . . . .	181	(181)	258	—	(258)	—
Balances at beginning of period, net of tax . .	(335)	(5,798)	(481)	—	(1,444)	(8,058)
Terminated cash flow hedge . . . . .	—	—	370	(370)	—	—
Other comprehensive loss before reclassifications . . . . .	(2,877)	—	(24)	—	—	(2,901)
Amounts reclassified from AOCL . . . . .	12	—	135	123	1,444	1,714
Net current period other comprehensive income (loss) . . . . .	(2,865)	—	111	123	1,444	(1,187)
Balances at end of period . . . . .	<u>\$(3,200)</u>	<u>\$(5,798)</u>	<u>\$ —</u>	<u>\$(247)</u>	<u>\$ —</u>	<u>\$(9,245)</u>

The disproportionate tax effects from securities available for sale and cash flow hedges arose due to tax effects of other comprehensive income (“OCI”) in the presence of a valuation allowance against our deferred tax assets and a pretax loss from operations. Generally, the amount of income tax expense or benefit allocated to operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided when, in the presence of a valuation allowance against deferred tax assets, there is a pretax loss from operations and pretax income from other categories in the current period. In such instances, income from other categories must offset the current loss from operations, the tax benefit of such offset being reflected in operations. During the second quarter of 2013, we terminated our last remaining cash flow hedge and cleared the disproportionate tax effects relating to cash flow hedges from accumulated other comprehensive loss (see note #13).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

A summary of reclassifications out of each component of AOCL for the years ended December 31 follows:

AOCL Component	Reclassified From AOCL (In thousands)	Affected Line Item in Consolidated Statements of Operations
2015		
Unrealized losses on securities available for sale		
	\$ 75	Net gains on securities
	<u>—</u>	Net impairment loss recognized in earnings
	75	Total reclassifications before tax
	<u>26</u>	Income tax expense (benefit)
	<u>\$ 49</u>	Reclassifications, net of tax
2014		
Unrealized losses on securities available for sale		
	\$ 329	Net gains on securities
	<u>(9)</u>	Net impairment loss recognized in earnings
	320	Total reclassifications before tax
	<u>112</u>	Income tax expense (benefit)
	<u>\$ 208</u>	Reclassifications, net of tax
Unrealized losses on settled derivatives		
	\$ (380)	Interest expense
	<u>(133)</u>	Income tax expense (benefit)
	<u>\$ (247)</u>	Reclassification, net of tax
	<u>\$ (39)</u>	Total reclassifications for the period, net of tax
2013		
Unrealized losses on securities available for sale		
	\$ 7	Net gains on securities
	<u>(26)</u>	Net impairment loss recognized in earnings
	(19)	Total reclassifications before tax
	<u>(7)</u>	Income tax expense (benefit)
	<u>\$ (12)</u>	Reclassifications, net of tax
Unrealized losses on cash flow hedges		
	\$ (208)	Interest expense
	<u>(73)</u>	Income tax expense (benefit)
	<u>\$ (135)</u>	Reclassification, net of tax
Unrealized losses on settled derivatives		
	\$ (189)	Interest expense
	<u>(66)</u>	Income tax expense (benefit)
	<u>\$ (123)</u>	Reclassification, net of tax
Disproportionate tax effects from cash flow hedges		
	<u>\$ 1,444</u>	Income tax expense (benefit)
	<u>\$ (1,714)</u>	Total reclassifications for the period, net of tax

# **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

## **NOTE 25 – INDEPENDENT BANK CORPORATION (PARENT COMPANY ONLY) FINANCIAL INFORMATION**

Presented below are condensed financial statements for our parent company.

### **CONDENSED STATEMENTS OF FINANCIAL CONDITION**

	December 31,	
	2015	2014
	(In thousands)	
ASSETS		
Cash and due from banks . . . . .	\$ 10,800	\$ 5,174
Interest bearing deposits - time . . . . .	5,000	12,500
Investment in subsidiaries . . . . .	261,016	258,901
Other assets . . . . .	10,120	9,583
Total Assets . . . . .	<u>\$286,936</u>	<u>\$286,158</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Subordinated debentures . . . . .	\$ 35,569	\$ 35,569
Other liabilities . . . . .	378	382
Shareholders' equity . . . . .	<u>250,989</u>	<u>250,207</u>
Total Liabilities and Shareholders' Equity . . . . .	<u>\$286,936</u>	<u>\$286,158</u>

### **CONDENSED STATEMENTS OF OPERATIONS**

	<u>Year Ended December 31,</u>		
	<u>2015</u>	<u>2014</u>	<u>2013</u>
	<u>(In thousands)</u>		
<b>OPERATING INCOME (LOSS)</b>			
Interest income .....	\$ 72	\$ 64	\$ —
Gain on extinguishment of debt .....	—	500	—
Gain on securities .....	—	295	—
Increase in fair value of U.S. Treasury warrant .....	—	—	(1,025)
Other income .....	<u>31</u>	<u>35</u>	<u>63</u>
Total Operating Income (Loss) .....	<u>103</u>	<u>894</u>	<u>(962)</u>
<b>OPERATING EXPENSES</b>			
Interest expense .....	1,021	1,462	2,317
Administrative and other expenses .....	<u>560</u>	<u>527</u>	<u>682</u>
Total Operating Expenses .....	<u>1,581</u>	<u>1,989</u>	<u>2,999</u>
Loss Before Income Tax and Equity in Undistributed Net Income of Subsidiaries .....	(1,478)	(1,095)	(3,961)
Income tax benefit .....	<u>(542)</u>	<u>(383)</u>	<u>(9,053)</u>
Income (Loss) Before Equity in Undistributed Net Income of Subsidiaries .....	(936)	(712)	5,092
Equity in undistributed net income of subsidiaries .....	<u>20,953</u>	<u>18,733</u>	<u>72,417</u>
Net Income .....	<u>\$20,017</u>	<u>\$18,021</u>	<u>\$77,509</u>



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONDENSED STATEMENTS OF CASH FLOWS**

	<b>Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(In thousands)</b>		
Net Income .....	\$ 20,017	\$ 18,021	\$ 77,509
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH USED IN OPERATING ACTIVITIES			
Deferred income taxes .....	(542)	(383)	(8,955)
Share based compensation .....	21	46	84
Gain on extinguishment of debt .....	—	(500)	—
Gain on securities .....	—	(295)	—
Decrease in other assets .....	5	118	738
Increase (decrease) in other liabilities .....	(6)	287	(5,858)
Equity in undistributed net income of subsidiaries operations .....	(20,953)	(18,733)	(72,417)
Total Adjustments .....	(21,475)	(19,460)	(86,408)
Net Cash Used in Operating Activities .....	(1,458)	(1,439)	(8,899)
CASH FLOW FROM INVESTING ACTIVITIES			
Purchases of interest bearing deposits - time .....	(5,000)	(17,500)	—
Maturity of interest bearing deposits - time .....	12,500	5,000	—
Return of capital from subsidiary .....	18,500	15,000	7,500
Net Cash From Investing Activities .....	26,000	2,500	7,500
CASH FLOW FROM (USED IN) FINANCING ACTIVITIES			
Repurchase of common stock .....	(13,498)	—	—
Dividends paid .....	(5,896)	(4,129)	—
Proceeds from issuance of common stock .....	1,569	1,242	100,230
Share based compensation withholding obligation .....	(1,091)	—	(513)
Redemption of subordinated debt .....	—	(4,654)	(9,452)
Redemption of convertible preferred stock and common stock warrant .....	—	—	(81,000)
Net Cash From (Used in) Financing Activities .....	(18,916)	(7,541)	9,265
Net Increase (Decrease) in Cash and Cash Equivalents .....	5,626	(6,480)	7,866
Cash and Cash Equivalents at Beginning of Year .....	5,174	11,654	3,788
Cash and Cash Equivalents at End of Year .....	\$ 10,800	\$ 5,174	\$ 11,654

**NOTE 26 – BRANCH SALE**

On April 29, 2015 we entered into a Purchase and Assumption Agreement (“PAA”) with Isabella Bank (based in Mt. Pleasant, Michigan). Pursuant to the PAA, on August 28, 2015, we sold the fixed assets, real property and certain other assets of our bank branch located in Midland, Michigan (the “Midland Branch”) to Isabella Bank. The deposit liabilities of the Midland Branch were assumed by Isabella Bank which totaled \$8.7 million on the date of sale. Under the terms of the PAA, Isabella Bank paid a premium of \$0.6 million (which was equal to 6.0% of the average deposit liabilities of \$9.7 million based on the 20-day average ending two business days prior to the closing date of August 28, 2015) and \$0.85 million for the real property and fixed assets (including the ATM). The real property and the fixed assets had a net book value of approximately \$0.2 million as of August 28, 2015. We recorded a net gain of \$1.2 million in the third quarter of 2015 on the sale of the Midland Branch.

## QUARTERLY FINANCIAL DATA (UNAUDITED)

A summary of selected quarterly results of operations for the years ended December 31 follows:

	Three Months Ended			
	March 31,	June 30,	September 30,	December 31,
	(In thousands, except per share amounts)			
2015				
Interest income . . . . .	\$19,552	\$20,131	\$20,293	\$20,866
Net interest income . . . . .	18,091	18,701	18,841	19,353
Provision for loan losses . . . . .	(659)	(134)	(244)	(1,677)
Income before income tax . . . . .	5,561	8,243	7,325	8,251
Net income . . . . .	3,781	5,619	5,047	5,570
Income per common share				
Basic . . . . .	0.16	0.25	0.22	0.25
Diluted . . . . .	0.16	0.24	0.22	0.25
2014				
Interest income . . . . .	\$20,283	\$20,357	\$20,068	\$19,847
Net interest income . . . . .	18,478	18,538	18,183	18,057
Provision for loan losses . . . . .	428	(1,845)	(632)	(1,087)
Income before income tax . . . . .	4,605	7,899	7,274	5,438
Net income . . . . .	3,138	6,052	4,929	3,902
Income per common share				
Basic . . . . .	0.14	0.26	0.21	0.17
Diluted . . . . .	0.13	0.26	0.21	0.17

During the fourth quarter of 2015, we recognized a recovery of impairment on our capitalized mortgage loan servicing rights of \$0.8 million (see note #4). During the fourth quarter of 2014, we recognized an additional impairment on our capitalized mortgage loan servicing rights of \$1.0 million (see note #4) and a gain on the extinguishment of debt of \$0.5 million (see note #10).

## QUARTERLY SUMMARY (UNAUDITED)

	Reported Sales Prices of Common Shares						Cash Dividends Declared	
	2015			2014			2015	2014
	High	Low	Close	High	Low	Close		
First quarter . . . . .	\$13.20	\$12.07	\$12.83	\$14.25	\$11.78	\$12.98	\$0.06	\$ —
Second quarter . . . . .	13.93	12.62	13.56	13.88	12.45	12.87	0.06	0.06
Third quarter . . . . .	15.27	13.20	14.76	13.47	11.77	11.92	0.06	0.06
Fourth quarter . . . . .	15.88	13.71	15.23	13.20	11.47	13.05	0.08	0.06

We have approximately 1,600 holders of record of our common stock. Our common stock trades on the Nasdaq Global Select Market System under the symbol “IBCP.” The prices shown above are supplied by Nasdaq and reflect the inter-dealer prices and may not include retail markups, markdowns or commissions. There may have been transactions or quotations at higher or lower prices of which we are not aware.

In addition to limitations imposed by the provisions of the Michigan Business Corporation Act (which, among other things, limits us from paying dividends to the extent we are insolvent), our ability to pay dividends is limited by our ability to obtain funds from our Bank and by regulatory capital guidelines applicable to us (see note #20).

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Robert N. Shuster  
  
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# INDEPENDENT BANK

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STOCK Independent Bank Corporation's common stock trades on the NASDAQ Global Select Market System under the symbol IBCP.

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DIVIDEND REINVESTMENT AND DIRECT STOCK PURCHASES OR SALES Investors Choice is our Dividend Reinvestment & Direct Stock Purchase and Sale Plan sponsored and administered by American Stock Transfer & Trust Company, LLC, the transfer agent for Independent Bank Corporation. A plan booklet is available by writing to our Chief Financial Officer. The plan materials are also available at the American Stock Transfer & Trust Company website ([amstock.com](http://amstock.com)).

FORM 10-K Shareholders may obtain, without charge, a copy of Form 10-K, the 2015 Annual Report to the Securities and Exchange Commission, through our website at [IndependentBank.com](http://IndependentBank.com) or by writing to the Chief Financial Officer, Independent Bank Corporation, 4200 East Beltline, Grand Rapids, Michigan 49525 or by email at [info@ibcp.com](mailto:info@ibcp.com).





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