

MACATAWA BANK CORP  
Form 10-Q  
July 25, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-25927

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

Michigan 38-3391345  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444

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Indicate by checkmark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

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Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if smaller reporting company)

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:  
27,261,325 shares of the Company's Common Stock (no par value) were outstanding as of July 25, 2013.

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Forward-Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Macatawa Bank Corporation. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "may", "should", "will", "is likely", or is "probable" to occur or "continue", has "begun" or "is scheduled" or "on track" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "intends", "predicts", "projects", or "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "near term", "going forward", "starting", "initiative," "trend" and variations of such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, statements related to stabilization of our loan portfolio, trends in credit quality metrics, future capital levels and capital needs, including the impact of Basel III, real estate valuation, future levels of repossessed and foreclosed properties and nonperforming assets, future levels of losses and costs associated with the administration and disposition of repossessed and foreclosed properties and nonperforming assets, future levels of loan charge-offs, future levels of other real estate owned, future levels of provisions for loan losses, the rate of asset dispositions, future dividends, future growth and funding sources, future cost of funds, future liquidity levels, future profitability levels, future FDIC assessment levels, future net interest margin levels, building and improving our investment portfolio, diversifying our credit risk, the effects on earnings of changes in interest rates, future economic conditions, future effects of new or changed accounting standards, future loss recoveries, future balances of short-term investments, future loan demand and loan growth, future levels of mortgage banking revenue and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including deferred tax assets) and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to sell other real estate owned at its carrying value or at all, successfully implement new programs and initiatives, increase efficiencies, maintain our current levels of deposits and other sources of funding, maintain liquidity, respond to declines in collateral values and credit quality, increase loan volume, originate high quality loans, maintain or improve mortgage banking income, realize the benefit of our deferred tax assets, resume payment of dividends and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Macatawa Bank Corporation, specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Macatawa Bank Corporation does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2012. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

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## Part I Financial Information

## Item 1.

## MACATAWA BANK CORPORATION

## CONSOLIDATED BALANCE SHEETS

As of June 30, 2013 (unaudited) and December 31, 2012

(dollars in thousands, except per share data)	June 30, 2013	December 31, 2012
<b>ASSETS</b>		
Cash and due from banks	\$27,605	\$33,556
Federal funds sold and other short-term investments	129,849	192,802
Cash and cash equivalents	157,454	226,358
Interest-bearing time deposits in other financial institutions	25,000	---
Securities available for sale, at fair value	129,659	123,497
Securities held to maturity (fair value 2013 - \$5,494 and 2012 - \$4,301)	5,380	4,300
Federal Home Loan Bank (FHLB) stock	11,236	11,236
Loans held for sale, at fair value	4,553	8,130
Total loans	1,012,887	1,052,348
Allowance for loan losses	(22,248 )	(23,739 )
Net loans	990,639	1,028,609
Premises and equipment – net	53,302	53,576
Accrued interest receivable	3,405	3,411
Bank-owned life insurance	27,162	26,804
Other real estate owned	45,845	51,582
Net deferred tax asset	17,788	18,780
Other assets	5,405	4,435
Total assets	\$1,476,828	\$1,560,718
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$318,981	\$339,520
Interest-bearing	880,597	946,741
Total deposits	1,199,578	1,286,261
Other borrowed funds	90,658	91,822
Long-term debt	41,238	41,238
Subordinated debt	1,650	1,650
Accrued expenses and other liabilities	10,452	9,240
Total liabilities	1,343,576	1,430,211
Commitments and contingent liabilities	---	---
Shareholders' equity		
Preferred stock, no par value, 500,000 shares authorized; Series A Noncumulative Convertible Perpetual Preferred Stock, liquidation value of \$1,000 per share, 31,290 shares issued and outstanding at June 30, 2013 and December 31, 2012	30,604	30,604
	2,260	2,560

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Series B Noncumulative Convertible Perpetual Preferred Stock, liquidation value of \$1,000 per share, 2,300 shares issued and outstanding at June 30, 2013 and 2,600 shares issued and outstanding at December 31, 2012

Common stock, no par value, 200,000,000 shares authorized; 27,261,325 shares issued and outstanding at June 30, 2013 and 27,203,825 shares issued and outstanding at December 31, 2012

Retained deficit	188,080	187,718
Accumulated other comprehensive income (loss)	(86,258 )	(91,335 )
Total shareholders' equity	(1,434 )	960
Total liabilities and shareholders' equity	133,252	130,507
	\$1,476,828	\$1,560,718

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
Three and Six Month Periods Ended June 30, 2013 and 2012  
(unaudited)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
(dollars in thousands, except per share data)				
Interest income				
Loans, including fees	\$11,493	\$13,237	\$23,161	\$26,763
Securities				
Taxable	448	384	877	701
Tax-exempt	155	65	296	108
FHLB Stock	97	84	196	169
Federal funds sold and other short-term investments	114	130	210	257
Total interest income	12,307	13,900	24,740	27,998
Interest expense				
Deposits	982	1,525	2,067	3,175
Debt and other borrowed funds	862	1,053	1,726	2,221
Total interest expense	1,844	2,578	3,793	5,396
Net interest income	10,463	11,322	20,947	22,602
Provision for loan losses	(1,000 )	(1,750 )	(1,750 )	(5,350 )
Net interest income after provision for loan losses	11,463	13,072	22,697	27,952
Noninterest income				
Service charges and fees	976	776	1,888	1,571
Net gains on mortgage loans	708	780	1,533	1,251
Trust fees	625	598	1,213	1,207
Gain on sale of securities	61	59	80	59
ATM and debit card fees	1,132	1,064	2,109	2,045
Other	709	723	1,351	1,578
Total noninterest income	4,211	4,000	8,174	7,711
Noninterest expense				
Salaries and benefits	5,732	5,723	11,525	11,443
Occupancy of premises	905	941	1,851	1,912
Furniture and equipment	845	858	1,595	1,685
Legal and professional	183	180	373	392
Marketing and promotion	246	210	492	420
Data processing	352	368	704	719
FDIC assessment	345	479	817	1,188
ATM and debit card processing	361	308	652	596
Bond and D&O Insurance	183	215	368	483
Losses on repossessed and foreclosed properties	294	1,934	353	3,531

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Administration and disposition of problem assets	1,005	1,256	1,907	2,718
Other	1,424	1,414	2,819	2,905
Total noninterest expenses	11,875	13,886	23,456	27,992
Income before income tax	3,799	3,186	7,415	7,671
Income tax expense	1,196	---	2,338	---
Net income	2,603	3,186	5,077	7,671
Dividends declared on preferred shares	---	---	---	---
Net income available to common shares	\$2,603	\$3,186	\$5,077	\$7,671
Basic earnings per common share	\$0.10	\$0.12	\$0.19	\$0.28
Diluted earnings per common share	\$0.10	\$0.12	\$0.19	\$0.28
Cash dividends per common share	\$---	\$---	\$---	\$---

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 Three and Six Month Periods Ended June 30, 2013 and 2012  
 (unaudited)

(dollars in thousands)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Three Months Ended June 30, 2012
Net income	\$2,603	\$ 3,186	\$5,077	\$ 7,671
Other comprehensive income (loss):				
Unrealized gains (losses):				
Net change in unrealized gains (losses) on securities available for sale	(3,460)	560	(3,603)	523
Tax effect	1,211	(196 )	1,261	(183 )
Net change in unrealized gains (losses) on securities available for sale, net of tax	(2,249)	364	(2,342)	340
Less: reclassification adjustments:				
Reclassification for gains included in net income	61	59	80	59
Tax effect	(21 )	(21 )	(28 )	(21 )
Reclassification for gains included in net income, net of tax	40	38	52	38
Other comprehensive income (loss), net of tax	(2,289)	326	(2,394)	302
Comprehensive income	\$314	\$ 3,512	\$2,683	\$ 7,973

See accompanying notes to consolidated financial statements.

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## MACATAWA BANK CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Six Month Periods Ended June 30, 2013 and 2012

(unaudited)

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(dollars in thousands, except per share data)	Preferred Stock		Common	Retained	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Series A	Series B	Stock	(Deficit)		
Balance, January 1, 2012	\$30,604	\$2,560	\$187,709	\$(126,825)	\$ 378	\$ 94,426
Net income for six months ended June 30, 2012				7,671		7,671
Net change in unrealized gain (loss) on securities available for sale, net of tax					302	302
Balance, June 30, 2012	\$30,604	\$2,560	\$187,709	\$(119,154)	\$ 680	\$ 102,399
Balance, January 1, 2013	\$30,604	\$2,560	\$187,718	\$(91,335 )	\$ 960	\$ 130,507
Net income for six months ended June 30, 2013				5,077		5,077
Conversion of 300 shares of Preferred Stock Series B to 50,000 shares of Common Stock		(300 )	300			---
Net change in unrealized gain (loss) on securities available for sale, net of tax					(2,394 )	(2,394 )
Stock compensation expense			62			62
Balance, June 30, 2013	\$30,604	\$2,260	\$188,080	\$(86,258 )	\$ (1,434 )	\$ 133,252

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Six Month Periods Ended June 30, 2013 and 2012  
(unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
(dollars in thousands)		
Cash flows from operating activities		
Net income	\$5,077	\$7,671
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	1,452	1,416
Stock compensation expense	62	---
Provision for loan losses	(1,750 )	(5,350 )
Origination of loans for sale	(63,160 )	(59,412 )
Proceeds from sales of loans originated for sale	68,270	55,059
Net gains on mortgage loans	(1,533 )	(1,251 )
Gain on sales of securities	(80 )	(59 )
Write-down of other real estate	967	3,550
Net gain on sales of other real estate	(614 )	(20 )
Decrease (increase) in net deferred tax asset	2,283	---
Decrease (increase) in accrued interest receivable and other assets	(964 )	1,579
Earnings in bank-owned life insurance	(358 )	(447 )
Increase in accrued expenses and other liabilities	2,838	911
Net cash from operating activities	12,490	3,647
Cash flows from investing activities		
Loan originations and payments, net	36,966	27,174
Change in interest-bearing deposits in other financial institutions	(25,000 )	---
Purchases of securities available for sale	(27,049 )	(67,461 )
Purchases of securities held to maturity	(1,100 )	---
Proceeds from:		
Maturities and calls of securities available for sale	8,319	25,613
Sales of securities available for sale	3,778	4,050
Principal paydowns on securities	3,290	1,035
Sales of other real estate	8,138	8,587
Additions to premises and equipment	(889 )	(407 )
Net cash from investing activities	6,453	(1,409 )
Cash flows from financing activities		
Net decrease in in-market deposits	(86,683 )	20,228
Repayments of other borrowed funds	(1,164 )	(21,114 )
Net cash from financing activities	(87,847 )	(886 )
Net change in cash and cash equivalents	(68,904 )	1,352
Cash and cash equivalents at beginning of period	226,358	243,042
Cash and cash equivalents at end of period	\$157,454	\$244,394
Supplemental cash flow information		

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Interest paid	\$3,061	\$4,727
Income taxes paid	55	100
Supplemental noncash disclosures:		
Transfers from loans to other real estate	2,754	7,725
Security settlement	(1,626 )	4,670

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation ("the Company", "our", "we") and its wholly-owned subsidiary, Macatawa Bank ("the Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The Bank operates 26 full service branch offices providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan.

The Company owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company under accounting principles generally accepted in the United States of America.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) believed necessary for a fair presentation have been included.

Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. For further information, refer to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, valuation of deferred tax assets, loss contingencies, fair value of other real estate owned and fair values of financial instruments are particularly subject to change.

Regulatory Developments:

Release of Memorandum of Understanding with Macatawa Bank and its Regulators

On April 12, 2013, the Federal Deposit Insurance Corporation ("FDIC") and the Michigan Department of Insurance and Financial Services ("DIFS"), the primary banking regulators of the Bank, notified the Bank that the Bank's Memorandum of Understanding ("MOU") with the FDIC and DIFS had served its purpose and was released. As a result, the Bank is no longer subject to any regulatory order, memorandum of understanding or other similar regulatory directive or proceeding and has returned to a normal regulatory operating environment.

The MOU documented an understanding the Bank reached with regulators in connection with termination of the Bank's former Consent Order on March 2, 2012. The requirements of the MOU which are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 are no longer applicable to the Bank. In particular, the enhanced regulatory capital requirements of the MOU no longer apply to the Bank and the Bank is no

longer required to obtain the prior written consent of the FDIC and DIFS before the Bank declares or pays dividends.

We believe the FDIC and DIFS released the MOU as a result of: (i) the Bank's substantial compliance with the MOU, (ii) our implementation of enhanced corporate governance practices and disciplined business and banking principles, (iii) substantial improvements in the Bank's asset quality, (iv) improved liquidity, (v) continued improvement in the Bank's financial condition and earnings performance, and (vi) Bank regulatory capital levels well in excess of the levels required to be classified as "well capitalized" for regulatory purposes and to comply with our MOU due to our successful capital raise and the Bank's retained earnings.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Board Resolution

In connection with the termination of the Company's Written Agreement by the Federal Reserve Bank of Chicago ("FRB") on October 26, 2012, the Board of Directors of the Company adopted a resolution requiring the Company to obtain written approval from the FRB before declaring or paying any dividends, increasing holding company debt, or redeeming any capital stock.

Reclassifications: Some items in the prior period financial statements were reclassified to conform to the current presentation.

Allowance for Loan Losses: The allowance for loan losses (allowance) is a valuation allowance for probable incurred credit losses inherent in our loan portfolio, increased by the provision for loan losses and recoveries, and decreased by charge-offs of loans. Management believes the allowance for loan losses balance to be adequate based on known and inherent risks in the portfolio, past loan loss experience, information about specific borrower situations and estimated collateral values, economic conditions and other relevant factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Management continues its collection efforts on previously charged-off balances and applies recoveries as additions to the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current qualitative factors. The Company maintains a loss migration analysis that tracks loan losses and recoveries based on loan class and the loan risk grade assignment for commercial loans. At June 30, 2013, an 18 month annualized historical loss experience was used for commercial loans and a 12 month historical loss experience period was applied to residential mortgage loans and consumer loans. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, external factors and other considerations.

A loan is impaired when, based on current information and events, it is believed to be probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified and a concession has been made, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Commercial and commercial real estate loans with relationship balances exceeding \$500,000 and an internal risk grading of 6 or worse are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated and the loan is reported at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment and they are not separately identified for impairment disclosures.

Troubled debt restructurings are also considered impaired with impairment generally measured at the present value of estimated future cash flows using the loan's effective rate at inception or using the fair value of collateral, less

estimated costs to sell, if repayment is expected solely from the collateral.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed unless they add value to the property.

Income Taxes: Income tax expense is the sum of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

We recognize a tax position 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. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. We recognize interest and penalties related to income tax matters in income tax expense.

Adoption of New Accounting Standards: The Financial Accounting Standards Board ("FASB") has issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This ASU is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the statement where net income is presented or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in their entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this ASU apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP and that report items of other comprehensive income. For public entities, the amendments in this ASU are effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted this ASU on January 1, 2013 by including the required disclosures in Note 2 to the consolidated financial statements.

## NOTE 2 – SECURITIES

The amortized cost and fair value of securities at period-end were as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>June 30, 2013</u>				
Available for Sale:				
U.S. Treasury and federal agency securities	\$ 50,552	\$ 95	\$ (1,259 )	\$ 49,388
U.S. Agency MBS and CMOs	20,130	14	(243 )	19,901
Tax-exempt state and municipal bonds	23,830	52	(1,040 )	22,842
Taxable state and municipal bonds	27,984	422	(209 )	28,197
Corporate bonds and other debt securities	7,871	51	(86 )	7,836
Other equity securities	1,500	---	(5 )	1,495
	\$ 131,867	\$ 634	\$ (2,842 )	\$ 129,659
Held to Maturity				
State and municipal bonds	\$ 5,380	\$ 114	\$ ---	\$ 5,494
<u>December 31, 2012</u>				
Available for Sale:				
U.S. Treasury and federal agency securities	\$ 42,245	\$ 340	\$ (21 )	\$ 42,564
U. S. Agency MBS and CMOs	23,495	272	(6 )	23,761
Tax-exempt state and municipal bonds	20,598	244	(49 )	20,793

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Taxable state and municipal bonds	26,726	619	(49	)	27,296
Corporate bonds	7,456	77	(7	)	7,526
Other equity securities	1,500	57	---		1,557
	\$ 122,020	\$ 1,609	\$ (132	)	\$ 123,497
Held to Maturity:					
State and municipal bonds	\$ 4,300	\$ 1	\$ ---		\$ 4,301

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## NOTE 2 – SECURITIES (Continued)

Proceeds from the sale of securities available for sale were \$3.2 million in the three month period ended June 30, 2013 and \$3.8 million in the six month period ended June 30, 2013 resulting in net gains on sale of \$61,000 and \$80,000, respectively, as reported in the consolidated statements of income. This resulted in reclassifications of \$61,000 (\$40,000 net of tax) and \$80,000 (\$52,000 net of tax) from accumulated other comprehensive income to gain on sale of securities in the consolidated statements of income in the three and six month periods ended June 30, 2013.

Proceeds from the sale of securities available for sale were \$4.1 million for the three and six month periods ended June 30, 2012, resulting in net gain on sale of \$59,000, as reported in the consolidated statements of income. This resulted in reclassification of \$59,000 (\$38,000 net of tax) from accumulated other comprehensive income to gain on sale of securities in the consolidated statements of income in the three and six month periods ended June 30, 2012.

Contractual maturities of debt securities at June 30, 2013 were as follows (dollars in thousands):

	Held-to-Maturity Securities		Available-for-Sale Securities	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$4,080	\$4,194	\$3,796	\$3,834
Due from one to five years	430	430	50,651	50,671
Due from five to ten years	590	590	43,298	42,037
Due after ten years	280	280	32,622	31,622
	\$5,380	\$5,494	\$130,367	\$128,164

Securities with unrealized losses at June 30, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (dollars in thousands):

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>June 30, 2013</u>						
U.S. Treasury and federal agency securities	\$40,108	\$ (1,259 )	\$ ---	\$ ---	\$40,108	\$ (1,259 )
U.S. Agency MBS and CMOs	18,893	(243 )	---	---	18,893	(243 )
Tax-exempt state and municipal bonds	19,024	(1,040 )	---	---	19,024	(1,040 )
Taxable state and municipal bonds	10,011	(199 )	326	(10 )	10,337	(209 )
Corporate bonds and other debt securities	3,639	(86 )	---	---	3,639	(86 )
Other equity securities	1,500	(5 )	---	---	1,500	(5 )
Total temporarily impaired	\$93,175	\$ (2,832 )	\$326	\$ (10 )	\$93,501	\$ (2,842 )

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>December 31, 2012</u>						
U.S. Treasury and federal agency securities	\$10,977	\$ (21 )	\$ ---	\$ ---	\$10,977	\$ (21 )

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U.S. Agency MBS and CMOs	3,373	(6	)	---	---	3,373	(6	)
Tax-exempt state and municipal bonds	4,613	(49	)	---	---	4,613	(49	)
Taxable state and municipal bonds	4,661	(49	)	---	---	4,661	(49	)
Corporate bonds	3,945	(7	)			3,945	(7	)
Other equity securities	---	---		---	---	---	---	
Total temporarily impaired	\$27,569	\$ (132	)	\$---	\$ ---	\$27,569	\$ (132	)

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## NOTE 2 – SECURITIES (Continued)

## Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Management determined that no OTTI charges were necessary during the three and six month periods ended June 30, 2013 and 2012.

Securities with a carrying value of approximately \$7.0 million and \$7.4 million were pledged as security for public deposits, letters of credit and for other purposes required or permitted by law at June 30, 2013 and December 31, 2012, respectively.

## NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

	June 30, 2013	December 31, 2012
Commercial and industrial	\$242,759	\$259,700
Commercial real estate:		
Residential developed	22,788	26,090
Unsecured to residential developers	7,048	5,547
Vacant and unimproved	49,992	56,525
Commercial development	1,469	1,799
Residential improved	70,223	75,813
Commercial improved	250,544	255,738
Manufacturing and industrial	77,591	81,447
Total commercial real estate	479,655	502,959
Consumer		
Residential mortgage	181,292	182,625
Unsecured	1,601	1,683
Home equity	96,463	92,764
Other secured	11,117	12,617
Total consumer	290,473	289,689
Total loans	1,012,887	1,052,348
Allowance for loan losses	(22,248 )	(23,739 )
	\$990,639	\$1,028,609

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## NOTE 3 – LOANS (Continued)

Activity in the allowance for loan losses by portfolio segment was as follows (dollars in thousands):

	Commercial and		Commercial		
<u>Three months ended June 30, 2013:</u>	Industrial	Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 5,980	\$ 13,358	\$ 4,102	\$ 47	\$23,487
Charge-offs	(87 )	(222 )	(389 )	---	(698 )
Recoveries	71	310	78	---	459
Provision for loan losses	(362 )	(1,122 )	464	20	(1,000 )
Ending Balance	\$ 5,602	\$ 12,324	\$ 4,255	\$ 67	\$22,248

	Commercial and		Commercial		
<u>Three months ended June 30, 2012:</u>	Industrial	Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 7,507	\$ 17,565	\$ 4,366	\$ 13	\$29,451
Charge-offs	(21 )	(799 )	(79 )	---	(899 )
Recoveries	110	201	67	---	378
Provision for loan losses	(958 )	(1,728 )	900	36	(1,750 )
Ending Balance	\$ 6,638	\$ 15,239	\$ 5,254	\$ 49	\$27,180

	Commercial and		Commercial		
<u>Six months ended June 30, 2013:</u>	Industrial	Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 6,459	\$ 13,457	\$ 3,787	\$ 36	\$23,739
Charge-offs	(249 )	(459 )	(633 )	---	(1,341 )
Recoveries	427	994	179	---	1,600
Provision for loan losses	(1,035 )	(1,668 )	922	31	(1,750 )
Ending Balance	\$ 5,602	\$ 12,324	\$ 4,255	\$ 67	\$22,248

	Commercial and		Commercial		
<u>Six months ended June 30, 2012:</u>	Industrial	Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 6,313	\$ 20,475	\$ 4,821	\$ 32	\$31,641
Charge-offs	(989 )	(2,506 )	(901 )	---	(4,396 )
Recoveries	280	4,885	120	---	5,285
Provision for loan losses	1,034	(7,615 )	1,214	17	(5,350 )
Ending Balance	\$ 6,638	\$ 15,239	\$ 5,254	\$ 49	\$27,180

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## NOTE 3 – LOANS (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (dollars in thousands):

June 30, 2013:

	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 1,963	\$ 1,890	\$ 1,065	\$ ---	\$ 4,918
Collectively evaluated for impairment	3,639	10,434	3,190	67	17,330
Total ending allowance balance	\$ 5,602	\$ 12,324	\$ 4,255	\$ 67	\$ 22,248
Loans:					
Individually reviewed for impairment	\$ 13,086	\$ 48,395	\$ 15,145	\$ ---	\$ 76,626
Collectively evaluated for impairment	229,673	431,260	275,328	---	936,261
Total ending loans balance	\$ 242,759	\$ 479,655	\$ 290,473	\$ ---	\$ 1,012,887

December 31, 2012:

	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 2,920	\$ 2,418	\$ 716	\$ ---	\$ 6,054
Collectively evaluated for impairment	3,539	11,039	3,071	36	17,685
Total ending allowance balance	\$ 6,459	\$ 13,457	\$ 3,787	\$ 36	\$ 23,739
Loans:					
Individually reviewed for impairment	\$ 14,390	\$ 54,831	\$ 14,086	\$ ---	\$ 83,307
Collectively evaluated for impairment	245,310	448,128	275,603	---	969,041
Total ending loans balance	\$ 259,700	\$ 502,959	\$ 289,689	\$ ---	\$ 1,052,348

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## NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of June 30, 2013 (dollars in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$4,397	\$ 4,394	\$ ---
Commercial real estate:			
Residential developed	5,551	4,618	---
Unsecured to residential developers	---	---	---
Vacant and unimproved	880	880	---
Commercial development	---	---	---
Residential improved	1,073	1,073	---
Commercial improved	3,180	3,165	---
Manufacturing and industrial	810	810	---
	11,494	10,546	---
Consumer:			
Residential mortgage	---	---	---
Unsecured	---	---	---
Home equity	---	---	---
Other secured	---	---	---
	\$ 15,891	\$ 14,940	\$ ---
With an allowance recorded:			
Commercial and industrial	\$ 8,738	\$ 8,693	\$ 1,963
Commercial real estate:			
Residential developed	1,783	1,783	174
Unsecured to residential developers	---	---	---
Vacant and unimproved	1,995	1,995	101
Commercial development	14	14	1
Residential improved	10,247	10,247	411
Commercial improved	19,327	19,327	1,092
Manufacturing and industrial	4,482	4,482	111
	37,848	37,848	1,890
Consumer:			
Residential mortgage	9,433	9,433	663
Unsecured	---	---	---
Home equity	5,712	5,712	402
Other secured	---	---	---
	15,145	15,145	1,065



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	\$61,731	\$ 61,686	\$ 4,918
Total	\$77,622	\$ 76,626	\$ 4,918

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## NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2012 (dollars in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$ 2,515	\$ 2,512	\$ ---
Commercial real estate:			
Residential developed	7,136	6,283	---
Unsecured to residential developers	---	---	---
Vacant and unimproved	2,321	2,136	---
Commercial development	213	213	---
Residential improved	3,293	3,019	---
Commercial improved	7,268	6,127	---
Manufacturing and industrial	3,686	3,686	---
	23,917	21,464	
Consumer:			
Residential mortgage	4,614	3,062	---
Unsecured	---	---	---
Home equity	---	---	---
Other secured	---	---	---
	4,614	3,062	---
	\$ 31,046	\$ 27,038	\$ ---
With an allowance recorded:			
Commercial and industrial	\$ 11,878	\$ 11,878	\$ 2,920
Commercial real estate:			
Residential developed	1,524	1,524	337
Unsecured to residential developers	---	---	---
Vacant and unimproved	1,688	1,688	34
Commercial development	---	---	---
Residential improved	10,063	10,063	842
Commercial improved	15,386	15,386	1,071
Manufacturing and industrial	4,706	4,706	134
	33,367	33,367	2,418
Consumer:			
Residential mortgage	10,220	10,220	664
Unsecured	---	---	---
Home equity	804	804	52
Other secured	---	---	---
	11,024	11,024	716

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	\$ 56,269	\$ 56,269	\$ 6,054
Total	\$ 87,315	\$ 83,307	\$ 6,054

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## NOTE 3 – LOANS (Continued)

The following table presents information regarding average balances of impaired loans and interest recognized on impaired loans for the three and six month periods ended June 30, 2013 and 2012 (dollars in thousands):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Average of impaired loans during the period:				
Commercial and industrial	\$14,823	\$14,788	\$16,027	\$16,874
Commercial real estate:				
Residential developed	6,553	8,351	6,841	8,445
Unsecured to residential developers	---	---	---	---
Vacant and unimproved	3,031	3,862	3,339	3,672
Commercial development	14	217	15	218
Residential improved	11,678	13,440	12,102	13,993
Commercial improved	21,032	17,280	21,488	16,690
Manufacturing and industrial	6,136	9,299	6,577	9,384
Consumer	15,183	16,136	14,917	16,030
Interest income recognized during impairment:				
Commercial and industrial	784	465	1,127	827
Commercial real estate	816	626	1,434	1,211
Consumer	137	144	260	278
Cash-basis interest income recognized				
Commercial and industrial	599	487	935	815
Commercial real estate	879	627	1,469	1,215
Consumer	133	139	257	276

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## NOTE 3 – LOANS (Continued)

Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of June 30, 2013:

	Nonaccrual	Over 90 days Accruing
Commercial and industrial	\$ 4,081	\$ ---
Commercial real estate:		
Residential developed	2,238	---
Unsecured to residential developers	---	---
Vacant and unimproved	486	---
Commercial development	2	---
Residential improved	651	---
Commercial improved	2,166	158
Manufacturing and industrial	---	---
	5,543	158
Consumer:		
Residential mortgage	619	---
Unsecured	34	---
Home equity	339	---
Other secured	---	---
	992	---
Total	\$ 10,616	\$ 158

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2012:

	Nonaccrual	Over 90 days Accruing
Commercial and industrial	\$ 7,657	\$ ---
Commercial real estate:		
Residential developed	3,024	---
Unsecured to residential developers	---	---
Vacant and unimproved	706	---
Commercial development	2	196
Residential improved	1,159	---
Commercial improved	1,521	422

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Manufacturing and industrial	225	---
	6,637	618
Consumer:		
Residential mortgage	447	---
Unsecured	19	---
Home equity	625	---
Other secured	---	---
	1,091	---
Total	\$ 15,385	\$ 618

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## NOTE 3 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of June 30, 2013 by class of loans (dollars in thousands):

	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$ 197	\$ 168	\$ 365	\$ 242,394	\$ 242,759
Commercial real estate:					
Residential developed	---	1,917	1,917	20,871	22,788
Unsecured to residential developers	---	---	---	7,048	7,048
Vacant and unimproved	454	---	454	49,538	49,992
Commercial development	---	2	2	1,467	1,469
Residential improved	185	160	345	69,878	70,223
Commercial improved	310	1,861	2,171	248,373	250,544
Manufacturing and industrial	---	---	---	77,591	77,591
	949	3,940	4,889	474,766	479,655
Consumer:					
Residential mortgage	101	616	717	180,575	181,292
Unsecured	---	---	---	1,601	1,601
Home equity	334	324	658	95,805	96,463
Other secured	52	---	52	11,065	11,117
	487	940	1,427	289,046	290,473
Total	\$ 1,633	\$ 5,048	\$ 6,681	\$ 1,006,206	\$ 1,012,887

The following table presents the aging of the recorded investment in past due loans as of December 31, 2012 by class of loans (dollars in thousands):

	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$ 395	\$ 219	\$ 614	\$ 259,086	\$ 259,700
Commercial real estate:					
Residential developed	---	35	35	26,055	26,090
Unsecured to residential developers	---	---	---	5,547	5,547
Vacant and unimproved	17	652	669	55,856	56,525
Commercial development	---	199	199	1,600	1,799
Residential improved	520	192	712	75,101	75,813
Commercial improved	2,502	1,436	3,938	251,800	255,738

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Manufacturing and industrial	200	25	225	81,222	81,447
	3,239	2,539	5,778	497,181	502,959
Consumer:					
Residential mortgage	647	110	757	181,868	182,625
Unsecured	---	---	---	1,683	1,683
Home equity	415	264	679	92,085	92,764
Other secured	59	---	59	12,558	12,617
	1,121	374	1,495	288,194	289,689
Total	\$4,755	\$3,132	\$7,887	\$1,044,461	\$1,052,348

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## NOTE 3 – LOANS (Continued)

The Company had allocated \$4,809,000 and \$6,005,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of June 30, 2013 and December 31, 2012, respectively. These loans involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. The Company has been active at utilizing these programs and working with its customers to reduce the risk of foreclosure. For commercial loans, these modifications typically include an interest only period and, in some cases, a lowering of the interest rate on the loan. In some cases, the modification will include separating the note into two notes with the first note structured to be supported by current cash flows and collateral, and the second note made for the remaining unsecured debt. The second note is charged off immediately and collected only after the first note is paid in full. This modification type is commonly referred to as an A-B note structure. For consumer mortgage loans, the restructuring typically includes a lowering of the interest rate to provide payment and cash flow relief. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status.

Typically, once a loan is identified as a TDR, it will retain that designation until it is paid off, since the restructured loans generally are not at market rates at the time of restructuring. An exception to this would be a loan that is modified under an A-B note structure. If the remaining “A” note is at a market rate at the time of restructuring (taking into account the borrower’s credit risk and prevailing market conditions), the loan can be removed from TDR designation in a subsequent calendar year after six months of performance in accordance with the new terms. The market rate relative to the borrower’s credit risk is determined through analysis of market pricing information gathered from peers and use of a loan pricing model. The general objective of the model is to achieve a consistent return on equity from one credit to the next, taking into consideration their differences in credit risk. In the model, credits with higher risk receive a higher potential loss allocation, and therefore require a higher interest rate to achieve the target return on equity. In general, when a loan is removed from TDR status it would no longer be considered impaired. As a result, allowance allocations for loans removed from TDR status would be based on the historical based allocation for the applicable loan grade and loan class. During the three and six months ended June 30, 2013 and throughout 2012, no loans were removed from TDR status. Given the nature of the TDRs outstanding at June 30, 2013, it is unlikely that any such loans will be removed from TDR status in 2013.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

The following table presents information regarding troubled debt restructurings as of June 30, 2013 and December 31, 2012 (dollars in thousands):

	June 30, 2013		December 31, 2012	
	Number of	Outstanding Recorded	Number of	Outstanding Recorded
	Loans	Loans Balance	Loans	Loans Balance
Commercial and industrial	59	\$ 12,965	58	\$ 14,485
Commercial real estate	123	43,514	142	49,936
Consumer	107	15,188	86	13,634
	289	\$ 71,667	286	\$ 78,055

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## NOTE 3 – LOANS (Continued)

The following table presents information regarding troubled debt restructurings executed during the three month periods ended June 30, 2013 and 2012 (dollars in thousands):

	Three Months Ended June 30, 2013			Three Months Ended June 30, 2012		
	Number of Loans	Outstanding Recorded Balance	Principal Writedown upon Modification	Number of Loans	Outstanding Recorded Balance	Principal Writedown upon Modification
Commercial and industrial	2	\$ 237	\$ ---	3	\$ 93	\$ 9
Commercial real estate	4	1,276	---	9	1,301	---
Consumer	7	448	---	2	275	---
	13	\$ 1,961	\$ ---	14	\$ 1,669	\$ 9

The following table presents information regarding troubled debt restructurings executed during the six month periods ended June 30, 2013 and 2012 (dollars in thousands):

	Six Months Ended June 30, 2013			Six Months Ended June 30, 2012		
	Number of Loans	Outstanding Recorded Balance	Principal Writedown upon Modification	Number of Loans	Outstanding Recorded Balance	Principal Writedown upon Modification
Commercial and industrial	3	\$ 262	\$ ---	13	\$ 1,335	\$ 9
Commercial real estate	9	2,717	---	39	7,698	86
Consumer	30	5,469	1,770	9	1,462	260
	42	\$ 8,448	\$ 1,770	61	\$ 10,495	\$ 355

According to the accounting standards, not all loan modifications are TDRs. TDRs are modifications or renewals where the Company has granted a concession to a borrower in financial distress. The Company reviews all modifications and renewals for determination of TDR status. In some situations a borrower may be experiencing financial distress, but the Company does not provide a concession. These modifications are not considered TDRs. In other cases, the Company might provide a concession, such as a reduction in interest rate, but the borrower is not experiencing financial distress. This could be the case if the Company is matching a competitor's interest rate. These modifications would also not be considered TDRs. Finally, any renewals at existing terms for borrowers not experiencing financial distress would not be considered TDRs. The following table presents information regarding modifications and renewals executed during the three month periods ended June 30, 2013 and 2012 that are not considered TDRs (dollars in thousands):

Three Months Ended	Three Months Ended
-----------------------	-----------------------

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	June 30, 2013		June 30, 2012	
	Number	Outstanding	Number	Outstanding
	of	Recorded	of	Recorded
	Loans	Balance	Loans	Balance
Commercial and industrial	124	\$ 18,526	156	\$ 27,628
Commercial real estate	103	40,047	85	28,906
Consumer	17	738	22	815
	244	\$ 59,311	263	\$ 57,349

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## NOTE 3 – LOANS (Continued)

The following table presents information regarding modifications and renewals executed during the six month periods ended June 30, 2013 and 2012 that are not considered TDRs (dollars in thousands):

	Six Months Ended June 30, 2013		Six Months Ended June 30, 2012	
	Number of Recorded Loans	Outstanding Balance	Number of Recorded Loans	Outstanding Balance
Commercial and industrial	210	\$ 48,453	250	\$ 60,918
Commercial real estate	197	75,636	164	65,706
Consumer	28	932	46	1,687
	435	\$ 125,021	460	\$ 128,311

The table below presents, by class, information regarding troubled debt restructured loans which had payment defaults during the three month periods ended June 30, 2013 and 2012 (dollars in thousands). Included are loans that became delinquent more than 90 days past due or transferred to nonaccrual within 12 months of restructuring.

	Three Months Ended June 30, 2013		Three Months Ended June 30, 2012	
	Number of Recorded Loans	Outstanding Balance	Number of Recorded Loans	Outstanding Balance
Commercial and industrial	---	\$ ---	1	\$ 20
Commercial real estate	---	---	---	---
Consumer	---	---	---	---

The table below presents, by class, information regarding troubled debt restructured loans which had payment defaults during the six month periods ended June 30, 2013 and 2012 (dollars in thousands). Included are loans that became delinquent more than 90 days past due or transferred to nonaccrual within 12 months of restructuring.

	Six Months Ended June 30, 2013		Six Months Ended June 30, 2012	
	Number of Recorded Loans	Outstanding Balance	Number of Recorded Loans	Outstanding Balance
Commercial and industrial	---	\$ ---	3	\$ 112
Commercial real estate	---	---	1	76

Consumer

---      ---      1      70

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## NOTE 3 – LOANS (Continued)

Credit Quality Indicators: The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually and classifies these relationships by credit risk grading. The Company uses an eight point grading system, with grades 5 through 8 being considered classified, or watch, credits. All commercial loans are assigned a grade at origination, at each renewal or any amendment. When a credit is first downgraded to a watch credit (either through renewal, amendment, loan officer identification or the loan review process), an Administrative Loan Review (“ALR”) is generated by credit and the loan officer. All watch credits have an ALR completed monthly which analyzes the collateral position and cash flow of the borrower and its guarantors. The loan officer is required to complete both a short term and long term plan to rehabilitate or exit the credit and to give monthly comments on the progress to these plans. Management meets quarterly with loan officers to discuss each of these credits in detail and to help formulate solutions where progress has stalled. When necessary, the loan officer proposes changes to the assigned loan grade as part of the ALR. Additionally, Loan Review reviews all loan grades upon origination, renewal or amendment and again as loans are selected through the loan review process. The credit will stay on the ALR until either its grade has improved to a 4 or the credit relationship is at a zero balance. The Company uses the following definitions for the risk grades:

1. Excellent - Loans supported by extremely strong financial condition or secured by the Bank’s own deposits. Minimal risk to the Bank and the probability of serious rapid financial deterioration is extremely small.

2. Above Average - Loans supported by sound financial statements that indicate the ability to repay or borrowings secured (and margined properly) with marketable securities. Nominal risk to the Bank and probability of serious financial deterioration is highly unlikely. The overall quality of these credits is very high.

3. Good Quality - Loans supported by satisfactory asset quality and liquidity, good debt capacity coverage, and good management in all critical positions. Loans are secured by acceptable collateral with adequate margins. There is a slight risk of deterioration if adverse market conditions prevail.

4. Acceptable Risk - Loans carrying an acceptable risk to the Bank, which may be slightly below average quality. The borrower has limited financial strength with considerable leverage. There is some probability of deterioration if adverse market conditions prevail. These credits should be monitored closely by the Relationship Manager.

5. Marginally Acceptable - Loans are of marginal quality with above normal risk to the Bank. The borrower shows acceptable asset quality but very little liquidity with high leverage. There is inconsistent earning performance without the ability to sustain adverse market conditions. The primary source of repayment is questionable, but the secondary source of repayment still remains an option. Very close attention by the Relationship Manager and management is needed.

6. Substandard - Loans are inadequately protected by the net worth and paying capacity of the borrower or the collateral pledged. The primary and secondary sources of repayment are questionable. Heavy debt condition may be evident and volume and earnings deterioration may be underway. It is possible that the Bank will sustain some loss if the deficiencies are not immediately addressed and corrected.

7. Doubtful - Loans supported by weak or no financial statements that indicate the ability to repay the entire loan is questionable. Loans in this category are normally characterized less than adequate collateral, insolvent, or extremely weak financial condition. A loan classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses makes collection or liquidation in full highly questionable. The possibility of loss is extremely high, however, activity may be underway to minimize the loss or maximize the recovery.

8. Loss - Loans are considered uncollectible and of little or no value as a bank asset.

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## NOTE 3 – LOANS (Continued)

As of June 30, 2013, the risk grade category of commercial loans by class of loans was as follows (dollars in thousands):

	1	2	3	4	5	6	7	8
Commercial and industrial	\$1,311	\$10,458	\$68,445	\$141,786	\$14,299	\$2,378	\$4,081	\$---
Commercial real estate:								
Residential developed	---	---	721	6,636	7,347	5,846	2,238	---
Unsecured to residential developers	---	---	---	6,974	74	---	---	---
Vacant and unimproved	---	---	11,846	26,713	10,413	536	486	---
Commercial development	---	---	---	1,282	170	14	2	---
Residential improved	---	112	10,402	38,403	13,392	7,263	651	---
Commercial improved	---	1,164	51,982	152,281	32,758	10,193	2,166	---
Manufacturing and industrial	---	252	21,190	46,150	7,888	2,110	---	---
	\$1,311	\$11,986	\$164,586	\$420,225	\$86,341	\$28,340	\$9,624	\$---

As of December 31, 2012, the risk grade category of commercial loans by class of loans was as follows (dollars in thousands):

	1	2	3	4	5	6	7	8
Commercial and industrial	\$1,349	\$20,630	\$72,723	\$141,425	\$12,027	\$3,884	\$7,662	\$---
Commercial real estate:								
Residential developed	---	---	715	6,240	9,772	6,339	3,024	---
Unsecured to residential developers	---	---	---	5,535	12	---	---	---
Vacant and unimproved	---	---	12,532	29,654	12,412	1,221	706	---
Commercial development	---	---	---	482	1,102	213	2	---
Residential improved	---	115	9,973	41,578	14,471	8,517	1,159	---
Commercial improved	---	2,009	40,253	159,353	37,449	15,153	1,521	---
Manufacturing and industrial	---	2,087	17,795	48,061	9,592	3,687	225	---
	\$1,349	\$24,841	\$153,991	\$432,328	\$96,837	\$39,014	\$14,299	\$---

Commercial loans rated a 6 or worse per the Company's internal risk rating system are considered substandard, doubtful or loss. Commercial loans classified as substandard or worse were as follows at period-end (dollars in thousands):

	December
June 30,	31,
2013	2012

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Not classified as impaired	\$8,189	\$ 13,015
Classified as impaired	29,775	40,298
Total commercial loans classified substandard or worse	\$37,964	\$ 53,313

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## NOTE 3 – LOANS (Continued)

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For consumer loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in consumer loans based on payment activity (dollars in thousands):

	Residential	Consumer	Home	Consumer
<u>June 30, 2013</u>	Mortgage	Unsecured	Equity	Other
Performing	\$ 180,676	\$ 1,601	\$96,139	\$ 11,117
Nonperforming	616	---	324	---
Total	\$ 181,292	\$ 1,601	\$96,463	\$ 11,117

	Residential	Consumer	Home	Consumer
<u>December 31, 2012</u>	Mortgage	Unsecured	Equity	Other
Performing	\$ 182,515	\$ 1,683	\$92,500	\$ 12,617
Nonperforming	110	---	264	---
Total	\$ 182,625	\$ 1,683	\$92,764	\$ 12,617

## NOTE 4 – OTHER REAL ESTATE OWNED

Other real estate owned was as follows (dollars in thousands):

	Six	Year	Six
	Months	Ended	Months
	Ended	December	Ended
	June 30,	31,	June 30,
	2013	2012	2012
Beginning balance	\$69,743	\$ 83,663	\$83,663
Additions, transfers from loans and fixed assets	2,754	9,168	7,725
Proceeds from sales of other real estate owned	(8,138 )	(18,729 )	(8,587 )
Valuation allowance reversal upon sale	(2,308 )	(4,300 )	(1,998 )
Gain (loss) on sale of other real estate owned	614	(59 )	20
	62,665	69,743	80,823
Less: valuation allowance	(16,820)	(18,161 )	(18,777)
Ending balance	\$45,845	\$ 51,582	\$62,046

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## NOTE 4 – OTHER REAL ESTATE OWNED (Continued)

Activity in the valuation allowance was as follows (dollars in thousands):

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Beginning balance	\$18,161	\$17,225
Additions charged to expense	967	3,550
Reversals upon sale	(2,308 )	(1,998 )
Ending balance	\$16,820	\$18,777

## NOTE 5 – FAIR VALUE

ASC Topic 820, Fair Value Measurements and Disclosures, 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 three levels of inputs that may be used to measure fair value include:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair values of certain securities held to maturity are determined by computing discounted cash flows using observable and unobservable market inputs (Level 3 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from third party investors (Level 2 inputs).

Impaired Loans: Loans identified as impaired are measured using one of three methods: the loan's observable market price, the fair value of collateral or the present value of expected future cash flows. For each period presented, no impaired loans were measured using the loan's observable market price. If an impaired loan has had a chargeoff or if the fair value of the collateral is less than the recorded investment in the loan, we establish a specific reserve and report the loan as nonrecurring Level 3. The fair value of collateral of impaired loans is generally based on recent real estate appraisals. 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 appraisers

to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Other real estate owned (OREO) properties are initially recorded at fair value, less estimated costs to sell when acquired, establishing a new cost basis. Adjustments to OREO are measured at fair value, less costs to sell. Fair values are generally based on third party appraisals or realtor evaluations of the property. These appraisals and evaluations 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 appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized through a valuation allowance, and the property is reported as nonrecurring Level 3.

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## NOTE 5 – FAIR VALUE (Continued)

Assets measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>June 30, 2013</u>				
U.S. Treasury and federal agency securities	\$49,388	\$ ---	\$ 49,388	\$ ---
U.S. Agency MBS and CMOs	19,901	---	19,901	---
Tax-exempt state and municipal bonds	22,842	---	22,841	---
Taxable state and municipal bonds	28,197	---	28,197	---
Corporate bonds and other debt securities	7,836	---	7,836	---
Other equity securities	1,495	---	1,495	---
Loans held for sale	4,553	---	4,553	---
<u>December 31, 2012</u>				
U.S. Treasury and federal agency securities	\$42,564	\$ ---	\$ 42,564	\$ ---
U.S. Agency MBS and CMOs	23,761	---	23,761	---
Tax-exempt state and municipal bonds	20,793	---	20,793	---
Taxable state and municipal bonds	27,296	---	27,296	---
Corporate bonds	7,526	---	7,526	---
Other equity securities	1,557	---	1,557	---
Loans held for sale	8,130	---	8,130	---

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>June 30, 2013</u>				

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Impaired loans	\$27,306	\$ ---	\$ ---	\$ 27,306
Other real estate owned	36,792	---	---	36,792

December 31, 2012

Impaired loans	\$34,668	\$ ---	\$ ---	\$ 34,668
Other real estate owned	41,594	---	---	41,594

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## NOTE 5 – FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows at June 30, 2013 and December 31, 2012 (dollars in thousands).

	Level in Fair Value Hierarchy	June 30, 2013		December 31, 2012	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets					
Cash and due from banks	Level 1	\$27,605	\$27,605	\$33,556	\$33,556
Cash equivalents	Level 2	129,849	129,849	192,802	192,802
Interest-bearing time deposits in other financial institutions	Level 2	25,000	25,000	---	---
Securities held to maturity	Level 3	5,380	5,494	4,300	4,301
FHLB stock		11,236	NA	11,236	NA
Loans, net	Level 2	963,333	959,015	993,941	999,619
Bank owned life insurance	Level 3	27,162	27,162	26,804	26,804
Accrued interest receivable	Level 2	3,405	3,405	3,411	3,411
Financial liabilities					
Deposits	Level 2	(1,199,578)	(1,201,112)	(1,286,261)	(1,285,819)
Other borrowed funds	Level 2	(90,658 )	(90,770 )	(91,822 )	(95,213 )
Long-term debt	Level 2	(41,238 )	(35,111 )	(41,238 )	(30,463 )
Subordinated debt	Level 2	(1,650 )	(1,650 )	(1,650 )	(1,650 )
Accrued interest payable	Level 2	(5,591 )	(5,591 )	(4,858 )	(4,858 )
Off-balance sheet credit-related items					
Loan commitments		---	---	---	---

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, interest-bearing time deposits in other financial institutions, bank owned life insurance, accrued interest receivable and payable, demand deposits, short-term borrowings and variable rate loans or deposits that reprice frequently and fully. Security fair values are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities as discussed above. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet credit-related items is not significant.

## NOTE 6 – DEPOSITS

Deposits are summarized as follows (in thousands):



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	June 30, 2013	December 31, 2012
Noninterest-bearing demand	\$318,981	\$339,520
Interest bearing demand	261,178	278,765
Savings and money market accounts	455,452	476,803
Certificates of deposit	163,967	191,173
	\$1,199,578	\$1,286,261

Approximately \$58.6 million and \$69.2 million in certificates of deposit were in denominations of \$100,000 or more at June 30, 2013 and December 31, 2012, respectively.

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## NOTE 7 - OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and borrowings from the Federal Reserve Bank.

Federal Home Loan Bank Advances

At period-end, advances from the Federal Home Loan Bank were as follows (dollars in thousands):

<u>Principal Terms</u>	Advance Amount	Range of Maturities	Weighted Average Interest Rate
June 30, 2013			
Single maturity fixed rate advances	\$80,000	August 2016 to February 2019	1.69 %
Amortizable mortgage advances	10,658	March 2018 to July 2018	3.77 %
	\$90,658		

<u>Principal Terms</u>	Advance Amount	Range of Maturities	Weighted Average Interest Rate
December 31, 2012			
Single maturity fixed rate advances	\$ 80,000	May 2015 to September 2016	1.70 %
Amortizable mortgage advances	11,822	March 2018 to July 2018	3.78 %
	\$ 91,822		

Each advance is subject to a prepayment fee if paid prior to its maturity date. Fixed rate advances are payable at maturity. Amortizable mortgage advances are fixed rate advances with scheduled repayments based upon amortization to maturity. These advances were collateralized by residential and commercial real estate loans totaling \$419,756,000 and \$413,482,000 under a blanket lien arrangement at June 30, 2013 and December 31, 2012, respectively.

During the second quarter of 2013, the Bank modified the terms of six of its existing FHLB advances (totaling \$60.0 million) having the effect of extending the weighted average maturity for all outstanding advances from 3.22 years to 4.86 years and reducing the weighted average interest rate from 1.95% to 1.94%. As the modifications did not result in the terms being substantially different (as defined in ASC 470-50-40-10), the transaction is accounted for as a modification, not extinguishment of debt. Accordingly, the prepayment fees incurred are amortized as an adjustment of the yield over the remaining life of each advance.

Scheduled repayments of FHLB advances as of June 30, 2013 were as follows (in thousands):

2013	\$667
2014	1,884
2015	1,938
2016	21,996
2017	2,055
Thereafter	62,118
	\$90,658

Federal Reserve Bank Borrowings

The Company has a financing arrangement with the Federal Reserve Bank. There were no borrowings outstanding at June 30, 2013 and December 31, 2012, and the Company had approximately \$29.0 million and \$30.3 million in unused borrowing capacity based on commercial and mortgage loans pledged to the Federal Reserve Bank totaling \$35.0 million and \$37.2 million at June 30, 2013 and December 31, 2012, respectively.

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## NOTE 8 - EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the three month periods ended June 30, 2013 and 2012 are as follows (dollars in thousands, except per share data):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Net income	\$2,603	\$3,186	\$5,077	\$7,671
Dividends declared on preferred shares	---	---	---	---
Net income available to common shares	\$2,603	\$3,186	\$5,077	\$7,671
Weighted average shares outstanding, including participating stock awards - Basic	27,260,748	27,082,825	27,185,505	27,082,825
Dilutive potential common shares:				
Stock options	---	---	---	---
Conversion of preferred stock	---	---	---	---
Stock warrants	---	---	---	---
Weighted average shares outstanding - Diluted	27,260,748	27,082,825	27,185,505	27,082,825
Basic earnings per common share	\$0.10	\$0.12	\$0.19	\$0.28
Diluted earnings per common share	\$0.10	\$0.12	\$0.19	\$0.28

Stock options for 445,392 shares of common stock for both the three and six month periods ended June 30, 2013 were not considered in computing diluted earnings per share because they were antidilutive. Stock options for 556,191 shares of common stock for both the three and six month periods ended June 30, 2012 were not considered in computing diluted earnings per share because they were antidilutive. Potential common shares associated with convertible preferred stock and stock warrants were not considered in computing diluted earnings per share in each period because they were antidilutive.

## NOTE 9 - FEDERAL INCOME TAXES

Income tax expense (benefit) was as follows (dollars in thousands):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Current	\$55	\$ (176 )	\$55	\$ (163 )

Deferred (benefit) expense	1,141	176	2,283	163
	\$1,196	\$---	\$2,338	\$---

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## NOTE 9 - FEDERAL INCOME TAXES (Continued)

The difference between the financial statement tax expense and amount computed by applying the statutory federal tax rate to pretax income was reconciled as follows (dollars in thousands):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Statutory rate	35 %	35 %	35 %	35 %
Statutory rate applied to income before taxes	1,330	1,115	\$ 2,595	\$ 2,685
Add (deduct)				
Change in valuation allowance	---	(822 )	---	(2,295 )
Tax-exempt interest income	(50 )	(20 )	(96 )	(32 )
Bank-owned life insurance	(65 )	(79 )	(125 )	(157 )
Other, net	(19 )	(194 )	(36 )	(201 )
	\$ 1,196	\$ ---	\$ 2,338	\$ ---

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies.

We established an \$18.0 million valuation allowance on deferred tax assets in 2009 based primarily on our net operating losses for 2009 and 2008.

Throughout 2012, the positive evidence increased, while the negative evidence decreased. The most significant negative evidence at December 31, 2012 was the level of other real estate owned at \$51.6 million, which was down \$14.8 million from December 31, 2011. We achieved our 11<sup>th</sup> consecutive quarter of profitability as of December 31, 2012. With the positive results of the fourth quarter of 2012, we moved into a cumulative income position for the most recent three year period. In the first quarter of 2012, the FDIC and DIFS terminated the Bank's Consent Order and, in the fourth quarter of 2012, the FRB terminated its Written Agreement with the Company, reducing regulatory uncertainty. Based on this, sustained improvement in asset quality and our projected results, our analysis at December 31, 2012 concluded that it was "more likely than not" that we will continue to produce earnings and that the positive evidence outweighed the negative evidence regarding our ability to utilize our deferred tax assets. As such, the full valuation allowance of \$18.9 million was reversed to federal income tax expense at December 31, 2012. In the second quarter of 2013, we achieved our 13<sup>th</sup> consecutive quarter of profitability and the FDIC and DIFS released the Bank's MOU. We concluded that no valuation allowance on our net deferred tax asset was necessary at June 30, 2013.

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## NOTE 9 - FEDERAL INCOME TAXES (Continued)

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

	June 30, 2013	December 31, 2012
Deferred tax assets		
Allowance for loan losses	\$7,787	\$ 8,309
Nonaccrual loan interest	1,043	1,023
Valuation allowance on other real estate owned	5,887	6,356
Net operating loss carryforward	2,617	4,188
Unrealized loss on securities available for sale	774	---
Other	1,918	1,794
Gross deferred tax assets	20,026	21,670
Valuation allowance	---	---
Total net deferred tax assets	20,026	21,670
Deferred tax liabilities		
Depreciation	(1,549 )	(1,693 )
Unrealized gain on securities available for sale	---	(517 )
Prepaid expenses	(308 )	(308 )
Other	(381 )	(372 )
Gross deferred tax liabilities	(2,238 )	(2,890 )
Net deferred tax asset	\$17,788	\$ 18,780

At June 30, 2013, we had federal net operating loss carry forwards of \$7.5 million that expire through 2030.

There were no unrecognized tax benefits at June 30, 2013 or December 31, 2012 and the Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2009.

## NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK

Some financial instruments are used to meet customer financing needs and to reduce exposure to interest rate changes. These financial instruments include commitments to extend credit and standby letters of credit. These involve, to varying degrees, credit and interest rate risk in excess of the amount reported in the financial statements.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment, and generally have fixed expiration dates. Standby letters of credit are conditional commitments to guarantee a customer's performance to a third party. Exposure to credit loss if the other party does not perform is represented by the contractual amount for commitments to extend credit and standby letters of credit.

Collateral or other security is normally not obtained for these financial instruments prior to their use and many of the commitments are expected to expire without being used.

A summary of the contractual amounts of financial instruments with off balance sheet risk was as follows at period-end (dollars in thousands):

	June 30, 2013	December 31, 2012
Commitments to make loans	\$112,666	\$75,319
Letters of credit	8,445	8,200
Unused lines of credit	276,752	276,620

The notional amount of commitments to fund mortgage loans to be sold into the secondary market was approximately \$16.4 million and \$26.9 million at June 30, 2013 and December 31, 2012, respectively.

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NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK (Continued)

At June 30, 2013, approximately 28% of the Bank's commitments to make loans were at fixed rates, offered at current market rates. The remainder of the commitments to make loans were at variable rates tied to the prime rate and generally expire within 30 days. The majority of the unused lines of credit were at variable rates tied to the prime rate.

NOTE 11 – CONTINGENCIES

We and our subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business. As of June 30, 2013, there were no material pending legal proceedings to which we or any of our subsidiaries are a party or which any of our properties are the subject.

NOTE 12 – SHAREHOLDERS' EQUITY

In connection with the October 26, 2012 termination of the Company's Written Agreement with the Federal Reserve Bank of Chicago, the Board of Directors adopted a resolution requiring the Company to obtain written approval from the FRB before declaring or paying any dividends, increasing holding company debt, or redeeming any capital stock. The payment of future cash dividends by the Company is largely dependent upon dividends received from the Bank out of its earnings. The Bank had retained earnings of approximately \$9.4 million at June 30, 2013.

On April 12, 2013, the FDIC and DIFS, the primary banking regulators of the Bank, notified the Bank that the Bank's MOU with the FDIC and DIFS had served its purpose and was released. As a result, the Bank is no longer subject to any regulatory order, memorandum of understanding or other similar regulatory directive or proceeding and has returned to a normal regulatory operating environment. The requirements of the MOU which are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 are no longer applicable to the Bank. In particular, the enhanced regulatory capital requirements of the MOU no longer apply to the Bank and the Bank is no longer required to obtain the prior written consent of the FDIC and DIFS before the Bank declares or pays dividends.

Regulatory Capital

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.



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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

## NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

At June 30, 2013 and December 31, 2012, actual capital levels and minimum required levels were (in thousands):

	Actual		Minimum Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations				Minimum Required Under MOU (1)			
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio		
<u>June 30, 2013</u>												
Total capital (to risk weighted assets)												
Consolidated	\$175,009	16.1 %	\$86,832	8.0 %	N/	A	N/	A	N/	A	N/	A
Bank	171,579	15.8	86,884	8.0	\$108,605	10.0 %	N/	A	N/	A	N/	A
Tier 1 capital (to risk weighted assets)												
Consolidated	159,945	14.7	43,416	4.0	N/	A	N/	A	N/	A	N/	A
Bank	157,896	14.5	43,442	4.0	65,163	6.0	N/	A	N/	A	N/	A
Tier 1 capital (to average assets)												
Consolidated	159,945	10.9	58,959	4.0	N/	A	N/	A	N/	A	N/	A
Bank	157,896	10.7	58,923	4.0	73,654	5.0	\$N/	A	N/	A	N/	A
<u>December 31, 2012</u>												
Total capital (to risk weighted assets)												
Consolidated	\$168,929	15.0 %	\$90,244	8.0 %	N/	A	N/	A	N/	A	N/	A
Bank	164,214	14.5	90,299	8.0	\$112,874	10.0 %	N/	A	N/	A	N/	A
Tier 1 capital (to risk weighted assets)												
Consolidated	150,857	13.4	45,122	4.0	N/	A	N/	A	N/	A	N/	A
Bank	149,960	13.3	45,150	4.0	67,724	6.0	N/	A	N/	A	N/	A
Tier 1 capital (to average assets)												
Consolidated	150,857	10.4	58,312	4.0	N/	A	N/	A	N/	A	N/	A
Bank	149,960	10.3	58,371	4.0	72,964	5.0	\$116,742	8.0 %	N/	A	N/	A

(1)The MOU is applicable only to the December 31, 2012 information presented in these columns.

Approximately \$40.0 million and \$37.7 million of trust preferred securities outstanding at June 30, 2013 and December 31, 2012, respectively, qualified as Tier 1 capital. Refer to our 2012 Form 10-K for more information on the trust preferred securities.

The Bank was categorized as "well capitalized" at June 30, 2013 and December 31, 2012.

On July 3, 2013, the FDIC Board of Directors approved the Regulatory Capital Interim Final Rule, implementing Basel III. This rule redefines Tier 1 capital as two components (Common Equity Tier 1 and Additional Tier 1), creates a new capital ratio (Common Equity Tier 1 Risk-based Capital Ratio) and implements a capital conservation buffer. It also revises the prompt corrective action thresholds and makes changes to risk weights for certain assets and off-balance-sheet exposures. Banks are required to transition into the new rule beginning on January 1, 2015. Based on our capital levels and balance sheet composition at June 30, 2013, we do not believe implementation of the new rule will have a material impact on our capital needs.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements.

At June 30, 2013, we had total assets of \$1.48 billion, total loans of \$1.01 billion, total deposits of \$1.20 billion and shareholders' equity of \$133.3 million. During the second quarter of 2013, we recognized net income of \$2.6 million compared to net income of \$3.2 million in the second quarter of 2012. This represented our thirteenth consecutive quarter (over three full years) of profitability. With the reversal of our deferred tax asset valuation allowance at December 31, 2012, our earnings for the second quarter of 2013 reflected tax expense while the second quarter of 2012 did not.

As of June 30, 2013, the Company's and the Bank's risk-based regulatory capital ratios were at the highest they have ever been. The Bank was categorized as "well capitalized" at June 30, 2013.

On April 12, 2013, the Federal Deposit Insurance Corporation ("FDIC") and the Michigan Department of Insurance and Financial Services ("DIFS"), the primary banking regulators of the Bank, notified the Bank that the Bank's Memorandum of Understanding ("MOU") with the FDIC and DIFS had served its purpose and was released. As a result, the Bank is no longer subject to any regulatory order, memorandum of understanding or other similar regulatory directive or proceeding and has returned to a normal regulatory operating environment.

The MOU documented an understanding the Bank reached with regulators in connection with termination of the Bank's former Consent Order on March 2, 2012. The requirements of the MOU which are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 are no longer applicable to the Bank. In particular, the enhanced regulatory capital requirements of the MOU no longer apply to the Bank and the Bank is no longer required to obtain the prior written consent of the FDIC and DIFS before the Bank declares or pays dividends.

We believe the FDIC and DIFS released the MOU as a result of: (i) the Bank's substantial compliance with the MOU, (ii) our implementation of enhanced corporate governance practices and disciplined business and banking principles, (iii) substantial improvements in the Bank's asset quality, (iv) improved liquidity, (v) continued improvement in the Bank's financial condition and earnings performance, and (vi) Bank regulatory capital levels well in excess of the levels required to be classified as "well capitalized" for regulatory purposes and to comply with our MOU due to our successful capital raise and the Bank's retained earnings.

## RESULTS OF OPERATIONS

Summary: Net income available to common shares for the quarter ended June 30, 2013 was \$2.6 million (\$3.8 million on a pretax basis), compared to net income of \$3.2 million (\$3.2 million on a pretax basis) in the second quarter of 2012. Net income per common share on a diluted basis was \$0.10 for the second quarter of 2013 and \$0.12 for the second quarter of 2012. For the six months ended June 30, 2013, net income was \$5.1 million (\$7.4 million on a pretax basis), compared to \$7.7 million (\$7.7 million on a pretax basis) for the same period in 2012. Net income per common share on a diluted basis for the six months ended June 30, 2013 was \$0.19, compared to \$0.28 for the same period in 2012.

The improvement in pretax earnings in the second quarter of 2013 was a continuation of improvement in our nonperforming assets, with a reduction in nonperforming asset expenses of \$1.9 million compared to the second quarter of 2012. Net chargeoffs for the second quarter 2013 were \$239,000 compared to \$521,000 in the second quarter of 2012. We recorded a negative provision for loan losses of \$1.0 million in the second quarter 2013 compared to a negative \$1.8 million in the second quarter 2012. With the reversal of the deferred tax asset valuation allowance at December 31, 2012, tax expense is no longer offset by valuation allowance reversals and we recorded \$1.2 million in federal income tax expense in the second quarter of 2013 and none in the second quarter of 2012.

The reduction in pretax earnings in the first six months of 2013 compared to the same period in 2012 is due to an unusually large negative provision for loan loss expense taken in the first quarter of 2012 resulting from a large loan recovery collected in the first quarter of 2012. The provision for loan losses was a negative \$1.75 million for the six month period ended June 30, 2013 compared to a negative \$5.35 million for the same period in 2012. We recorded \$2.3 million in federal income tax expense in the first six months of 2013 and none in the first six months of 2012.

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Operating results in recent periods have been significantly impacted by the expense associated with problem loans and nonperforming assets. These expenses remain elevated but continue to show significant improvement. Apart from the provision for loan losses, expenses associated with nonperforming assets (including administration costs and losses) were \$1.3 million for the second quarter 2013 compared to \$3.2 million for the second quarter 2012. For the first half of 2013, such expenses totaled \$2.3 compared to \$6.2 million for the same period in 2012. Larger valuation writedowns on other real estate owned and higher levels of legal costs associated with nonperforming assets in the first half of 2012 were the primary reasons for the change between periods. Lost interest from elevated levels of nonperforming assets was approximately \$639,000 and \$1.4 million, respectively, for the three and six months ended June 30, 2013 compared to \$970,000 and \$2.1 million, respectively, for the three and six months ended June 30, 2012. Each of these items is discussed more fully below.

Net Interest Income: Net interest income totaled \$10.5 million for the second quarter of 2013 compared to \$11.3 million for the second quarter of 2012. For the first half of 2013, net interest income was \$20.9 million compared to \$22.6 million for the same period in 2012.

The decrease in net interest income in the second quarter of 2013 was due primarily to a decline in yield on our average interest earning assets. Our average yield on earning assets for the second quarter of 2013 declined 38 basis points from 4.08% to 3.70% compared to the same period in 2012. Average interest earning assets totaled \$1.33 billion for the second quarter of 2013 compared to \$1.36 billion for the second quarter of 2012. The net interest margin was 3.15% for the second quarter of 2013 compared to 3.32% for the second quarter of 2012. The decline in the margin for the most recent quarter was driven by the reduction in our average yield on earning assets, partially offset by a reduction in the cost of average interest bearing liabilities. An increase of \$47.9 million in average securities between periods partially mitigated the impact of reduction in average loan yield from 4.98% in the second quarter of 2012 to 4.39% in the second quarter of 2013.

Average interest earning assets decreased from \$1.35 billion for the first six months of 2012 to \$1.34 billion for the same period in 2013. Our average yield on earning assets declined 41 basis points for the first half of 2013 in comparison with the same period in 2012. Our net interest margin was 3.14% for the six month period in 2013 compared to 3.32% for the same period in 2012.

The declines in yields on interest earning assets for the three and six month periods ended June 30, 2013 were from decreases in the yield on our commercial, residential and consumer loan portfolios, which have repriced at lower levels in the generally low rate environment during this period. Our margin has been negatively impacted by the significant balances in liquid and short-term investments held during the past three years. As we deploy these balances in building our investment portfolio and booking high quality loans, we expect our margin to be positively impacted.

The cost of funds decreased 25 basis points to 0.70% in the second quarter of 2013 from 0.95% in the same period in 2012. The cost of funds decreased 27 basis points to 0.72% for the six months ended June 30, 2013 compared to 0.99% for the same period in 2012. For both the three and six month periods ended June 30, 2013, decreases in the rates paid on our deposit accounts in response to declining market rates and the rollover of time deposits and other borrowings at lower rates within the current rate environment caused the reduction in our cost of funds. Also contributing to the reduction was a shift in our deposit mix from higher costing time deposits to lower costing demand and savings accounts.

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The following table shows an analysis of net interest margin for the three month periods ended June 30, 2013 and 2012.

	For the three months ended June 30,					
	2013			2012		
	Average	Interest	Average	Average	Interest	Average
	Balance	Earned	Yield	Balance	Earned	Yield
	(Dollars in thousands)					
Assets						
Taxable securities	\$ 105,866	\$448	1.69 %	\$ 75,987	\$384	2.02 %
Tax-exempt securities (1)	27,968	155	3.63 %	9,955	65	4.47 %
Loans (2)	1,039,771	11,493	4.39 %	1,055,624	13,237	4.98 %
Federal Home Loan Bank stock	11,236	97	3.41 %	11,236	84	2.95 %
Federal funds sold and other short-term investments	146,716	114	0.31 %	203,251	130	0.25 %
Total interest earning assets (1)	1,331,557	12,307	3.70 %	1,356,053	13,900	4.08 %
Noninterest earning assets:						
Cash and due from banks	23,595			22,140		
Other	134,735			127,024		
Total assets	\$ 1,489,887			\$ 1,505,217		
Liabilities						
Deposits:						
Interest bearing demand	\$ 279,109	96	0.21 %	\$ 223,439	86	0.15 %
Savings and money market accounts	457,151	471	0.41 %	419,097	505	0.48 %
Time deposits	174,965	415	0.95 %	272,149	935	1.38 %
Borrowings:						
Other borrowed funds	92,307	490	2.10 %	132,326	672	2.01 %
Long-term debt	41,238	372	3.57 %	41,238	380	3.65 %
Total interest bearing liabilities	1,044,770	1,844	0.70 %	1,088,249	2,578	0.95 %
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	300,864			308,152		
Other noninterest bearing liabilities	9,716			7,580		
Shareholders' equity	134,537			101,236		
Total liabilities and shareholders' equity	\$ 1,489,887			\$ 1,505,217		
Net interest income		\$ 10,463			\$ 11,322	
Net interest spread (1)			3.00 %			3.13 %
Net interest margin (1)			3.15 %			3.32 %
Ratio of average interest earning assets to average interest bearing liabilities	127.45 %			124.61 %		

(1) Yield adjusted to fully tax equivalent.

(2) Includes average nonaccrual loans of approximately \$11.3 million and \$24.9 million for the three months ended June 30, 2013 and 2012.





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The following table shows an analysis of net interest margin for the six month periods ended June 30, 2013 and 2012.

	For the six months ended June 30,					
	2013			2012		
	Average	Interest	Average	Average	Interest	Average
	Balance	Earned	Yield	Balance	Earned	Yield
	(Dollars in thousands)					
<u>Assets</u>						
Taxable securities	\$104,101	\$877	1.68 %	\$67,941	\$701	2.06 %
Tax-exempt securities (1)	26,437	296	3.67 %	8,075	108	4.61 %
Loans (2)	1,047,631	23,161	4.41 %	1,062,338	26,763	5.01 %
Federal Home Loan Bank stock	11,236	196	3.47 %	11,236	169	2.97 %
Federal funds sold and other short-term investments	150,677	210	0.28 %	203,578	257	0.25 %
Total interest earning assets (1)	1,340,082	24,740	3.71 %	1,353,168	27,998	4.12 %
Noninterest earning assets:						
Cash and due from banks	22,610			21,751		
Other	135,566			126,697		
Total assets	\$1,498,258			\$1,501,616		
<u>Liabilities</u>						
Deposits:						
Interest bearing demand	\$268,235	177	0.13 %	\$216,973	182	0.17 %
Savings and money market accounts	470,049	1,018	0.43 %	407,196	1,014	0.50 %
Time deposits	181,702	872	0.97 %	284,150	1,979	1.40 %
Borrowings:						
Other borrowed funds	92,777	985	2.11 %	140,855	1,451	2.04 %
Long-term debt	41,238	741	3.58 %	41,238	770	3.70 %
Total interest bearing liabilities	1,054,001	3,793	0.72 %	1,090,412	5,396	0.99 %
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	302,246			305,742		
Other noninterest bearing liabilities	8,765			7,082		
Shareholders' equity	133,246			98,380		
Total liabilities and shareholders' equity	\$1,498,258			\$1,501,616		
Net interest income		\$20,947			\$22,602	
Net interest spread (1)			2.99 %			3.13 %
Net interest margin (1)			3.14 %			3.32 %
Ratio of average interest earning assets to average interest bearing liabilities	127.14 %			124.10 %		

(1) Yield adjusted to fully tax equivalent.

(2) Includes average nonaccrual loans of approximately \$13.4 million and \$28.1 million for the six months ended June 30, 2013 and 2012.



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Provision for Loan Losses: The provision for loan losses for the second quarter of 2013 was a negative \$1.0 million compared to a negative \$1.75 million for the second quarter of 2012. The negative provisions in both periods were the result of continued significant declines in the level of net charge-offs, reduction in the balances and required reserves on nonperforming loans and stabilizing real estate values on problem credits. The provision for loan losses for the first half of 2013 was a negative \$1.75 compared to a negative \$5.35 million for the same period in 2012. The larger negative provision in the first half of 2012 was primarily associated with a \$4.4 million recovery on a previously charged-off loan in the first quarter of 2012.

Net charge-offs were \$239,000 for the second quarter of 2013 compared to \$521,000 for the second quarter of 2012. The charge-offs for each period have largely been driven by declines in the value of real estate securing our loans.

The pace of the decline in real estate values, however, has been slowing, translating into a significant decline in charge-offs. We are also experiencing positive results from our collection efforts with loan recoveries increasing as evidenced by our net loan recovery positions in recent quarters. For the second quarter of 2013, loan recoveries were \$459,000 compared to \$378,000 for the same period in 2012. For the six months ended June 30, 2013, we experienced net recoveries of \$259,000 compared to net recoveries of \$889,000 for the same period in 2012. Loan recoveries for the six months ended June 30, 2013 were \$1.6 million compared to \$5.3 million for the same period in 2012. While we expect our collection efforts to produce further recoveries, the amount achieved in the first quarter of 2012 was unusually high.

We have also experienced a decline in the pace of commercial loans migrating to a lower loan grade, which receive higher allocations in our loan loss reserve, as more fully discussed under the heading "Allowance for Loan Losses" below. In addition to experiencing fewer downgrades of credits, we continue to see an increase in the quality of some credits resulting in an improved loan grade. Over the past two years, we have experienced improvements in our weighted average loan grade. We believe efforts that began in late 2009 and in early 2010 to improve loan administration and loan risk management practices have had a significant impact, ultimately allowing for the reduction in the level of the allowance for loan losses since then.

The amounts of loan loss provision in both the most recent quarter and comparable prior year period were the result of establishing our allowance for loan losses at levels believed necessary based upon our methodology for determining the adequacy of the allowance. The sustained lower level of quarterly net charge-offs over the past several quarters had a significant effect on the historical loss component of our methodology. More information about our allowance for loan losses and our methodology for establishing its level may be found under the heading "Allowance for Loan Losses" below.

Noninterest Income: Noninterest income for the three and six month periods ended June 30, 2013 increased to \$4.2 million and \$8.2 million, respectively, from \$4.0 million and \$7.7 million, respectively, for the same periods in 2012. The components of noninterest income are shown in the table below (in thousands):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Service charges and fees on deposit accounts	\$ 976	\$ 776	\$ 1,888	\$ 1,571
Net gains on mortgage loans	708	780	1,533	1,251
Trust fees	625	598	1,213	1,207
Gain as sales of securities	61	59	80	59
ATM and debit card fees	1,132	1,064	2,109	2,045
Bank owned life insurance ("BOLI") income	188	224	358	447

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Investment services fees	257	160	472	389
Other income	264	339	521	742
Total noninterest income	\$ 4,211	\$ 4,000	\$ 8,174	\$ 7,711

Service charges on deposit accounts increased for the three month and six periods ended June 30, 2013 due, primarily, to an increase in overdraft activity from our customer base. Mortgage gains continued to be elevated in the second quarter and first six months of 2013 and were comparable to the second quarter and first six months of 2012. The low interest rate environment has contributed significantly to the elevated level of mortgage originations and resulting gains on sales.

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Noninterest Expense: Noninterest expense decreased to \$11.9 million and \$23.5 million for the three and six month periods ended June 30, 2013, from \$13.9 million and \$28.0 million, respectively, for the same periods in 2012. The components of noninterest expense are shown in the table below (in thousands):

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Salaries and benefits	\$5,732	\$5,723	\$11,525	\$11,443
Occupancy of premises	905	941	1,851	1,912
Furniture and equipment	845	858	1,595	1,685
Legal and professional	183	180	373	392
Marketing and promotion	246	210	492	420
Data processing	352	368	704	719
FDIC assessment	345	479	817	1,188
ATM and debit card processing	361	308	652	596
Bond and D&O insurance	183	215	368	483
Administration and disposition of problem assets	1,299	3,190	2,260	6,249
Outside services	354	381	723	759
Other noninterest expense	1,070	1,033	2,096	2,146
Total noninterest expense	\$11,875	\$13,886	\$23,456	\$27,992

Several components of noninterest expense experienced a decline due to our ongoing efforts to manage expenses and scale our operations. Our largest component of noninterest expense, salaries and benefits, increased slightly in the second quarter of 2013 from the second quarter of 2012. We had 360 full-time equivalent employees at June 30, 2013 compared to 373 at June 30, 2012. The increased expense for the second quarter of 2013 was primarily attributable to the reinstatement of our 401k plan matching contributions beginning with the first quarter of 2013. This expense totaled \$136,000 for the second quarter of 2013. Incentive compensation programs have been implemented for certain departments in 2013, which have also increased compensation expense. Salaries and benefits increased by \$82,000 from \$11.4 million for the first six months of 2012 to \$11.5 million for the same period of 2013. The increase for the first half of 2013 was due to the reinstatement of our 401k plan matching contributions discussed above and also due to increased mortgage commissions from higher loan origination volume in 2013. The increases in salaries and benefits were partially offset by lower medical insurance expense resulting from lower claims experience in the three and six month periods ended June 30, 2013 compared to the same periods in 2012.

The next largest noninterest expense was our cost related to administration and disposition of problem assets. Costs associated with administration and disposition of problem assets include legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense includes survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties include both net losses on the sale of properties and unrealized losses from value declines for outstanding properties. We experienced significant decreases in each of these expense categories in the second quarter and first six months of 2013 compared to the same period in 2012.

These costs are itemized in the following table (in thousands):

Three Months	Three Months	Six Months	Six Months
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	Ended June 30, 2013	Ended June 30, 2012	Ended June 30, 2013	Ended June 30, 2012
Legal and professional – nonperforming assets	\$ 335	\$ 266	\$ 501	\$ 707
Reposessed and foreclosed property administration	670	990	1,406	2,011
Losses on reposessed and foreclosed properties	294	1,934	353	3,531
Total	\$ 1,299	\$ 3,190	\$ 2,260	\$ 6,249

Losses on reposessed assets and foreclosed properties decreased significantly for the three month period ended June 30, 2013, decreasing \$1.6 million from the same period in 2012. For the first six months of 2013, losses on reposessed assets and foreclosed properties were down \$3.2 million from the same period in 2012. The writedowns for each period have largely been driven by declines in the value of real estate. The pace of the decline in real estate values, however, has been slowing, translating into a significant decline in writedowns. During the second quarter of 2013, we realized net gains on sales of foreclosed properties of \$294,000, offsetting half the \$588,000 in valuation writedowns during the quarter. For the six months ended June 30, 2013, we realized net gains of \$614,000 on sales of foreclosed properties, significantly offsetting the \$967,000 in valuation writedowns for the period.

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Costs associated with administration and disposition of problem assets decreased due to the decrease in the level of other real estate owned. Other real estate owned decreased from \$62.0 million at June 30, 2012 and \$51.6 million at December 31, 2012 to \$45.8 million at June 30, 2013. As our level of problem loans and other real estate owned decreases, we believe we will experience more reductions in these costs going forward.

FDIC assessments decreased by \$134,000 to \$345,000 for the second quarter of 2013 compared to \$479,000 for the second quarter of 2012 as a result of our reduced level of deposits and due to a change in our assessment category resulting from the termination of the Bank's MOU by the FDIC and DIFS effective April 12, 2013. For the six months ended June 30, 2012, our FDIC assessments were \$817,000, compared to \$1.2 million for the same period in 2012.

We realized a \$32,000 reduction in our bond and D&O insurance costs in the second quarter of 2013 compared to the second quarter 2012 and a reduction of \$115,000 for the six month period ended June 30, 2013 compared to the same period in 2012 as a result of our improving financial condition and the decreased risk perceived by our insurance carriers.

Federal Income Tax Expense: We recorded \$1.2 million and \$2.3 million in federal income tax expense for the three and six month periods ended June 30, 2013, respectively, and no federal income tax expense in the same periods in 2012. From June 30, 2009 to December 31, 2012, we had concluded that a full valuation allowance needed to be maintained for all of our net deferred tax assets based primarily on our net operating losses in 2008 and 2009 and the continued challenging environment confronting banks that could negatively impact future operating results. With the termination of the Bank's Consent Order and the Company's Written Agreement, cumulative earnings in the most recent three year period and projections showing future taxable income at December 31, 2012, we concluded that the valuation allowance was no longer required and the \$18.9 million valuation allowance was reversed at that time. As a result, the financial results for the second quarter and first six months of 2013 reflect federal income tax expense, at an effective tax rate of 31.48% and 31.53%, respectively.

## FINANCIAL CONDITION

Summary: Due to the continuing soft economic conditions, we have been focused on improving our loan portfolio, reducing exposure in higher loan concentration types, and improving our financial condition through diversification of credit risk, improved capital ratios, and reduced reliance on non-core funding. We have experienced positive results in each of these areas over the past three years.

Total assets were \$1.48 billion at June 30, 2013, a decrease of \$83.9 million from \$1.56 billion at December 31, 2012. This change reflected increases of \$6.2 million in securities available for sale and \$25.0 million of interest-bearing time deposits in other financial institutions, offset by declines of \$39.5 million in our loan portfolio and \$68.9 million in cash and cash equivalents. Total deposits declined by \$86.7 million due to normal seasonal deposit usage and other borrowed funds were down by \$1.2 million at June 30, 2013 compared to December 31, 2012.

Cash and Cash Equivalents: Our cash and cash equivalents, which include federal funds sold and short-term investments, were \$157.5 million at June 30, 2013 compared to \$226.4 million at December 31, 2012. The \$68.9 million decrease was primarily the result of normal outflow of the seasonal build-up in deposits we typically experience toward year end. These balances have also been elevated due to high short term balances maintained by our large deposit customers. Part of the decrease also related to shifting some balances to two time deposit accounts as discussed below. We expect our balances of short term investments to remain elevated until loan demand materially increases and more attractive investment opportunities emerge.

Interest-bearing Time Deposits with Other Financial Institutions: We opened two time deposit accounts with our primary correspondent bank in the first quarter of 2013, each in equal amounts totaling \$25.0 million. One of these deposits matures within 12 months and the other within 18 months, and both provide a higher interest rate than federal



funds sold or other short-term investments.

Securities Available for Sale: Securities available for sale were \$129.7 million at June 30, 2013 compared to \$123.5 million at December 31, 2012. We began rebuilding our investment portfolio during the second quarter of 2011. The balance at June 30, 2013 primarily consisted of U.S. agency securities, agency mortgage backed securities and various municipal investments. We expect to continue to reinvest excess liquidity and selectively rebuild our investment portfolio.

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Portfolio Loans and Asset Quality: Total portfolio loans declined by \$39.5 million in the first six months of 2013 and were \$1.01 billion at June 30, 2013 compared to \$1.05 billion at December 31, 2012. During the first six months of 2013, our commercial and residential portfolios decreased by \$40.2 million and \$1.3 million, respectively, while our consumer portfolio increased by \$2.1 million.

We also saw an increase in the volume of residential mortgage loans originated for sale in the first six months of 2013 compared to the same period in 2012. Residential mortgage loans originated for sale were \$63.2 million in the first six months of 2013 compared to \$59.4 million for the same period in 2012. This increase was primarily due to market conditions and our focus on increasing our residential mortgage lending volume.

Our commercial loan portfolio balances declined in recent years reflecting the continuing weak economic conditions in West Michigan and our interest in improving the quality of our loan portfolio through reducing our exposure to these generally higher credit risk assets. We have focused our efforts on reducing our exposure to residential land development loans, diversifying our commercial loan portfolio and improving asset quality. We believe our loan portfolio has stabilized. During the fourth quarter of 2012, we achieved growth in our commercial loan portfolio for the first time since the fourth quarter of 2008 and balances held relatively steady in the first six months of 2013. The reduction in balances at June 30, 2013 are primarily seasonal paydowns of agricultural credits and removal of nonperforming or weaker credits from the Bank. We plan to continue measured, high quality loan portfolio growth in 2013.

Commercial and commercial real estate loans remained our largest loan segment and accounted for approximately 71% of the total loan portfolio at June 30, 2013 and 73% at December 31, 2012. Residential mortgage and consumer loans comprised approximately 29% of total loans at June 30, 2013 and 27% at December 31, 2012.

A further breakdown of the composition of the loan portfolio is shown in the table below (in thousands):

	June 30, 2013	Percent of Total Loans	December 31, 2012	Percent of Total Loans
Commercial real estate:(1)				
Residential developed	\$22,788	2.2	\$26,090	2.5
Unsecured to residential developers	7,048	0.7	5,547	0.5
Vacant and unimproved	49,992	4.9	56,525	5.3
Commercial development	1,469	0.2	1,799	0.2
Residential improved	70,223	6.9	75,813	7.2
Commercial improved	250,544	24.7	255,738	24.3
Manufacturing and industrial	77,591	7.7	81,447	7.7
Total commercial real estate loans	479,655	47.3	502,959	47.8
Commercial and industrial	242,759	24.0	259,700	24.7
Total commercial loans	722,414	71.3	762,659	72.5
Consumer:				
Residential mortgage	181,292	17.9	182,625	17.3
Unsecured	1,601	0.2	1,683	0.2
Home equity	96,463	9.5	92,764	8.8
Other secured	11,117	1.1	12,617	1.2
Total consumer	290,473	28.7	289,689	27.5
Total loans	\$1,012,887	100.0	\$1,052,348	100.0

(1) Includes both owner occupied and non-owner occupied commercial real estate.

Commercial real estate loans accounted for approximately 47% of the total loan portfolio at June 30, 2013 and consisted primarily of loans to business owners and developers of owner and non-owner occupied commercial properties and loans to developers of single and multi-family residential properties. In the table above, we show our commercial real estate portfolio by loans secured by residential and commercial real estate, and by stage of development. Improved loans are generally secured by properties that are under construction or completed and placed in use. Development loans are secured by properties that are in the process of development or fully developed. Vacant and unimproved loans are secured by raw land for which development has not yet begun and agricultural land.

Total commercial real estate loans declined \$23.3 million since December 31, 2012. Our commercial and industrial loan portfolio decreased by \$16.9 million to \$242.8 million at June 30, 2013 and represented 24% of our commercial portfolio. As discussed above, these reductions are largely due to seasonal paydowns of agricultural loans.

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Our consumer residential mortgage loan portfolio, which also includes residential construction loans made to individual homeowners, comprised approximately 18% of portfolio loans at June 30, 2013 and 17% at December 31, 2012 as we continue to execute our strategy to diversify our credit risk from commercial real estate. During 2013, we expect to continue to retain in our loan portfolio certain types of residential mortgage loans (primarily high quality, low loan to value loans) in an effort to continue to diversify our credit risk and deploy our excess liquidity. A large portion of our residential mortgage loan production continues to be sold on the secondary market with servicing released.

Despite retaining an increased amount of our residential mortgage production in portfolio, we saw an increase in the volume of residential mortgage loans originated for sale during 2013 compared to 2012 as discussed above. We have not yet had to repurchase any residential mortgage loans sold; however, due to market conditions many banks are being required to repurchase loans resulting from actual or alleged failure to strictly conform to the investor's purchase criteria.

Our portfolio of other consumer loans includes loans secured by personal property and home equity fixed term and line of credit loans. These types of loans increased by \$2.1 million to \$109.2 million at June 30, 2013 from \$107.1 million at December 31, 2012 due to an increase in home equity loans. Consumer loans comprised approximately 11% of our portfolio loans at June 30, 2013 and 10% at December 31, 2012.

The following table shows our loan origination activity for portfolio loans during the first six months of 2013, broken out by loan type and also shows average originated loan size (dollars in thousands):

	Portfolio Originations 2013	Percent of Total Originations	Average Loan Size
Commercial real estate:			
Residential developed	\$ 3,168	1.4	% \$ 396
Unsecured to residential developers	---	---	---
Vacant and unimproved	8,099	3.6	506
Commercial development	---	---	---
Residential improved	20,654	9.2	211
Commercial improved	31,784	14.1	578
Manufacturing and industrial	8,296	3.7	553
Total commercial real estate	72,001	32.0	375
Commercial and industrial	97,356	43.2	38
Total commercial	169,357	75.2	61
Consumer:			
Residential mortgage	30,608	13.6	214
Unsecured	214	0.1	19
Home equity	23,706	10.5	72
Other secured	1,481	0.6	13
Total consumer	56,009	24.8	93
Total portfolio loan originations	\$ 225,366	100.0	% \$ 67

Our loan portfolio is reviewed regularly by our senior management, our loan officers, and an internal loan review team that is independent of our loan originators and credit administration. An administrative loan committee consisting of senior management and seasoned lending and collections personnel meets monthly to manage our internal watch list and proactively manage high risk loans.

When reasonable doubt exists concerning collectability of interest or principal of one of our loans, the loan is placed in nonaccrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. At June 30, 2013, nonperforming assets totaled \$56.6 million compared to \$67.6 million at December 31, 2012. Additions to other real estate owned in the first six months of 2013 were just \$2.8 million. Based on the loans currently in their redemption period, we expect significantly reduced levels of loans moving into other real estate owned in 2013 compared to 2012. Proceeds from sales of foreclosed properties were \$8.1 million in the first six months of 2013 resulting in a net gain of \$614,000. Proceeds from sales of foreclosed properties were \$8.6 million in the first half of 2012, resulting in a net gain of \$20,000. We expect the level of sales of foreclosed properties for the remainder of 2013 to be similar to the levels experienced in 2012.

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Nonperforming loans include loans on nonaccrual status and loans delinquent more than 90 days but still accruing. As of June 30, 2013, nonperforming loans totaled \$10.8 million, or 1.06% of total portfolio loans, compared to \$16.0 million, or 1.52% of total portfolio loans, at December 31, 2012.

Loans for development or sale of 1-4 family residential properties comprised a large portion of nonperforming loans. They were approximately \$2.7 million, or 25.0% of total nonperforming loans, at June 30, 2013 compared to \$3.2 million, or 19.7% of total nonperforming loans, at December 31, 2012. The remaining balance of nonperforming loans at June 30, 2013 consisted of \$3.0 million of commercial real estate loans secured by various types of non-residential real estate, \$4.1 million of commercial and industrial loans, and \$1.0 million of consumer and residential mortgage loans.

Foreclosed and repossessed assets include assets acquired in settlement of loans. Foreclosed assets totaled \$45.8 million at June 30, 2013 and \$51.6 million at December 31, 2012. Of this balance at June 30, 2013, there were 95 commercial real estate properties totaling approximately \$43.2 million. The remaining balance was comprised of 31 residential properties totaling approximately \$2.6 million. Five commercial real estate properties comprised \$18.7 million, or 41%, of total other real estate owned at June 30, 2013. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less estimated costs to sell and then evaluated monthly for impairment after transfer using a lower of cost or market approach. Updated property valuations are obtained at least annually on all foreclosed assets.

At June 30, 2013, our foreclosed asset portfolio had a weighted average age held in portfolio of 2.61 years. Below is a breakout of our foreclosed asset portfolio at June 30, 2013 by property type and the percentages the property has been written down since taken into our possession and the combined writedown percentage, including losses taken when the property was loan collateral (dollars in thousands):

<u>Foreclosed Asset Property type</u>	Carrying Value at June 30, 2013	Foreclosed Asset Writedown		Combined Writedown (Loan and Foreclosed Asset)	
Single Family	\$ 1,929	3.3	%	31.0	%
Residential Lot	649	28.9	%	43.7	%
Multi-Family	150	---	%	14.9	%
Vacant Land	6,958	30.4	%	48.0	%
Residential Development	14,009	35.5	%	72.2	%
Commercial Office	3,210	29.1	%	49.7	%
Commercial Industrial	293	25.5	%	40.1	%
Commercial Improved	18,647	18.5	%	33.2	%
	\$45,845	26.7	%	55.3	%

The following table shows the composition and amount of our nonperforming assets (dollars in thousands):

	June 30, 2013	December 31, 2012
Nonaccrual loans	\$10,616	\$15,385
Loans 90 days past due and still accruing	158	618
Total nonperforming loans (NPLs)	10,774	16,003
Foreclosed assets	45,845	51,582

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Repossessed assets	---	6		
Total nonperforming assets (NPAs)	56,619	67,591		
Accruing restructured loans (ARLs) (1)	63,455	65,024		
Total NPAs and ARLs	\$120,074	\$132,615		
NPLs to total loans	1.06	%	1.52	%
NPAs to total assets	3.83	%	4.33	%

Comprised of approximately \$48.6 million and \$51.8 million of commercial loans and \$14.8 million and \$13.2 million of consumer loans whose terms have been restructured at June 30, 2013 and December 31, 2012, (1) respectively. Interest is being accrued on these loans under their restructured terms as they are less than 90 days past due.

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Allowance for loan losses: The allowance for loan losses at June 30, 2013 was \$22.2 million, a decrease of \$1.5 million, compared to \$23.7 million at December 31, 2012. The balance of the allowance for loan losses was 2.20% of total portfolio loans at June 30, 2013 compared to 2.26% of total portfolio loans at December 31, 2012. While this ratio decreased slightly, the allowance for loan losses to nonperforming loan coverage ratio continued to increase, from 148.34% at December 31, 2012 to 206.50% at June 30, 2013.

The table below shows the changes in these metrics over the past five quarters:

	Quarter Ended June 30, 2013	Quarter Ended March 31, 2013	Quarter Ended December 31, 2012	Quarter Ended September 30, 2012	Quarter Ended June 30, 2012
(in millions)					
Commercial loans	\$ 722.4	\$ 756.7	\$ 762.7	\$ 734.3	\$ 753.6
Nonperforming loans	10.8	14.2	16.0	17.4	18.9
Other real estate owned and repo assets	45.8	51.6	51.6	57.8	62.0
Total nonperforming assets	56.6	65.8	67.6	75.1	80.9
Net charge-offs (recoveries)	0.2	(0.5 )	2.0	(0.3 )	0.5
Total delinquencies	6.7	6.6	7.9	5.7	6.9

Nonperforming loans have continually declined since the first quarter of 2010 to \$10.8 million at June 30, 2013, which was our lowest level of nonperforming loans since the second quarter of 2007. As discussed earlier, we have had net loan recoveries in several quarters over the last year and a half. Our total delinquencies have continued to decline, from \$6.9 million at June 30, 2012 to \$6.7 million at June 30, 2013.

These factors all provide for a reduction in our allowance for loan losses, and thus impacts our provision for loan losses. The provision for loan losses increased \$750,000 to a negative \$1.0 million for the three months ended June 30, 2013 compared to a negative \$1.75 million for the same period of 2012. The increase was due to a smaller level of reduction in nonperforming loans as they continue to stabilize at a more reasonable level. Net chargeoffs were \$239,000 for the three months ended June 30, 2013 compared to net chargeoffs of \$521,000 for the same period in 2012. The ratio of net charge-offs to average loans was 0.09% on an annualized basis for the second quarter of 2013, compared to -0.19% for the first quarter of 2013 and 0.20% for the second quarter of 2012.

We are encouraged by the reduced level of charge-offs over recent quarters. We do, however, recognize that future chargeoffs and resulting provisions for loan losses are expected to be impacted by the timing and extent of changes in the overall economy and the real estate markets. We believe we have seen some stabilization in economic conditions and real estate markets. However, we expect it to take additional time for sustained improvement in the economy and real estate markets in order for us to reduce our nonperforming and impaired loans to acceptable levels.

Our allowance for loan losses is maintained at a level believed appropriate based upon our monthly assessment of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance and related provision for loan losses relies on several key elements, which include specific allowances for loans considered impaired, general allowance for commercial loans not considered impaired based upon applying our loan rating system, and general allocations based on historical trends for homogeneous loan groups with similar risk characteristics.

Impaired loans declined \$6.7 million to \$76.6 million at June 30, 2013 compared to \$83.3 million at December 31, 2012. The specific allowance for impaired loans decreased \$1.1 million to \$4.9 million, or 6.4% of total impaired loans, at June 30, 2013 compared to \$6.1 million, or 7.3% of total impaired loans, at December 31, 2012. The overall



balance of impaired loans remained elevated due to an accounting rule (ASU 2011-02) adopted in 2011 that requires us to identify classified loans that renew at existing contractual rates as troubled debt restructurings (“TDRs”) if the contractual rate is less than market rates for similar loans at the time of renewal. As TDRs are also considered impaired, this increased our impaired loan balance for each period presented as most of our classified loans renewed in this time period.

The general allowance allocated to commercial loans that were not considered to be impaired was based upon the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are stratified between real estate secured and non real estate secured. The real estate secured portfolio is further stratified by the type of real estate. Each stratified portfolio is assigned a loss allocation factor. A higher numerical grade assigned to a loan category generally results in a greater allocation percentage. Changes in risk grade of loans affect the amount of the allowance allocation.

The determination of our loss factors is based upon our actual loss history by loan grade and adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the analysis date. We use a rolling 18 month actual net chargeoff history as the base for our computation. Over the past two years, the 18 month period computations have reflected sizeable decreases in net chargeoff experience. We addressed this volatility in the qualitative factor considerations applied in our allowance for loan losses computation. Adjustments to the qualitative factors also involved consideration of different loss periods for the Bank, including 12 and 24 month periods. Considering the change in our qualitative factors and our commercial loan portfolio balances, the general allowance allocated to commercial loans decreased to \$14.1 million at June 30, 2013 compared to \$14.6 million at December 31, 2012. This resulted in a general reserve percentage allocated at June 30, 2013 of 2.13% of commercial loans, an increase from 2.12% at December 31, 2012. The qualitative component of our general allowance allocated to commercial loans increased from \$13.8 million at December 31, 2012 to \$14.0 million at June 30, 2013.

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Groups of homogeneous loans, such as residential real estate and open- and closed-end consumer loans, receive allowance allocations based on loan type. A rolling 12 month (4 quarter) historical loss experience period was applied to residential mortgage and consumer loan portfolios. As with commercial loans that are not considered impaired, the determination of the allowance allocation percentage is based principally on our historical loss experience. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans. The homogeneous loan allowance was \$3.2 million at June 30, 2013 and \$3.1 million at December 31, 2012.

The allowance allocations are not intended to imply limitations on usage of the allowance for loan losses. The entire allowance for loan losses is available for any loan losses without regard to loan type.

**Premises and Equipment:** Premises and equipment totaled \$53.3 million at June 30, 2013, representing a decrease of \$274,000 from \$53.6 million at December 31, 2012. The decline was largely from depreciation of current facilities in excess of capital additions during the first quarter of 2013.

**Deposits and Other Borrowings:** Total deposits decreased \$86.6 million to \$1.20 billion at June 30, 2013, as compared to \$1.29 billion at December 31, 2012. Non-interest checking account balances decreased \$20.5 million during the first six months of 2013. Interest bearing demand account balances decreased \$17.5 million and savings and money market account balance decreased \$22.4 million in the first six months of 2013. We decreased higher costing certificates of deposits by \$26.2 million in the first half of 2013. The reductions in balances of checking accounts were caused by normal seasonal outflows and some shifting between deposit types. We believe our success in maintaining the balances of personal and business checking and savings accounts was primarily attributable to our focus on quality customer service, the desire of customers to deal with a local bank, the convenience of our maturing branch network and the breadth and depth of our sophisticated product line.

Noninterest bearing demand accounts comprised 27% of total deposits at June 30, 2013 compared to 26% of total deposits at December 31, 2012. Because of the generally low rates paid on interest bearing account alternatives, many of our business customers chose to keep their balances in these more liquid and insured account types. Interest bearing demand, including money market and savings accounts, comprised 59% of total deposits at June 30, 2013 and December 31, 2012. Time accounts as a percentage of total deposits were 14% at June 30, 2013 and 15% at December 31, 2012.

Borrowed funds totaled \$133.5 million at June 30, 2013; including \$90.6 million of Federal Home Loan Bank advances, \$41.2 million in long-term debt associated with trust preferred securities and \$1.7 million in subordinated debt. Borrowed funds totaled \$134.7 million at December 31, 2012; including \$91.8 million of Federal Home Loan Bank advances, \$41.2 million in long-term debt associated with trust preferred securities and \$1.7 million in subordinated debt. Borrowed funds decreased by \$1.2 million in the first six months of 2013 as a result of an annual payment on an amortizing Federal Home Loan Bank advance in the first quarter of 2013.

During the second quarter of 2013, we modified the terms of six of our existing FHLB advances (totaling \$60.0 million) having the effect of extending the weighted average maturity for all outstanding advances from 3.22 years to 4.86 years and reducing the weighted average interest rate from 1.95% to 1.94%. As the modifications did not result in the terms being substantially different (as defined in ASC 470-50-40-10), the transaction is accounted for as a modification, not extinguishment of debt. Accordingly, the prepayment fees that were incurred are amortized as an adjustment of the yield over the remaining life of each advance.

In December 2009, we exercised our right to defer interest payments on our trust preferred securities for 20 consecutive quarters or until such earlier time as is determined by further action of the Board of Directors. During the deferral period, we may not declare or pay any dividends on our common stock or preferred stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities. Through

June 30, 2013, we have deferred interest payments for fifteen quarters. We continue to accrue interest during the deferral period and at June 30, 2013 total interest accrued for trust preferred securities was \$5.4 million, compared to \$4.7 million at December 31, 2012.

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Total shareholders' equity of \$133.3 million at June 30, 2013 increased \$2.8 million from \$130.5 million at December 31, 2012. The increase was primarily a result of net income of \$5.1 million earned in the first six months of 2013.

Our regulatory capital ratios improved again in the second quarter of 2013 and ended the second quarter 2013 at the highest levels in the Company's history. The Bank was categorized as "well capitalized" at June 30, 2013. The following table shows our regulatory capital ratios (on a consolidated basis) for the past several quarters:

	June 30, 2013	Mar 31, 2013	Dec 31, 2012	Sept 30, 2012	June 30, 2012	March 31, 2012	Dec 31, 2011
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Total capital to risk weighted assets	16.1%	15.4%	15.0%	14.9%	14.2%	13.7%	13.2%
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Tier 1 capital to average assets	10.9%	10.5%	10.4%	9.5 %	9.0 %	8.8 %	8.3 %
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All of the \$40.0 million of trust preferred securities outstanding at June 30, 2013 qualified as Tier 1 capital. The ratios have increased each quarter since March 31, 2010 due to declines in risk weighted assets, positive earnings for each quarter and the stock offering completed in the second quarter of 2011.

Cash dividends of \$2.9 million were declared on preferred shares during 2009. Following this, we suspended payment of cash dividends on our common and preferred stock for the remainder of 2009 and ever since then in an effort to preserve capital. As disclosed in Note 1 of the Consolidated Financial Statements, the Company resolved that it will not declare or pay any dividend without the prior written consent of the FRB. During the period that we do not declare and pay cash dividends on our preferred stock, we may not declare and pay cash dividends on our common stock. We expect to reassess our ability to resume the payment of dividends on our preferred and common stock if and when current levels of cash, earnings and capital are at acceptable levels and the prospects are positive for sustained economic growth and improved performance.

On July 3, 2013, the FDIC Board of Directors approved the Regulatory Capital Interim Final Rule, implementing Basel III. This rule redefines Tier 1 capital as two components (Common Equity Tier 1 and Additional Tier 1), creates a new capital ratio (Common Equity Tier 1 Risk-based Capital Ratio) and implements a capital conservation buffer. It also revises the prompt corrective action thresholds and makes changes to risk weights for certain assets and off-balance-sheet exposures. Banks are required to transition into the new rule beginning on January 1, 2015. Based on our capital levels and balance sheet composition at June 30, 2013, we do not believe implementation of the new rule will have a material impact on our capital needs.

LIQUIDITY

Liquidity of Macatawa Bank: The liquidity of a financial institution reflects its ability to manage 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 on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the FRB's discount window, the Federal Home Loan Bank, federal funds purchased lines of credit and other secured borrowing sources with our correspondent banks, loan payments by our borrowers, maturity and sales of our securities available for sale, growth of our deposits, federal funds sold and other short-term investments, and the various capital resources discussed above.

Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. Our liquidity management involves periodic monitoring of our assets considered to be liquid and illiquid, and our funding sources considered to be core and non-core and short-term (less than 12 months) and long-term. We have established parameters that monitor, among other items, our level of liquid assets to short-term liabilities, our level of non-core funding reliance and our level of available borrowing capacity. We maintain a diversified wholesale funding structure and actively manage our maturing wholesale sources to reduce the risk to liquidity shortages. We have also developed a contingency funding plan to stress test our liquidity requirements arising from certain events that may trigger liquidity shortages, such as rapid loan growth in excess of normal growth levels or the loss of deposits and other funding sources under extreme circumstances.

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In response to the volatile conditions in the national markets since 2008, we have actively pursued initiatives to further strengthen our liquidity position. The Bank reduced its reliance on non-core funding sources, including brokered deposits, and focused on achieving a non-core funding dependency ratio below its peer group average. We have had no brokered deposits on our balance sheet since December 2011. We also reduced other borrowed funds by \$56.8 million in 2012 and by \$1.2 million in the first six months of 2013. We continue to maintain significant on-balance sheet liquidity. At June 30, 2013, the Bank held \$129.8 million of federal funds sold and other short-term investments and \$25.0 million in time deposits with other financial institutions with maturities of less than 18 months. In addition, the Bank's borrowing capacity from correspondent banks has been improved and was approximately \$191.5 million as of June 30, 2013.

In the normal course of business, we enter into certain contractual obligations, including obligations which are considered in our overall liquidity management. The table below summarizes our significant contractual obligations at June 30, 2013.

(Dollars in thousands)	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long term debt	\$---	\$---	\$---	\$41,238
Subordinated debt	---	---	1,650	---
Time deposit maturities	88,727	62,015	13,225	---
Other borrowed funds	1,884	3,934	54,173	30,667
Total	\$90,611	\$65,949	\$69,048	\$71,905

In addition to normal loan funding, we also maintain liquidity to meet customer financing needs through unused lines of credit, unfunded loan commitments and standby letters of credit. The level and fluctuation of these commitments is also considered in our overall liquidity management. At June 30, 2013, we had a total of \$276.8 million in unused lines of credit, \$112.7 million in unfunded loan commitments and \$8.4 million in standby letters of credit.

**Liquidity of Holding Company:** The primary sources of liquidity for the Company are dividends from the Bank, existing cash resources and the various capital resources discussed above. Banking regulations and the laws of the state of Michigan in which our Bank is chartered limit the amount of dividends the Bank may declare and pay to the Company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Company in excess of retained earnings. Throughout 2011, 2012, and the first six months of 2013, the Company has not received dividends from the Bank, and the Company has suspended payment of dividends on its common and preferred stock. At June 30, 2013, the Bank had a retained earnings balance of approximately \$9.4 million. With the release of the Bank's MOU by its regulators effective April 12, 2013, the Bank is no longer required to obtain prior regulatory approval to pay dividends to the Company. Under the resolution adopted by the Company's Board of Directors, the Company may not pay any dividends without prior regulatory approval.

The Company continued to suspend payments of cash dividends on its preferred stock during 2010, 2011, 2012 and the first six months of 2013 until further action by the Board of Directors. During the period that the Company does not declare and pay cash dividends on its preferred stock, it may not declare and pay cash dividends on its common stock.

During 2010, 2011, 2012 and the first six months of 2013, the Company also continued to exercise its right to defer interest payments on its trust preferred securities for 20 consecutive quarters or until such earlier time as is determined by further action of the Board of Directors. During the deferral period, the Company may not declare or pay any dividends on its common stock or preferred stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities.

In June 2011, the Company closed its shareholder rights and public offerings and conversion of our 2% Subordinated Note due 2018, resulting in the issuance of 9,404,202 shares of common stock and net proceeds of \$20.4 million. The Company contributed \$10.0 million of the proceeds to the Bank in 2011 and retained the remaining \$10.3 million at the holding company level. The Company's cash balance at June 30, 2013 was \$9.4 million. The Company believes it has sufficient liquidity to meet its cash flow requirements.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES:**

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and future results could differ. The allowance for loan losses, other real estate owned valuation, loss contingencies and income taxes are deemed critical due to the required level of management judgment and the use of estimates, making them particularly subject to change.

Our methodology for determining the allowance for loan losses and the related provision for loan losses is described above in the "Allowance for Loan Losses" discussion. This area of accounting requires significant judgment due to the number of factors which can influence the collectability of a loan. Unanticipated changes in these factors could significantly change the level of the allowance for loan losses and the related provision for loan losses. Although, based upon our internal analysis, and in our judgment, we believe that we have provided an adequate allowance for loan losses, there can be no assurance that our analysis has properly identified all of the probable 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 the second quarter of 2013.

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Assets acquired through or instead of foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. New real estate appraisals are generally obtained at the time of foreclosure and are used to establish fair value. If fair value declines, a valuation allowance is recorded through expense. Estimating the initial and ongoing fair value of these properties involves a number of factors and judgments including holding time, costs to complete, holding costs, discount rate, absorption and other factors.

Loss contingencies are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. This, too, is an accounting area that involves significant judgment. Although, based upon our judgment, internal analysis, and consultations with legal counsel we believe that we have properly accounted for loss contingencies, future changes in the status of such contingencies could result in a significant change in the level of contingent liabilities and a related impact to operating earnings.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. At June 30, 2013, we had gross deferred tax assets of \$20.0 million and gross deferred tax liabilities of \$2.2 million resulting in a net deferred tax asset of \$17.8 million. Accounting standards require that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. Since mid 2009, we had maintained a full valuation allowance on our net deferred tax asset. At December 31, 2012, we considered all reasonably available positive and negative evidence and determined that with completing our eleventh consecutive profitable quarter, continued significant improvement in asset quality measures for the third straight year, the termination of Bank's Consent Order in the first quarter of 2012, the termination of the Company's Written Agreement in the fourth quarter of 2012 and our moving to a cumulative income position in the most recent three year period, that it was "more likely than not" that we will be able to realize our deferred tax assets and, as such, the full \$18.9 million valuation allowance was reversed as of December 31, 2012.

With the positive results in the first and second quarters of 2013 and the release of the Bank's MOU in the second quarter of 2013, we concluded at June 30, 2013 that no valuation allowance on our net deferred tax asset was required. Changes in tax laws, changes in tax rates, changes in ownership and our future level of earnings can impact the ultimate realization of our net deferred tax asset.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity ("EVE") resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.



We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

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The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of June 30, 2013 (dollars in thousands).

Interest Rate Scenario	Economic		Net	
	Value of Equity	Percent Change	Interest Income	Percent Change
Interest rates up 200 basis points	\$ 138,535	(3.22 )%	\$42,866	4.78 %
Interest rates up 100 basis points	141,945	(0.84 )	41,867	2.34
No change in interest rates	143,143	0	40,910	0
Interest rates down 100 basis points	143,832	0.48	40,612	(0.73 )
Interest rates down 200 basis points	144,047	0.63	40,404	(1.24 )

If interest rates were to increase, this analysis suggests that we are positioned for an improvement in net interest income over the next twelve months.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; and client preferences.

#### Item 4: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), we conducted (a) an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), as of June 30, 2013, the end of the period covered by this report.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as the Company's are designed to do, and management necessarily was required to apply its judgment in evaluating whether the benefits of the controls and procedures that the Company adopts outweigh their costs.

Our CEO and CFO, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report, have concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

Changes in Internal Controls. During the period covered by this report, there have been no changes in the (b)Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.



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PART II – OTHER INFORMATION

Item 6. Exhibits.

- 3.1 Restated Articles of Incorporation. Previously filed with the Commission on April 28, 2011 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 3.1. Here incorporated by reference.
- 3.2 Bylaws. Previously filed with the Commission on November 24, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 3.1. Here incorporated by reference.
- 3.3 Certificate of Designation of Series A Noncumulative Convertible Perpetual Preferred Stock. Previously filed with the Commission on November 5, 2008 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference.
- 3.4 Certificate of Designation of Series B Noncumulative Convertible Perpetual Preferred Stock. Previously filed with the Commission on July 2, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference.
- 4.1 Restated Articles of Incorporation. Exhibit 3.1 is here incorporated by reference.
- 4.2 Bylaws. Exhibit 3.2 is here incorporated by reference.
- 4.3 Certificate of Designation of Series A Noncumulative Convertible Perpetual Preferred Stock. Exhibit 3.3 is here incorporated by reference.
- 4.4 Certificate of Designation of Series B Noncumulative Convertible Perpetual Preferred Stock. Exhibit 3.4 is here incorporated by reference.
- 4.5 First Amended Settlement and Release and Warrant Issuance Agreement dated January 30, 2009. Previously filed with the Commission on January 30, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 10.1. Here incorporated by reference.
- 4.6 Second Amendment to Settlement and Release and Warrant Issuance Agreement dated April 30, 2009. Previously filed with the Commission on May 8, 2009 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 10.1. Here incorporated by reference.
- 4.7 Warrant Agreement between Macatawa Bank Corporation and Registrar and Transfer Company dated June 16, 2009. Previously filed with the Commission on June 19, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference.
- 4.8 Warrant Agreement Addendum between Macatawa Bank Corporation and Registrar and Transfer Company dated July 27, 2009. Previously filed with the Commission on July 31, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference.
- 4.9 Form of Warrant Certificate (first series). Previously filed with the Commission on June 19, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here incorporated by reference.
- 4.10 Form of Warrant Certificate (second series). Previously filed with the Commission on July 31, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here incorporated by reference.



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- 4.11 Form of 11% Subordinated Note Due 2017. Previously filed with the Commission on July 2, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here incorporated by reference.
- 4.12 Long-Term Debt. The registrant has outstanding long-term debt which at the time of this report does not exceed 10% of the registrant's total consolidated assets. The registrant agrees to furnish copies of the agreements defining the rights of holders of such long-term debt to the Commission upon request.
- 31.1 Certification of Chief Executive Officer.
- 31.2 Certification of Chief Financial Officer.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350.
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

MACATAWA BANK CORPORATION

/s/ Ronald L. Haan  
Ronald L. Haan  
Chief Executive Officer  
(Principal Executive Officer)

/s/ Jon W. Swets  
Jon W. Swets  
Senior Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

Dated: July 25, 2013

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