# Section 1: 10-Q (10-Q)

**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, 2019**

**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: 0-18415**

# Isabella Bank Corporation

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Michigan** | **38-2830092** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **401 N. Main St, Mt. Pleasant, MI** | **48858** |
| **(Address of principal executive offices)** | **(Zip code)** |

**(989) 772-9471**
**(Registrant's telephone number, including area code)**
**N/A**
**(Former name, former address and former fiscal year, if changed since last report)**

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|---|---|---|
| None | N/A | N/A |

Indicate by check mark 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 every Interactive Data File required to be submitted 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 such files). ☒ Yes ☐ No

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

| | | | |
|---|---|---|---|
| Large accelerated filer | ☐ | Accelerated filer | ☒ |
| Non-accelerated filer | ☐ | Smaller reporting company | ☒ |
| | | Emerging growth company | ☐ |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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 common shares outstanding of the registrant's Common Stock (no par value) was 7,917,099 as of August 6, 2019.

**ISABELLA BANK CORPORATION**
**QUARTERLY REPORT ON FORM 10-Q**
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**Forward Looking Statements**

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended and Rule 3b-6 promulgated thereunder. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project,” or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, federal or state tax laws, monetary and fiscal policy, the quality or composition of the loan or investment portfolio, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, cybersecurity risk, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

**Glossary of Acronyms and Abbreviations**

The acronyms and abbreviations identified below may be used throughout this Quarterly Report on Form 10-Q or in our other SEC filings. You may find it helpful to refer back to this page while reading this report.

| | |
|---|---|
| ACL: Allowance for Credit Losses | GAAP: U.S. generally accepted accounting principles |
| AFS: Available-for-sale | GLB Act: Gramm-Leach-Bliley Act of 1999 |
| ALLL: Allowance for loan and lease losses | IFRS: International Financial Reporting Standards |
| AOCI: Accumulated other comprehensive income | IRR: Interest rate risk |
| ASC: FASB Accounting Standards Codification | ISDA: International Swaps and Derivatives Association |
| ASU: FASB Accounting Standards Update | JOBS Act: Jumpstart our Business Startups Act |
| ATM: Automated Teller Machine | LIBOR: London Interbank Offered Rate |
| BHC Act: Bank Holding Company Act of 1956 | N/A: Not applicable |
| CECL: Current Expected Credit Losses | N/M: Not meaningful |
| CFPB: Consumer Financial Protection Bureau | NASDAQ: NASDAQ Stock Market Index |
| CIK: Central Index Key | NASDAQ Banks: NASDAQ Bank Stock Index |
| CRA: Community Reinvestment Act | NAV: Net asset value |
| DIF: Deposit Insurance Fund | NOW: Negotiable order of withdrawal |
| DIFS: Department of Insurance and Financial Services | NSF: Non-sufficient funds |
| Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors | OCI: Other comprehensive income (loss) |
| Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan | OMSR: Originated mortgage servicing rights |
| Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 | OREO: Other real estate owned |
| ESOP: Employee Stock Ownership Plan | OTTI: Other-than-temporary impairment |
| Exchange Act: Securities Exchange Act of 1934 | PBO: Projected benefit obligation |
| FASB: Financial Accounting Standards Board | PCAOB: Public Company Accounting Oversight Board |
| FDI Act: Federal Deposit Insurance Act | Rabbi Trust: A trust established to fund our Directors Plan |
| FDIC: Federal Deposit Insurance Corporation | SEC: U.S. Securities and Exchange Commission |
| FFIEC: Federal Financial Institutions Examinations Council | SOX: Sarbanes-Oxley Act of 2002 |
| FRB: Federal Reserve Bank | Tax Act: Tax Cuts and Jobs Act, enacted December 22, 2017 |
| FHLB: Federal Home Loan Bank | TDR: Troubled debt restructuring |
| Freddie Mac: Federal Home Loan Mortgage Corporation | XBRL: eXtensible Business Reporting Language |
| FTE: Fully taxable equivalent | Yield Curve: U.S. Treasury Yield Curve |

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## PART I – FINANCIAL INFORMATION

**Item 1. Financial Statements.**

### INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

| | June 30 2019 | December 31 2018 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | | |
| Cash and demand deposits due from banks | $ 21,935 | $ 23,534 |
| Interest bearing balances due from banks | 14,027 | 49,937 |
| **Total cash and cash equivalents** | **35,962** | **73,471** |
| AFS securities, at fair value | 470,449 | 494,834 |
| Mortgage loans AFS | 1,372 | 358 |
| Loans | | |
| Commercial | 701,954 | 659,529 |
| Agricultural | 120,363 | 127,161 |
| Residential real estate | 283,285 | 275,343 |
| Consumer | 71,020 | 66,674 |
| **Gross loans** | **1,176,622** | **1,128,707** |
| Less allowance for loan and lease losses | 8,037 | 8,375 |
| **Net loans** | **1,168,585** | **1,120,332** |
| Premises and equipment | 26,954 | 27,815 |
| Corporate owned life insurance policies | 28,090 | 27,733 |
| Accrued interest receivable | 6,193 | 6,928 |
| Equity securities without readily determinable fair values | 25,024 | 24,948 |
| Goodwill and other intangible assets | 48,413 | 48,451 |
| Other assets | 13,550 | 17,632 |
| **TOTAL ASSETS** | **$ 1,824,592** | **$ 1,842,502** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Deposits | | |
| Noninterest bearing | $ 244,240 | $ 236,534 |
| NOW accounts | 228,704 | 235,287 |
| Certificates of deposit under $250 and other savings | 722,860 | 744,944 |
| Certificates of deposit over $250 | 85,614 | 75,928 |
| **Total deposits** | **1,281,418** | **1,292,693** |
| Borrowed funds | 320,462 | 340,299 |
| Accrued interest payable and other liabilities | 14,598 | 13,991 |
| **Total liabilities** | **1,616,478** | **1,646,983** |
| Shareholders' equity | | |
| Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,918,494 shares (including 40,514 shares held in the Rabbi Trust) in 2019 and 7,870,969 shares (including 16,673 shares held in the Rabbi Trust) in 2018 | 140,965 | 140,416 |
| Shares to be issued for deferred compensation obligations | 5,434 | 5,431 |
| Retained earnings | 60,948 | 57,357 |
| Accumulated other comprehensive income (loss) | 767 | (7,685) |
| **Total shareholders' equity** | **208,114** | **195,519** |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 1,824,592** | **$ 1,842,502** |

See notes to interim condensed consolidated financial statements (unaudited).

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**
(Dollars in thousands except per share amounts)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| **Interest income** | | | | |
| Loans, including fees | $ 13,587 | $ 12,076 | $ 26,478 | $ 23,372 |
| AFS securities | | | | |
| Taxable | 1,873 | 2,110 | 3,831 | 4,232 |
| Nontaxable | 1,207 | 1,331 | 2,460 | 2,713 |
| Federal funds sold and other | 148 | 196 | 527 | 517 |
| **Total interest income** | **16,815** | **15,713** | **33,296** | **30,834** |
| **Interest expense** | | | | |
| Deposits | 2,865 | 2,230 | 5,583 | 4,276 |
| Borrowings | 1,662 | 1,511 | 3,236 | 2,866 |
| **Total interest expense** | **4,527** | **3,741** | **8,819** | **7,142** |
| **Net interest income** | **12,288** | **11,972** | **24,477** | **23,692** |
| Provision for loan losses | (179) | 328 | (145) | 712 |
| **Net interest income after provision for loan losses** | **12,467** | **11,644** | **24,622** | **22,980** |
| **Noninterest income** | | | | |
| Service charges and fees | 1,540 | 1,488 | 3,001 | 2,976 |
| Investment and Trust advisory fees | 780 | 738 | 1,457 | 1,396 |
| Earnings on corporate owned life insurance policies | 201 | 185 | 374 | 366 |
| Net gain on sale of mortgage loans | 116 | 87 | 209 | 168 |
| Other | 374 | 242 | 449 | 332 |
| **Total noninterest income** | **3,011** | **2,740** | **5,490** | **5,238** |
| **Noninterest expenses** | | | | |
| Compensation and benefits | 5,957 | 5,679 | 11,679 | 11,173 |
| Furniture and equipment | 1,409 | 1,537 | 2,903 | 2,986 |
| Occupancy | 834 | 807 | 1,764 | 1,631 |
| Other | 2,549 | 2,765 | 5,192 | 5,105 |
| **Total noninterest expenses** | **10,749** | **10,788** | **21,538** | **20,895** |
| **Income before federal income tax expense** | **4,729** | **3,596** | **8,574** | **7,323** |
| Federal income tax expense | 541 | 263 | 890 | 528 |
| **NET INCOME** | **$ 4,188** | **$ 3,333** | **$ 7,684** | **$ 6,795** |
| **Earnings per common share** | | | | |
| **Basic** | **$ 0.53** | **$ 0.42** | **$ 0.97** | **$ 0.86** |
| **Diluted** | **$ 0.52** | **$ 0.41** | **$ 0.95** | **$ 0.84** |
| **Cash dividends per common share** | **$ 0.26** | **$ 0.26** | **$ 0.52** | **$ 0.52** |

See notes to interim condensed consolidated financial statements (unaudited).

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**
(Dollars in thousands)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| **Net income** | **$ 4,188** | **$ 3,333** | **$ 7,684** | **$ 6,795** |
| Unrealized gains (losses) on AFS securities arising during the period | 4,876 | (1,978) | 10,830 | (10,035) |
| Tax effect [(1)] | (1,018) | 442 | (2,213) | 2,126 |
| Unrealized gains (losses) on AFS securities, net of tax | 3,858 | (1,536) | 8,617 | (7,909) |
| Unrealized gains (losses) on derivative instruments arising during the period | (127) | 31 | (208) | 153 |
| Tax effect [(1)] | 26 | (6) | 43 | (32) |
| Unrealized gains (losses) on derivative instruments, net of tax | (101) | 25 | (165) | 121 |
| **Other comprehensive income (loss), net of tax** | **3,757** | **(1,511)** | **8,452** | **(7,788)** |
| **Comprehensive income (loss)** | **$ 7,945** | **$ 1,822** | **$ 16,136** | **$ (993)** |

(1) See “Note 11 – Accumulated Other Comprehensive Income” for tax effect reconciliation.

See notes to interim condensed consolidated financial statements (unaudited).

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)**

(Dollars in thousands except per share amounts)

| | Common Stock | | | | | |
|---|---|---|---|---|---|---|
| | Common Shares Outstanding | Amount | Common Shares to be Issued for Deferred Compensation Obligations | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Totals |
| **Balance, January 1, 2018** | **7,857,293** | **$ 140,277** | **$ 5,502** | **$ 51,728** | **$ (2,602)** | **$ 194,905** |
| Comprehensive income (loss) | — | — | — | 6,795 | (7,788) | (993) |
| Adoption of ASU 2016-01 | — | — | — | (223) | 223 | — |
| Issuance of common stock | 121,437 | 3,272 | — | — | — | 3,272 |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations | — | 383 | (383) | — | — | — |
| Share-based payment awards under equity compensation plan | — | — | 304 | — | — | 304 |
| Common stock purchased for deferred compensation obligations | — | (205) | — | — | — | (205) |
| Common stock repurchased pursuant to publicly announced repurchase plan | (45,480) | (1,238) | — | — | — | (1,238) |
| Cash dividends paid ($0.52 per common share) | — | — | — | (4,096) | — | (4,096) |
| **Balance, June 30, 2018** | **7,933,250** | **$ 142,489** | **$ 5,423** | **$ 54,204** | **$ (10,167)** | **$ 191,949** |
| **Balance, January 1, 2019** | **7,870,969** | **$ 140,416** | **$ 5,431** | **$ 57,357** | **$ (7,685)** | **$ 195,519** |
| Comprehensive income (loss) | — | — | — | 7,684 | 8,452 | 16,136 |
| Issuance of common stock | 104,598 | 2,436 | — | — | — | 2,436 |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations | — | 268 | (268) | — | — | — |
| Share-based payment awards under equity compensation plan | — | — | 271 | — | — | 271 |
| Common stock purchased for deferred compensation obligations | — | (816) | — | — | — | (816) |
| Common stock repurchased pursuant to publicly announced repurchase plan | (57,073) | (1,339) | — | — | — | (1,339) |
| Cash dividends paid ($0.52 per common share) | — | — | — | (4,093) | — | (4,093) |
| **Balance, June 30, 2019** | **7,918,494** | **$ 140,965** | **$ 5,434** | **$ 60,948** | **$ 767** | **$ 208,114** |

See notes to interim condensed consolidated financial statements (unaudited).

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**
(Dollars in thousands)

| | Six Months Ended June 30 | |
|---|---|---|
| | 2019 | 2018 |
| **OPERATING ACTIVITIES** | | |
| Net income | $ 7,684 | $ 6,795 |
| Reconciliation of net income to net cash provided by operating activities: | | |
| Undistributed earnings of equity securities without readily determinable fair values | (76) | (64) |
| Provision for loan losses | (145) | 712 |
| Depreciation | 1,476 | 1,448 |
| Amortization of OMSR | 118 | 153 |
| Amortization of acquisition intangibles | 38 | 50 |
| Net amortization of AFS securities | 882 | 969 |
| Net unrealized (gains) losses on equity securities, at fair value | — | 41 |
| Net (gains) losses on sale of equity securities, at fair value | — | (1) |
| Net gain on sale of mortgage loans | (209) | (168) |
| Increase in cash value of corporate owned life insurance policies, net of expenses | (357) | (351) |
| Share-based payment awards under equity compensation plan | 271 | 304 |
| Origination of loans held-for-sale | (14,110) | (10,178) |
| Proceeds from loan sales | 13,305 | 10,486 |
| Net changes in operating assets and liabilities which provided (used) cash: | | |
| Accrued interest receivable | 735 | 1,379 |
| Other assets | 1,744 | (64) |
| Accrued interest payable and other liabilities | 756 | 94 |
| **Net cash provided by (used in) operating activities** | **12,112** | **11,605** |
| **INVESTING ACTIVITIES** | | |
| Activity in AFS securities | | |
| Maturities, calls, and principal payments | 43,296 | 39,609 |
| Purchases | (8,963) | (25,991) |
| Sale of equity securities, at fair value | — | 3,537 |
| Net loan principal (originations) collections | (48,585) | (60,517) |
| Proceeds from sales of foreclosed assets | 319 | 192 |
| Purchases of premises and equipment | (615) | (1,265) |
| Purchases of FHLB Stock | — | (225) |
| Funding of low income housing tax credit investments | (149) | (435) |
| **Net cash provided by (used in) investing activities** | **(14,697)** | **(45,095)** |

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**
(Dollars in thousands)

| | Six Months Ended June 30 | |
|---|---|---|
| | 2019 | 2018 |
| **FINANCING ACTIVITIES** | | |
| Net increase (decrease) in deposits | $ (11,275) | $ 9,504 |
| Net increase (decrease) in borrowed funds | (19,837) | 17,618 |
| Cash dividends paid on common stock | (4,093) | (4,096) |
| Proceeds from issuance of common stock | 2,436 | 3,272 |
| Common stock repurchased | (1,339) | (1,238) |
| Common stock purchased for deferred compensation obligations | (816) | (205) |
| **Net cash provided by (used in) financing activities** | **(34,924)** | **24,855** |
| **Increase (decrease) in cash and cash equivalents** | **(37,509)** | **(8,635)** |
| Cash and cash equivalents at beginning of period | 73,471 | 30,848 |
| **Cash and cash equivalents at end of period** | **$ 35,962** | **$ 22,213** |
| **SUPPLEMENTAL CASH FLOWS INFORMATION:** | | |
| Interest paid | $ 8,760 | $ 7,120 |
| **SUPPLEMENTAL NONCASH INFORMATION:** | | |
| Transfers of loans to foreclosed assets | $ 477 | $ 68 |

See notes to interim condensed consolidated financial statements (unaudited).

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**
(Dollars in thousands except per share amounts)

**Note 1 – Basis of Presentation**

As used in these notes, as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to the “Corporation”, “Isabella”, “we”, “our”, “us”, and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiary. References to Isabella Bank or the “Bank” refers to Isabella Bank Corporation’s subsidiary, Isabella Bank.

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP 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 GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2018.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2018.

**Reclassifications:** Certain amounts reported in the interim 2018 consolidated financial statements have been reclassified to conform with the 2019 presentation. Other assets and other liabilities on the interim condensed consolidated balance sheets were increased by $5,195 as of December 31, 2018 to reclassify pension and income tax related liabilities (pension: $3,470, income taxes $1,725). This resulted in a $5,195 increase in total assets as of December 31, 2018. All other balances and ratios were not materially impacted.

**Note 2 – Accounting Standards Updates**

**Recently Adopted Accounting Standards Updates**

*ASU No. 2016-02: “Leases (Topic 842)”*

In February 2016, ASU No. 2016-02 was issued to create *Topic 842 - Leases* which will require recognition of lease assets and lease liabilities on the balance sheet for leases previously classified as operating leases. Accounting guidance is set forth for both lessee and lessor accounting. Under lessee accounting, a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term.

For finance leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income; and 3) classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows. For operating leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis; and 3) classify all cash payments within operating activities in the statement of cash flows.

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new authoritative guidance was effective on January 1, 2019. We reviewed our lease agreements to determine the appropriate treatment under this guidance. These changes resulted in the recognition of a $72 operating lease asset and liability on the balance sheet as of January 1, 2019 which was restated prospectively. Given the current insignificant impact to our operating results, further financial statement disclosures were not considered necessary as of June 30, 2019.

**Pending Accounting Standards Updates**

*ASU No. 2016-13: “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments”*

In June 2016, ASU No. 2016-13 was issued and updated the measurement for credit losses for AFS debt securities and assets measured at amortized cost which includes loans, trade receivables, and any other financial assets with the contractual right to receive cash. Current GAAP requires an “incurred loss” methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. Under the incurred loss approach, entities are limited to a probable initial recognition threshold when credit losses are measured under GAAP; an entity generally only considers past events and current conditions in measuring the incurred loss.

Under the new guidance, the incurred loss impairment methodology in current GAAP is replaced with a methodology that reflects current expected credit losses (CECL). This methodology requires consideration of a broader range of reasonable and supportable information to calculate credit loss estimates. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances which applies to assets measured either collectively or individually.

The update allows an entity to revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts. In addition, the disclosures of credit quality indicators in relation to the amortized cost of financing receivables, a current disclosure requirement, are further disaggregated by year of origination (or vintage). The vintage information will be useful for financial statement users to better assess changes in underwriting standards and credit quality trends in asset portfolios over time and the effect of those changes on credit losses.

Overall, the update will allow entities the ability to measure expected credit losses without the restriction of incurred or probable losses that exist under current GAAP. For users of the financial statements, the update requires disclosure of decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019 and may have a significant impact on our operations and financial statement disclosures as well as that of the banking industry as a whole.

We have invested a considerable amount of effort toward this guidance and will continue to invest considerable effort until its effective date. A committee was formed and has developed a road map to implementation, and the committee is accountable for timely and accurate adoption of the guidance. A company that has focused on the ALLL for more than 10 years and serves hundreds of financial institutions has been engaged to provide us with education, advisory, and software solutions exclusively related to the ACL. We will run parallel processes which will help to ensure we are ready to calculate, review, and report the ACL by the required implementation date.

*ASU No. 2018-13: “Fair Value Measurement (Topic 820): Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement”*

In August 2018, ASU No. 2018-13 was issued and provided updated framework related to fair value disclosures. For entities required to make disclosures about recurring or nonrecurring fair value measurements, the update provides disclosure modifications which include the removal, modification and addition of specific disclosure requirements.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019 and will impact our financial statement disclosures.

*ASU No. 2018-14: “Compensation - Retirement Benefits - Defined Pension Plans - General (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans”*

In August 2018, ASU No. 2018-14 was issued and provided updated framework related to defined benefit plans. For employers that sponsor defined benefit pension or other postretirement plans, the update provides disclosure modifications which include the removal of six specific requirements, the addition of two specific requirements and clarification to existing requirements.

Disclosure additions include 1) the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates; 2) an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. Clarification items relate to 1) the projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets; and 2) the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets.

The new authoritative guidance is effective for fiscal years ending after December 15, 2020, with early adoption permitted, and will likely impact our financial statement disclosures.

*ASU No. 2018-15: "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract"*

In August 2018, ASU No. 2018-15 was issued and provided guidance on the accounting for implementation, setup, and other upfront costs (collectively referred to as implementation costs) for entities that are a customer in a hosting arrangement that is a service contract. The guidance also provides clarification on requirements to capitalize implementation costs and the required accounting for expenses related to capitalization of implementation costs.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted. The impact on our operating results and financial statement disclosures as a result of this update will depend upon our current and future arrangements and whether or not they meet the requirement to be capitalized.

**Note 3 – AFS Securities**

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows at:

| | June 30, 2019 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Government sponsored enterprises | $ 160 | $ — | $ — | $ 160 |
| States and political subdivisions | 172,197 | 4,546 | 1 | 176,742 |
| Auction rate money market preferred | 3,200 | — | 351 | 2,849 |
| Mortgage-backed securities | 173,992 | 621 | 1,273 | 173,340 |
| Collateralized mortgage obligations | 116,481 | 1,130 | 253 | 117,358 |
| **Total** | **$ 466,030** | **$ 6,297** | **$ 1,878** | **$ 470,449** |

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Government sponsored enterprises | $ 172 | $ — | $ 2 | $ 170 |
| States and political subdivisions | 188,992 | 2,125 | 251 | 190,866 |
| Auction rate money market preferred | 3,200 | — | 646 | 2,554 |
| Mortgage-backed securities | 189,688 | 76 | 5,280 | 184,484 |
| Collateralized mortgage obligations | 119,193 | 71 | 2,504 | 116,760 |
| **Total** | **$ 501,245** | **$ 2,272** | **$ 8,683** | **$ 494,834** |

The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2019 are as follows:

| | Maturing | | | | | |
|---|---|---|---|---|---|---|
| | Due in One Year or Less | After One Year But Within Five Years | After Five Years But Within Ten Years | After Ten Years | Securities with Variable Monthly Payments or Noncontractual Maturities | Total |
| Government sponsored enterprises | $ — | $ 160 | $ — | $ — | $ — | $ 160 |
| States and political subdivisions | 28,931 | 71,394 | 44,668 | 27,204 | — | 172,197 |
| Auction rate money market preferred | — | — | — | — | 3,200 | 3,200 |
| Mortgage-backed securities | — | — | — | — | 173,992 | 173,992 |
| Collateralized mortgage obligations | — | — | — | — | 116,481 | 116,481 |
| **Total amortized cost** | **$ 28,931** | **$ 71,554** | **$ 44,668** | **$ 27,204** | **$ 293,673** | **$ 466,030** |
| **Fair value** | **$ 29,073** | **$ 73,042** | **$ 46,185** | **$ 28,602** | **$ 293,547** | **$ 470,449** |

Expected maturities for government sponsored enterprises and states and political subdivisions may differ from contractual maturities because issuers may have the right to call or prepay obligations.

As the auction rate money market preferred investments have continual call dates, they are not reported by a specific maturity group. Because of their variable monthly payments, mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group.

The following information pertains to AFS securities with gross unrealized losses at June 30, 2019 and December 31, 2018, aggregated by investment category and length of time that individual securities have been in a continuous loss position.

| | June 30, 2019 | | | | |
|---|---|---|---|---|---|
| | Less Than Twelve Months | | Twelve Months or More | | |
| | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Total Unrealized Losses |
| Government sponsored enterprises | $ — | $ — | $ — | $ — | $ — |
| States and political subdivisions | — | — | 1 | 824 | 1 |
| Auction rate money market preferred | — | — | 351 | 2,849 | 351 |
| Mortgage-backed securities | 6 | 3,193 | 1,267 | 106,137 | 1,273 |
| Collateralized mortgage obligations | — | — | 253 | 23,423 | 253 |
| **Total** | **$ 6** | **$ 3,193** | **$ 1,872** | **$ 133,233** | **$ 1,878** |
| **Number of securities in an unrealized loss position:** | | **1** | | **39** | **40** |

| | December 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Less Than Twelve Months | | Twelve Months or More | | |
| | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Total Unrealized Losses |
| Government sponsored enterprises | $ — | $ — | $ 2 | $ 170 | $ 2 |
| States and political subdivisions | 83 | 14,732 | 168 | 15,090 | 251 |
| Auction rate money market preferred | — | — | 646 | 2,554 | 646 |
| Mortgage-backed securities | 896 | 43,485 | 4,384 | 124,253 | 5,280 |
| Collateralized mortgage obligations | 199 | 21,886 | 2,305 | 87,929 | 2,504 |
| **Total** | **$ 1,178** | **$ 80,103** | **$ 7,505** | **$ 229,996** | **$ 8,683** |
| **Number of securities in an unrealized loss position:** | | **66** | | **102** | **168** |

The reduction in unrealized losses on our AFS securities portfolio resulted from recent decreases in intermediate-term and long-term benchmark interest rates.

As of June 30, 2019 and December 31, 2018, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position should be identified as other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

- Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable the issuer will be unable to pay the amount when due?
- Is it more likely than not that we will have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended?

Based on our analysis which included the criteria outlined above and the fact that we have asserted that we do not have to sell AFS securities in an unrealized loss position, we do not believe that the values of any other AFS securities are other-than-temporarily impaired as of June 30, 2019 or December 31, 2018, with the exception of one municipal bond previously identified which had no activity during the period.

**Note 4 – Loans and ALLL**

We grant commercial, agricultural, residential real estate, and consumer loans to customers situated primarily in Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The ability of the borrowers to honor their repayment obligations is often dependent upon the real estate, agricultural, manufacturing, retail, gaming, tourism, health care, higher education, and general economic conditions of this region. Substantially all of our consumer and residential real estate loans are secured by various items of property, while commercial loans are secured primarily by real estate, business assets, and personal guarantees. A portion of loans are unsecured.

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the appropriate amortization methods.

The accrual of interest on commercial and agricultural loans, as well as residential real estate loans, is discontinued at the time a loan is 90 days or more past due unless the credit is well-secured and in the process of short-term collection. Upon transferring a loan to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if a charge-off is necessary. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on the contractual term of the loan. In all cases, a loan is placed in nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

When a loan is placed in nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance and achievement of current payment status.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, advances to mortgage brokers, farmland and agricultural production, and loans to states and political subdivisions. Repayment of these loans is dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to $15,000. Borrowers with direct credit needs of more than $15,000 may be serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, property, or equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we may require annual financial statements, prepare cash flow analyses, and review credit reports.

We entered into a mortgage purchase program in 2016 with a financial institution where we participate in advances to mortgage brokers (“advances”). The mortgage brokers originate residential mortgage loans with the intent to sell them on the secondary market. We participate in the advance to the mortgage broker, which is secured by the underlying mortgage loan, until it is ultimately sold on the secondary market. As such, the average life of each participated advance is approximately 20-30 days. Funds from the sale of the loan are used to pay off our participation in the advance to the mortgage broker. We classify these advances as commercial loans and include the outstanding balance in commercial loans on our consolidated balance sheet. Under the participation agreement, we committed to a maximum outstanding aggregate amount of $40,000. The difference between our outstanding balance and the maximum outstanding aggregate amount is classified as “Unfunded commitments under lines of credit” in the “Contractual Obligations and Loan Commitments” section of the Management's Discussion and Analysis of Financial Condition and Results of Operations of this report.

We offer adjustable rate mortgages, construction loans, and fixed rate residential real estate loans which have amortization periods up to a maximum of 30 years. We consider the anticipated direction of interest rates, balance sheet duration, the sensitivity of our balance sheet to changes in interest rates, our liquidity needs, and overall loan demand to determine whether or not to sell fixed rate loans to Freddie Mac.

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 100% of the lower of the appraised value of the property or the purchase price. Private mortgage insurance is typically required on loans with loan-to-value ratios in excess of 80% unless the loan qualifies for government guarantees.

Underwriting criteria for originated residential real estate loans generally include:

- Evaluation of the borrower's ability to make monthly payments.
- Evaluation of the value of the property securing the loan.
- Ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower's gross income.
- Ensuring all debt servicing does not exceed 40% of income.
- Verification of acceptable credit reports.
- Verification of employment, income, and financial information.

Appraisals are performed by independent appraisers and reviewed for appropriateness. Generally, mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market underwriting system; loans in excess of $1,000 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 15 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectability of the loan balance is probable. Subsequent recoveries, if any, are credited to the ALLL.

The ALLL is evaluated on a regular basis for appropriateness. Our periodic review of the collectability of a loan considers historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan's outstanding balance and the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio, with the exception of advances to mortgage brokers, over the preceding five years. With no historical losses on advances to mortgage brokers, there is no allocation in the commercial segment displayed in the following tables. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A summary of changes in the ALLL and the recorded investment in loans by segments follows:

| | Allowance for Loan Losses | | | | | |
|---|---|---|---|---|---|---|
| | Three Months Ended June 30, 2019 | | | | | |
| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
| April 1, 2019 | $ 2,248 | $ 775 | $ 2,305 | $ 891 | $ 2,179 | $ 8,398 |
| Charge-offs | (164) | — | (94) | (75) | — | (333) |
| Recoveries | 22 | — | 91 | 38 | — | 151 |
| Provision for loan losses | (26) | (163) | (420) | 73 | 357 | (179) |
| **June 30, 2019** | **$ 2,080** | **$ 612** | **$ 1,882** | **$ 927** | **$ 2,536** | **$ 8,037** |

| | Allowance for Loan Losses | | | | | |
|---|---|---|---|---|---|---|
| | Six Months Ended June 30, 2019 | | | | | |
| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
| January 1, 2019 | $ 2,563 | $ 775 | $ 1,992 | $ 857 | $ 2,188 | $ 8,375 |
| Charge-offs | (172) | — | (96) | (203) | — | (471) |
| Recoveries | 74 | — | 118 | 86 | — | 278 |
| Provision for loan losses | (385) | (163) | (132) | 187 | 348 | (145) |
| **June 30, 2019** | **$ 2,080** | **$ 612** | **$ 1,882** | **$ 927** | **$ 2,536** | **$ 8,037** |

**Allowance for Loan Losses and Recorded Investment in Loans**
**June 30, 2019**

| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| **ALLL** | | | | | | |
| Individually evaluated for impairment | $ 58 | $ 123 | $ 1,298 | $ — | $ — | $ 1,479 |
| Collectively evaluated for impairment | 2,022 | 489 | 584 | 927 | 2,536 | 6,558 |
| **Total** | **$ 2,080** | **$ 612** | **$ 1,882** | **$ 927** | **$ 2,536** | **$ 8,037** |
| **Loans** | | | | | | |
| Individually evaluated for impairment | $ 9,029 | $ 13,472 | $ 6,389 | $ 7 | | $ 28,897 |
| Collectively evaluated for impairment | 692,925 | 106,891 | 276,896 | 71,013 | | 1,147,725 |
| **Total** | **$ 701,954** | **$ 120,363** | **$ 283,285** | **$ 71,020** | | **$ 1,176,622** |

**Allowance for Loan Losses**
**Three Months Ended June 30, 2018**

| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| April 1, 2018 | $ 1,840 | $ 1,224 | $ 2,482 | $ 795 | $ 1,859 | $ 8,200 |
| Charge-offs | (489) | — | (29) | (48) | — | (566) |
| Recoveries | 101 | — | 69 | 68 | — | 238 |
| Provision for loan losses | 745 | (242) | (355) | 67 | 113 | 328 |
| **June 30, 2018** | **$ 2,197** | **$ 982** | **$ 2,167** | **$ 882** | **$ 1,972** | **$ 8,200** |

**Allowance for Loan Losses**
**Six Months Ended June 30, 2018**

| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| January 1, 2018 | $ 1,706 | $ 611 | $ 2,563 | $ 900 | $ 1,920 | $ 7,700 |
| Charge-offs | (494) | — | (39) | (136) | — | (669) |
| Recoveries | 204 | — | 125 | 128 | — | 457 |
| Provision for loan losses | 781 | 371 | (482) | (10) | 52 | 712 |
| **June 30, 2018** | **$ 2,197** | **$ 982** | **$ 2,167** | **$ 882** | **$ 1,972** | **$ 8,200** |

**Allowance for Loan Losses and Recorded Investment in Loans**
**December 31, 2018**

| | Commercial | Agricultural | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| **ALLL** | | | | | | |
| Individually evaluated for impairment | $ 443 | $ 132 | $ 1,363 | $ — | $ — | $ 1,938 |
| Collectively evaluated for impairment | 2,120 | 643 | 629 | 857 | 2,188 | 6,437 |
| **Total** | **$ 2,563** | **$ 775** | **$ 1,992** | **$ 857** | **$ 2,188** | **$ 8,375** |
| **Loans** | | | | | | |
| Individually evaluated for impairment | $ 9,899 | $ 14,298 | $ 6,893 | $ 9 | | $ 31,099 |
| Collectively evaluated for impairment | 649,630 | 112,863 | 268,450 | 66,665 | | 1,097,608 |
| **Total** | **$ 659,529** | **$ 127,161** | **$ 275,343** | **$ 66,674** | | **$ 1,128,707** |

The following tables display the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit risk ratings as of:

| | June 30, 2019 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Commercial | | | | Agricultural | | | |
| | Real Estate | Other | Advances to Mortgage Brokers | Total | Real Estate | Other | Total | Total |
| Rating | | | | | | | | |
| 1 - Excellent | $ — | $ 19 | $ — | $ 19 | $ — | $ — | $ — | $ 19 |
| 2 - High quality | 3,324 | 14,853 | — | 18,177 | 2,333 | 405 | 2,738 | 20,915 |
| 3 - High satisfactory | 121,222 | 46,845 | 37,966 | 206,033 | 17,632 | 5,814 | 23,446 | 229,479 |
| 4 - Low satisfactory | 359,329 | 88,910 | — | 448,239 | 44,106 | 19,816 | 63,922 | 512,161 |
| 5 - Special mention | 16,631 | 5,768 | — | 22,399 | 10,060 | 5,065 | 15,125 | 37,524 |
| 6 - Substandard | 4,803 | 592 | — | 5,395 | 6,013 | 3,587 | 9,600 | 14,995 |
| 7 - Vulnerable | 450 | 1,242 | — | 1,692 | 3,593 | 1,939 | 5,532 | 7,224 |
| 8 - Doubtful | — | — | — | — | — | — | — | — |
| 9 - Loss | — | — | — | — | — | — | — | — |
| **Total** | **$ 505,759** | **$ 158,229** | **$ 37,966** | **$ 701,954** | **$ 83,737** | **$ 36,626** | **$ 120,363** | **$ 822,317** |

| | December 31, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Commercial | | | | Agricultural | | | |
| | Real Estate | Other | Advances to Mortgage Brokers | Total | Real Estate | Other | Total | Total |
| Rating | | | | | | | | |
| 1 - Excellent | $ 21 | $ 31 | $ — | $ 52 | $ 51 | $ 28 | $ 79 | $ 131 |
| 2 - High quality | 4,564 | 13,473 | — | 18,037 | 2,729 | 613 | 3,342 | 21,379 |
| 3 - High satisfactory | 127,573 | 43,199 | 11,793 | 182,565 | 18,325 | 7,039 | 25,364 | 207,929 |
| 4 - Low satisfactory | 344,920 | 84,634 | — | 429,554 | 46,636 | 19,344 | 65,980 | 495,534 |
| 5 - Special mention | 12,847 | 5,287 | — | 18,134 | 10,520 | 5,624 | 16,144 | 34,278 |
| 6 - Substandard | 7,428 | 2,002 | — | 9,430 | 6,343 | 4,960 | 11,303 | 20,733 |
| 7 - Vulnerable | 334 | 1,423 | — | 1,757 | 2,716 | 2,233 | 4,949 | 6,706 |
| 8 - Doubtful | — | — | — | — | — | — | — | — |
| 9 - Loss | — | — | — | — | — | — | — | — |
| **Total** | **$ 497,687** | **$ 150,049** | **$ 11,793** | **$ 659,529** | **$ 87,320** | **$ 39,841** | **$ 127,161** | **$ 786,690** |

Internally assigned credit risk ratings are reviewed, at a minimum, when loans are renewed or when management has knowledge of improvements or deterioration of the credit quality of individual credits. Descriptions of the internally assigned credit risk ratings for commercial and agricultural loans are as follows:

**1. EXCELLENT – Substantially Risk Free**

Credit has strong financial condition and solid earnings history, characterized by:

- High liquidity, strong cash flow, low leverage.
- Unquestioned ability to meet all obligations when due.
- Experienced management, with management succession in place.
- Secured by cash.

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**2. HIGH QUALITY – Limited Risk**

Credit with sound financial condition and a positive trend in earnings supplemented by:

- Favorable liquidity and leverage ratios.
- Ability to meet all obligations when due.
- Management with successful track record.
- Steady and satisfactory earnings history.
- If loan is secured, collateral is of high quality and readily marketable.
- Access to alternative financing.
- Well defined primary and secondary source of repayment.
- If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.

**3. HIGH SATISFACTORY – Reasonable Risk**

Credit with satisfactory financial condition and further characterized by:

- Working capital adequate to support operations.
- Cash flow sufficient to pay debts as scheduled.
- Management experience and depth appear favorable.
- Loan performing according to terms.
- If loan is secured, collateral is acceptable and loan is fully protected.

**4. LOW SATISFACTORY – Acceptable Risk**

Credit with bankable risks, although some signs of weaknesses are shown:

- Would include most start-up businesses.
- Occasional instances of trade slowness or repayment delinquency – may have been 10-30 days slow within the past year.
- Management's abilities are apparent yet unproven.
- Weakness in primary source of repayment with adequate secondary source of repayment.
- Loan structure generally in accordance with policy.
- If secured, loan collateral coverage is marginal.

**To be classified as less than satisfactory, only one of the following criteria must be met.**

**5. SPECIAL MENTION – Criticized**

Credit constitutes an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitutes an unwarranted risk in light of the circumstances surrounding a specific loan:

- Downward trend in sales, profit levels, and margins.
- Impaired working capital position.
- Cash flow is strained in order to meet debt repayment.
- Loan delinquency (30-60 days) and overdrafts may occur.
- Shrinking equity cushion.
- Diminishing primary source of repayment and questionable secondary source.
- Management abilities are questionable.
- Weak industry conditions.
- Litigation pending against the borrower.
- Loan may need to be restructured to improve collateral position or reduce payments.
- Collateral or guaranty offers limited protection.
- Negative debt service coverage, however the credit is well collateralized and payments are current.

**6. SUBSTANDARD – Classified**

Credit is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged. There is a distinct possibility we will implement collection procedures if the loan deficiencies are not corrected. Any commercial loan placed in nonaccrual status will be rated "7" or worse. In addition, the following characteristics may apply:

- Sustained losses have severely eroded the equity and cash flow.
- Deteriorating liquidity.
- Serious management problems or internal fraud.
- Original repayment terms liberalized.
- Likelihood of bankruptcy.
- Inability to access other funding sources.
- Reliance on secondary source of repayment.
- Litigation filed against borrower.
- Interest non-accrual may be warranted.
- Collateral provides little or no value.
- Requires excessive attention of the loan officer.
- Borrower is uncooperative with loan officer.

**7. VULNERABLE – Classified**

Credit is considered "Substandard" and warrants placing in nonaccrual status. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:

- Insufficient cash flow to service debt.
- Minimal or no payments being received.
- Limited options available to avoid the collection process.
- Transition status, expect action will take place to collect loan without immediate progress being made.

**8. DOUBTFUL – Workout**

Credit has all the weaknesses inherent in a "Substandard" loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:

- Normal operations are severely diminished or have ceased.
- Seriously impaired cash flow.
- Original repayment terms materially altered.
- Secondary source of repayment is inadequate.
- Survivability as a "going concern" is impossible.
- Collection process has begun.
- Bankruptcy petition has been filed.
- Judgments have been filed.
- Portion of the loan balance has been charged-off.

**9. LOSS – Charge-off**

Credit is considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification is for charged-off loans but does not mean that the asset has absolutely no recovery or salvage value. These loans are further characterized by:

- Liquidation or reorganization under Bankruptcy, with poor prospects of collection.
- Fraudulently overstated assets and/or earnings.
- Collateral has marginal or no value.
- Debtor cannot be located.
- Over 120 days delinquent.

Our primary credit quality indicator for residential real estate and consumer loans is the individual loan’s past due aging. The following tables summarize the past due and current loans for the entire loan portfolio as of:

| | June 30, 2019 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Accruing Interest and Past Due: | | | | | | |
| | 30-59 Days | 60-89 Days | 90 Days or More | Nonaccrual | Total Past Due and Nonaccrual | Current | Total |
| Commercial | | | | | | | |
| Commercial real estate | $ 47 | $ — | $ — | $ 450 | $ 497 | $ 505,262 | $ 505,759 |
| Commercial other | 484 | 20 | — | 1,242 | 1,746 | 156,483 | 158,229 |
| Advances to mortgage brokers | — | — | — | — | — | 37,966 | 37,966 |
| Total commercial | 531 | 20 | — | 1,692 | 2,243 | 699,711 | 701,954 |
| Agricultural | | | | | | | |
| Agricultural real estate | 609 | 280 | — | 3,593 | 4,482 | 79,255 | 83,737 |
| Agricultural other | 251 | — | — | 1,939 | 2,190 | 34,436 | 36,626 |
| Total agricultural | 860 | 280 | — | 5,532 | 6,672 | 113,691 | 120,363 |
| Residential real estate | | | | | | | |
| Senior liens | 334 | 133 | 110 | 883 | 1,460 | 241,243 | 242,703 |
| Junior liens | 6 | — | — | — | 6 | 6,378 | 6,384 |
| Home equity lines of credit | 224 | — | — | — | 224 | 33,974 | 34,198 |
| Total residential real estate | 564 | 133 | 110 | 883 | 1,690 | 281,595 | 283,285 |
| Consumer | | | | | | | |
| Secured | 38 | 50 | — | — | 88 | 67,256 | 67,344 |
| Unsecured | 4 | 2 | — | — | 6 | 3,670 | 3,676 |
| Total consumer | 42 | 52 | — | — | 94 | 70,926 | 71,020 |
| **Total** | **$ 1,997** | **$ 485** | **$ 110** | **$ 8,107** | **$ 10,699** | **$ 1,165,923** | **$ 1,176,622** |

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| | December 31, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Accruing Interest and Past Due: | | | | | | |
| | 30-59 Days | 60-89 Days | 90 Days or More | Nonaccrual | Total Past Due and Nonaccrual | Current | Total |
| Commercial | | | | | | | |
| Commercial real estate | $ 60 | $ — | $ — | $ 334 | $ 394 | $ 497,293 | $ 497,687 |
| Commercial other | 277 | 628 | — | 1,423 | 2,328 | 147,721 | 150,049 |
| Advances to mortgage brokers | — | — | — | — | — | 11,793 | 11,793 |
| Total commercial | 337 | 628 | — | 1,757 | 2,722 | 656,807 | 659,529 |
| Agricultural | | | | | | | |
| Agricultural real estate | 428 | — | — | 2,716 | 3,144 | 84,176 | 87,320 |
| Agricultural other | — | — | — | 2,233 | 2,233 | 37,608 | 39,841 |
| Total agricultural | 428 | — | — | 4,949 | 5,377 | 121,784 | 127,161 |
| Residential real estate | | | | | | | |
| Senior liens | 2,254 | 203 | 113 | 554 | 3,124 | 233,438 | 236,562 |
| Junior liens | 2 | 6 | — | — | 8 | 6,001 | 6,009 |
| Home equity lines of credit | 76 | — | — | — | 76 | 32,696 | 32,772 |
| Total residential real estate | 2,332 | 209 | 113 | 554 | 3,208 | 272,135 | 275,343 |
| Consumer | | | | | | | |
| Secured | 95 | — | — | — | 95 | 62,721 | 62,816 |
| Unsecured | 10 | — | — | — | 10 | 3,848 | 3,858 |
| Total consumer | 105 | — | — | — | 105 | 66,569 | 66,674 |
| **Total** | **$ 3,202** | **$ 837** | **$ 113** | **$ 7,260** | **$ 11,412** | **$ 1,117,295** | **$ 1,128,707** |

**Impaired Loans**

Loans may be classified as impaired if they meet one or more of the following criteria:

1. There has been a charge-off of its principal balance (in whole or in part);
2. The loan has been classified as a TDR; or
3. The loan is in nonaccrual status.

Impairment is measured on a loan-by-loan basis for commercial and agricultural loans by comparing the loan’s outstanding balance to the present value of expected future cash flows discounted at the loan’s effective interest rate, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. Large groups of smaller-balance, homogeneous residential real estate and consumer loans are collectively evaluated for impairment by comparing the loan’s unpaid principal balance to the present value of expected future cash flows discounted at the loan’s effective interest rate.

We do not recognize interest income on impaired loans in nonaccrual status. For impaired loans not classified as nonaccrual, interest income is recognized daily, as earned, according to the terms of the loan agreement and the principal amount outstanding. The following is a summary of information pertaining to impaired loans as of:

| | June 30, 2019 | | | December 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Recorded Balance | Unpaid Principal Balance | Valuation Allowance | Recorded Balance | Unpaid Principal Balance | Valuation Allowance |
| **Impaired loans with a valuation allowance** | | | | | | |
| Commercial real estate | $ 2,144 | $ 2,385 | $ 53 | $ 3,969 | $ 4,211 | $ 437 |
| Commercial other | 11 | 11 | 5 | 12 | 12 | 6 |
| Agricultural real estate | 1,513 | 1,513 | 97 | 392 | 392 | 112 |
| Agricultural other | 1,237 | 1,237 | 26 | 44 | 44 | 20 |
| Residential real estate senior liens | 6,347 | 6,818 | 1,296 | 6,834 | 7,289 | 1,361 |
| Residential real estate junior liens | 12 | 12 | 2 | 12 | 12 | 2 |
| **Total impaired loans with a valuation allowance** | **11,264** | **11,976** | **1,479** | **11,263** | **11,960** | **1,938** |
| **Impaired loans without a valuation allowance** | | | | | | |
| Commercial real estate | 4,189 | 4,328 | | 2,794 | 2,947 | |
| Commercial other | 2,685 | 2,685 | | 3,124 | 3,231 | |
| Agricultural real estate | 6,985 | 6,985 | | 7,618 | 7,618 | |
| Agricultural other | 3,737 | 3,737 | | 6,244 | 6,287 | |
| Home equity lines of credit | 30 | 330 | | 47 | 347 | |
| Consumer secured | 7 | 7 | | 9 | 9 | |
| **Total impaired loans without a valuation allowance** | **17,633** | **18,072** | | **19,836** | **20,439** | |
| **Impaired loans** | | | | | | |
| Commercial | 9,029 | 9,409 | 58 | 9,899 | 10,401 | 443 |
| Agricultural | 13,472 | 13,472 | 123 | 14,298 | 14,341 | 132 |
| Residential real estate | 6,389 | 7,160 | 1,298 | 6,893 | 7,648 | 1,363 |
| Consumer | 7 | 7 | — | 9 | 9 | — |
| **Total impaired loans** | **$ 28,897** | **$ 30,048** | **$ 1,479** | **$ 31,099** | **$ 32,399** | **$ 1,938** |

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The following is a summary of information pertaining to impaired loans for the:

| | Three Months Ended June 30 | | | |
|---|---|---|---|---|
| | 2019 | | 2018 | |
| | Average Recorded Balance | Interest Income Recognized | Average Recorded Balance | Interest Income Recognized |
| **Impaired loans with a valuation allowance** | | | | |
| Commercial real estate | $ 2,497 | $ 7 | $ 5,006 | $ 13 |
| Commercial other | 11 | — | 1,463 | 15 |
| Agricultural real estate | 951 | 57 | 639 | 2 |
| Agricultural other | 641 | 9 | — | — |
| Residential real estate senior liens | 6,439 | 19 | 7,747 | 16 |
| Residential real estate junior liens | 12 | — | 30 | — |
| **Total impaired loans with a valuation allowance** | **10,551** | **92** | **14,885** | **46** |
| **Impaired loans without a valuation allowance** | | | | |
| Commercial real estate | 3,985 | 21 | 3,084 | 12 |
| Commercial other | 2,751 | 13 | 1,301 | 2 |
| Agricultural real estate | 7,307 | 58 | 7,610 | 237 |
| Agricultural other | 4,833 | 86 | 3,933 | 115 |
| Home equity lines of credit | 34 | — | 68 | — |
| Consumer secured | 8 | — | 12 | — |
| **Total impaired loans without a valuation allowance** | **18,918** | **178** | **16,008** | **366** |
| **Impaired loans** | | | | |
| Commercial | 9,244 | 41 | 10,854 | 42 |
| Agricultural | 13,732 | 210 | 12,182 | 354 |
| Residential real estate | 6,485 | 19 | 7,845 | 16 |
| Consumer | 8 | — | 12 | — |
| **Total impaired loans** | **$ 29,469** | **$ 270** | **$ 30,893** | **$ 412** |

| | Six Months Ended June 30 | | | |
|---|---|---|---|---|
| | 2019 | | 2018 | |
| | Average Recorded Balance | Interest Income Recognized | Average Recorded Balance | Interest Income Recognized |
| **Impaired loans with a valuation allowance** | | | | |
| Commercial real estate | $ 2,952 | $ 56 | $ 5,012 | $ 104 |
| Commercial other | 11 | — | 1,505 | 39 |
| Agricultural real estate | 671 | 63 | 540 | 6 |
| Agricultural other | 343 | 9 | — | — |
| Residential real estate senior liens | 6,561 | 87 | 7,785 | 90 |
| Residential real estate junior liens | 12 | — | 35 | — |
| **Total impaired loans with a valuation allowance** | **10,550** | **215** | **14,877** | **239** |
| **Impaired loans without a valuation allowance** | | | | |
| Commercial real estate | 3,636 | 74 | 2,606 | 47 |
| Commercial other | 2,861 | 34 | 1,248 | 19 |
| Agricultural real estate | 7,465 | 65 | 7,804 | 277 |
| Agricultural other | 5,460 | 156 | 3,264 | 151 |
| Home equity lines of credit | 38 | 6 | 72 | 5 |
| Consumer secured | 8 | — | 13 | — |
| **Total impaired loans without a valuation allowance** | **19,468** | **335** | **15,007** | **499** |
| **Impaired loans** | | | | |
| Commercial | 9,460 | 164 | 10,371 | 209 |
| Agricultural | 13,939 | 293 | 11,608 | 434 |
| Residential real estate | 6,611 | 93 | 7,892 | 95 |
| Consumer | 8 | — | 13 | — |
| **Total impaired loans** | **$ 30,018** | **$ 550** | **$ 29,884** | **$ 738** |

We had committed to advance $444 and $542 in connection with impaired loans, which includes TDRs, as of June 30, 2019 and December 31, 2018, respectively.

**Troubled Debt Restructurings**

A loan modification is considered to be a TDR when the modification includes terms outside of normal lending practices to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

- Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
- Extending the amortization period beyond typical lending guidelines for loans with similar risk characteristics.
- Agreeing to an interest only payment structure and delaying principal payments.
- Forgiving principal.
- Forgiving accrued interest.

To determine if a borrower is experiencing financial difficulties, factors we consider include:

- The borrower is currently in default on any of their debt.
- The borrower would likely default on any of their debt if the concession is not granted.
- The borrower’s cash flow is insufficient to service all of their debt if the concession is not granted.
- The borrower has declared, or is in the process of declaring, bankruptcy.
- The borrower is unlikely to continue as a going concern (if the entity is a business).

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The following is a summary of information pertaining to TDRs granted for the:

| | Three Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial other | 1 | $ 37 | $ 37 | 1 | $ 105 | $ 105 |
| Agricultural other | 1 | 1,311 | 1,311 | 13 | 3,330 | 3,306 |
| Residential real estate | — | — | — | 5 | 327 | 327 |
| **Total** | **2** | **$ 1,348** | **$ 1,348** | **19** | **$ 3,762** | **$ 3,738** |

| | Six Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial other | 2 | $ 184 | $ 184 | 4 | $ 1,360 | $ 1,360 |
| Agricultural other | 3 | 1,834 | 1,834 | 15 | 4,391 | 4,368 |
| Residential real estate | — | — | — | 7 | 493 | 493 |
| **Total** | **5** | **$ 2,018** | **$ 2,018** | **26** | **$ 6,244** | **$ 6,221** |

The following is a summary of concessions we granted to borrowers in financial difficulty for the:

| | Three Months Ended June 30 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2019 | | | | 2018 | | | |
| | Below Market Interest Rate | | Below Market Interest Rate and Extension of Amortization Period | | Below Market Interest Rate | | Below Market Interest Rate and Extension of Amortization Period | |
| | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment |
| Commercial other | — | $ — | 1 | $ 37 | — | $ — | 1 | $ 105 |
| Agricultural other | — | — | 1 | 1,311 | 6 | 1,770 | 7 | 1,560 |
| Residential real estate | — | — | — | — | 1 | 56 | 4 | 271 |
| **Total** | **—** | **$ —** | **2** | **$ 1,348** | **7** | **$ 1,826** | **12** | **$ 1,936** |

| | Six Months Ended June 30 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2019 | | | | 2018 | | | |
| | Below Market Interest Rate | | Below Market Interest Rate and Extension of Amortization Period | | Below Market Interest Rate | | Below Market Interest Rate and Extension of Amortization Period | |
| | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment |
| Commercial other | — | $ — | 2 | $ 184 | 1 | $ 174 | 3 | $ 1,186 |
| Agricultural other | — | — | 3 | 1,834 | 7 | 1,868 | 8 | 2,523 |
| Residential real estate | — | — | — | — | 1 | 56 | 6 | 437 |
| **Total** | **—** | **$ —** | **5** | **$ 2,018** | **9** | **$ 2,098** | **17** | **$ 4,146** |

We did not restructure any loans by forgiving principal or accrued interest in the three and six month periods ended June 30, 2019 or 2018.

Based on our historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs, including TDRs that have been modified in the past 12 months that subsequently defaulted, are analyzed in the same manner as other impaired loans within their respective loan segment.

We had no loans that defaulted in the three and six month periods ended June 30, 2019 and 2018 which were modified within 12 months prior to the default date.

The following is a summary of TDR loan balances as of:

| | June 30 2019 | December 31 2018 |
|---|---|---|
| TDRs | $ 25,965 | $ 26,951 |

**Note 5 – Equity Securities Without Readily Determinable Fair Values**

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost, and investments in unconsolidated entities accounted for under the equity method of accounting.

Equity securities without readily determinable fair values consist of the following as of:

| | June 30 2019 | December 31 2018 |
|---|---|---|
| FHLB Stock | $ 15,050 | $ 15,050 |
| Corporate Settlement Solutions, LLC | 7,641 | 7,565 |
| FRB Stock | 1,999 | 1,999 |
| Other | 334 | 334 |
| **Total** | **$ 25,024** | **$ 24,948** |

**Note 6 – Borrowed Funds**

Borrowed funds consist of the following obligations as of:

| | June 30, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Amount | Rate | Amount | Rate |
| FHLB advances | $ 295,000 | 2.27% | $ 300,000 | 2.20% |
| Securities sold under agreements to repurchase without stated maturity dates | 25,462 | 0.09% | 40,299 | 0.11% |
| **Total** | **$ 320,462** | **2.10%** | **$ 340,299** | **1.95%** |

FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans, specific AFS securities, and FHLB stock.

The following table lists the maturities and weighted average interest rates of FHLB advances as of:

| | June 30, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Amount | Rate | Amount | Rate |
| Fixed rate due 2019 | $ 50,000 | 1.89% | $ 100,000 | 1.94% |
| Fixed rate due 2020 | 55,000 | 2.18% | 55,000 | 2.18% |
| Fixed rate due 2021 | 50,000 | 1.91% | 50,000 | 1.91% |
| Variable rate due 2021 (1) | 10,000 | 2.82% | 10,000 | 2.93% |
| Fixed rate due 2022 | 20,000 | 1.97% | 20,000 | 1.97% |
| Fixed rate due 2023 | 45,000 | 2.97% | 35,000 | 3.17% |
| Fixed rate due 2024 | 55,000 | 2.68% | 20,000 | 2.96% |
| Fixed rate due 2026 | 10,000 | 1.17% | 10,000 | 1.17% |
| **Total** | **$ 295,000** | **2.27%** | **$ 300,000** | **2.20%** |

(1) Hedged advance (see “Derivative Instruments” section below)

Securities sold under agreements to repurchase are classified as secured borrowings and are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of $25,477 and $40,316 at June 30, 2019 and December 31, 2018, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following tables provide a summary of securities sold under repurchase agreements without stated maturity dates and federal funds purchased. We had no FRB Discount Window advances during the three and six month periods ended June 30, 2019 and 2018.

| | Three Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Maximum Month End Balance | Average Balance | Weighted Average Interest Rate During the Period | Maximum Month End Balance | Average Balance | Weighted Average Interest Rate During the Period |
| Securities sold under agreements to repurchase without stated maturity dates | $ 26,761 | $ 26,569 | 0.09% | $ 34,242 | $ 32,957 | 0.09% |
| Federal funds purchased | 7,070 | 1,982 | 2.65% | 16,200 | 9,199 | 1.82% |

| | Six Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Maximum Month End Balance | Average Balance | Weighted Average Interest Rate During the Period | Maximum Month End Balance | Average Balance | Weighted Average Interest Rate During the Period |
| Securities sold under agreements to repurchase without stated maturity dates | $ 37,441 | $ 30,755 | 0.04% | $ 38,967 | $ 34,467 | 0.09% |
| Federal funds purchased | 7,070 | 1,224 | 1.71% | 16,200 | 6,843 | 1.77% |

We had pledged AFS securities and 1-4 family residential real estate loans in the following amounts at:

| | June 30 2019 | December 31 2018 |
|---|---|---|
| Pledged to secure borrowed funds | $ 427,819 | $ 431,430 |
| Pledged to secure repurchase agreements | 25,477 | 40,316 |
| Pledged for public deposits and for other purposes necessary or required by law | 34,177 | 58,107 |
| **Total** | **$ 487,473** | **$ 529,853** |

AFS securities pledged to repurchase agreements without stated maturity dates consisted of the following at:

| | June 30 2019 | December 31 2018 |
|---|---|---|
| States and political subdivisions | $ 25,477 | $ 23,268 |
| Mortgage-backed securities | — | 10,736 |
| Collateralized mortgage obligations | — | 6,312 |
| **Total** | **$ 25,477** | **$ 40,316** |

AFS securities pledged to repurchase agreements are monitored to ensure the appropriate level is collateralized. In the event of maturities, calls, significant principal repayments, or significant decline in market values, we have an adequate level of AFS securities to pledge to satisfy required collateral.

As of June 30, 2019, we had the ability to borrow up to an additional $153,006, based on assets pledged as collateral. We had no investment securities that were restricted to be pledged for specific purposes.

**Derivative Instruments**

We have entered into interest rate swaps to manage exposure to interest rate risk and variability in cash flows. The interest rate swaps, associated with our variable rate borrowings, are designated upon inception as cash flow hedges of forecasted interest payments. We have entered into LIBOR-based interest rate swaps that involve the receipt of variable amounts in exchange for fixed rate payments, in effect converting variable rate debt to fixed rate debt.

Cash flow hedges are assessed for effectiveness using regression analysis. The effective portion of changes in fair value are recorded in OCI and subsequently reclassified into interest expense in the same period in which the related interest on the

variable rate borrowings affects earnings. In the event that a portion of the changes in fair value were determined to be ineffective, the ineffective amount would be recorded in earnings.

The following tables provide information on derivatives related to variable rate borrowings as of:

| | June 30, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | Pay Rate | Receive Rate | Remaining Life (Years) | Notional Amount | Balance Sheet Location | Fair Value |
| **Derivatives designated as hedging instruments** | | | | | | |
| Cash Flow Hedges: | | | | | | |
| Interest rate swaps | 1.56% | 3-Month LIBOR | 1.8 | $ 10,000 | Other Assets | $ 115 |

| | December 31, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Pay Rate | Receive Rate | Remaining Life (Years) | Notional Amount | Balance Sheet Location | Fair Value |
| **Derivatives designated as hedging instruments** | | | | | | |
| Cash Flow Hedges: | | | | | | |
| Interest rate swaps | 1.56% | 3-Month LIBOR | 2.3 | $ 10,000 | Other Assets | $ 323 |

Derivatives contain an element of credit risk which arises from the possibility that we will incur a loss as a result of a counterparty failing to meet its contractual obligations. Credit risk is minimized through counterparty collateral, transaction limits and monitoring procedures. We also manage dealer credit risk by entering into interest rate derivatives only with primary and highly rated counterparties, the use of ISDA master agreements, and the use of counterparty limits. We do not anticipate any losses from failure of interest rate derivative counterparties to honor their obligations.

**Note 7 – Revenue**

Our revenue is comprised primarily of interest income, service charges and fees, gains on the sale of loans and AFS securities, earnings on corporate owned life insurance policies, and other noninterest income. Other noninterest income is typically service and performance driven in nature and comprised primarily of investment and trust advisory fees. We recognize revenue, excluding interest income, in accordance with ASC 606, Revenue From Contracts with Customers. Revenue is recognized when our performance obligation has been satisfied according to our contractual obligation.

We record receivables when revenue is unpaid and collectability is reasonably assured. Accounts receivable balances primarily represent amounts due from customers for which revenue has been recognized. Accounts receivable balances are recorded in the consolidated balance sheets in accrued interest receivable and other assets. For the three and six month periods ended June 30, 2019 and 2018, we satisfied our performance obligations pursuant to contracts with customers. As a result, we have not recorded any contract assets or liabilities. We estimate no returns or allowances for the three and six month periods ended June 30, 2019 and 2018.

Our contracts with customers define our performance obligations with clearly established pricing which does not require us to allocate or disaggregate revenue by performance obligation. A summary of revenue recognized for each major category of contracts with customers, subject to ASC 606, is as follows for the:

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| Debit card income | $ 657 | $ 621 | $ 1,240 | $ 1,209 |
| Trust service fees | 602 | 564 | 1,111 | 1,066 |
| Investment advisory fees | 178 | 174 | 346 | 330 |
| Service charges and fees related to deposit accounts | 79 | 82 | 158 | 167 |
| **Total** | **$ 1,516** | **$ 1,441** | **$ 2,855** | **$ 2,772** |

A large portion of our revenue consists of interest income which is not subject to the requirements set forth in ASC 606.

**Note 8 – Other Noninterest Expenses**

A summary of expenses included in other noninterest expenses is as follows for the:

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| Audit, consulting, and legal fees | $ 461 | $ 661 | $ 916 | $ 1,179 |
| ATM and debit card fees | 298 | 234 | 546 | 466 |
| Loan underwriting fees | 168 | 165 | 484 | 314 |
| Director fees | 190 | 222 | 397 | 431 |
| Memberships and subscriptions | 176 | 146 | 343 | 269 |
| FDIC insurance premiums | 162 | 156 | 332 | 320 |
| Donations and community relations | 190 | 210 | 330 | 361 |
| Marketing costs | 171 | 149 | 313 | 259 |
| Education and travel | 56 | 101 | 213 | 216 |
| All other | 677 | 721 | 1,318 | 1,290 |
| **Total other** | **$ 2,549** | **$ 2,765** | **$ 5,192** | **$ 5,105** |

**Note 9 – Federal Income Taxes**

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of income before federal income tax expense is as follows for the:

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| Income taxes at statutory rate | $ 994 | $ 755 | $ 1,801 | $ 1,538 |
| Effect of nontaxable income | | | | |
| Interest income on tax exempt municipal securities | (236) | (264) | (480) | (538) |
| Earnings on corporate owned life insurance policies | (43) | (38) | (79) | (74) |
| Effect of tax credits | (177) | (201) | (357) | (401) |
| Other | (4) | (8) | (8) | (19) |
| Total effect of nontaxable income | (460) | (511) | (924) | (1,032) |
| Effect of nondeductible expenses | 7 | 19 | 13 | 22 |
| **Federal income tax expense** | **$ 541** | **$ 263** | **$ 890** | **$ 528** |

**Note 10 – Computation of Earnings Per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate solely to outstanding shares in the Directors Plan.

Earnings per common share have been computed based on the following for the:

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| Average number of common shares outstanding for basic calculation | 7,910,512 | 7,912,374 | 7,895,610 | 7,887,961 |
| Average potential effect of common shares in the Directors Plan (1) | 179,364 | 173,222 | 189,355 | 186,174 |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 8,089,876 | 8,085,596 | 8,084,965 | 8,074,135 |
| Net income | $ 4,188 | $ 3,333 | $ 7,684 | $ 6,795 |
| **Earnings per common share** | | | | |
| **Basic** | **$ 0.53** | **$ 0.42** | **$ 0.97** | **$ 0.86** |
| **Diluted** | **$ 0.52** | **$ 0.41** | **$ 0.95** | **$ 0.84** |

(1) Exclusive of shares held in the Rabbi Trust

**Note 11 – Accumulated Other Comprehensive Income**

The following table summarizes the changes in AOCI by component for the:

| | Three Months Ended June 30 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2019 | | | | 2018 | | | |
| | Unrealized Gains (Losses) on AFS Securities | Unrealized Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total | Unrealized Gains (Losses) on AFS Securities | Unrealized Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total |
| **Balance, April 1** | **$ (441)** | **$ 192** | **$ (2,741)** | **$ (2,990)** | **$ (5,759)** | **$ 326** | **$ (3,223)** | **$ (8,656)** |
| OCI before reclassifications | 4,876 | (127) | — | 4,749 | (1,978) | 31 | — | (1,947) |
| Tax effect | (1,018) | 26 | — | (992) | 442 | (6) | — | 436 |
| OCI, net of tax | 3,858 | (101) | — | 3,757 | (1,536) | 25 | — | (1,511) |
| **Balance, June 30** | **$ 3,417** | **$ 91** | **$ (2,741)** | **$ 767** | **$ (7,295)** | **$ 351** | **$ (3,223)** | **$ (10,167)** |

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| | Six Months Ended June 30 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2019 | | | | 2018 | | | |
| | Unrealized Gains (Losses) on AFS Securities | Unrealized Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total | Unrealized Gains (Losses) on AFS Securities | Unrealized Gains (Losses) on Derivative Instruments | Defined Benefit Pension Plan | Total |
| **Balance, January 1** | **$ (5,200)** | **$ 256** | **$ (2,741)** | **$ (7,685)** | **$ 391** | **$ 230** | **$ (3,223)** | **$ (2,602)** |
| OCI before reclassifications | 10,830 | (208) | — | 10,622 | (10,035) | 153 | — | (9,882) |
| Tax effect | (2,213) | 43 | — | (2,170) | 2,126 | (32) | — | 2,094 |
| OCI, net of tax | 8,617 | (165) | — | 8,452 | (7,909) | 121 | — | (7,788) |
| Adoption of ASU 2016-01 | — | — | — | — | 223 | — | — | 223 |
| **Balance, June 30** | **$ 3,417** | **$ 91** | **$ (2,741)** | **$ 767** | **$ (7,295)** | **$ 351** | **$ (3,223)** | **$ (10,167)** |

Included in OCI for the three and six month periods ended June 30, 2019 and 2018 are changes in unrealized gains and losses related to auction rate money market preferred stocks. These investments, for federal income tax purposes, have no deferred federal income taxes related to unrealized gains or losses given the nature of the investments.

A summary of the components of unrealized gains on AFS securities included in OCI follows for the:

| | Three Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Auction Rate Money Market Preferred Stocks | All Other AFS Securities | Total | Auction Rate Money Market Preferred and Preferred Stocks | All Other AFS Securities | Total |
| Unrealized gains (losses) arising during the period | $ 30 | $ 4,846 | $ 4,876 | $ 123 | $ (2,101) | $ (1,978) |
| Tax effect | — | (1,018) | (1,018) | — | 442 | 442 |
| **Unrealized gains (losses), net of tax** | **$ 30** | **$ 3,828** | **$ 3,858** | **$ 123** | **$ (1,659)** | **$ (1,536)** |

| | Six Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | | 2018 | | |
| | Auction Rate Money Market Preferred Stocks | All Other AFS Securities | Total | Auction Rate Money Market Preferred and Preferred Stocks | All Other AFS Securities | Total |
| Unrealized gains (losses) arising during the period | $ 295 | $ 10,535 | $ 10,830 | $ 86 | $ (10,121) | $ (10,035) |
| Tax effect | — | (2,213) | (2,213) | — | 2,126 | 2,126 |
| **Unrealized gains (losses), net of tax** | **$ 295** | **$ 8,322** | **$ 8,617** | **$ 86** | **$ (7,995)** | **$ (7,909)** |

**Note 12 – Fair Value**

Under fair value measurement and disclosure authoritative guidance, we group assets and liabilities measured at fair value into three levels, based on the markets in which the assets and liabilities are traded, and the reliability of the assumptions used to determine fair value, based on the prioritization of inputs in the valuation techniques. These levels are:

| | |
|---|---|
| Level 1: | Valuation is based upon quoted prices for identical instruments traded in active markets. |
| Level 2: | Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model based valuation techniques for which all significant assumptions are observable in the market. |
| Level 3: | Valuation is generated from model based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. |

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. Transfers between measurement levels are recognized at the end of reporting periods.

Fair value measurement requires the use of an exit price notion which may differ from entrance pricing. Generally we believe our assets and liabilities classified as Level 1 or Level 2 approximate an exit price notion.

Following is a description of the valuation methodologies, key inputs, and an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

*AFS securities:* AFS securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

*Loans:* We do not record loans at fair value on a recurring basis. However, from time-to-time, loans are classified as impaired and a specific allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will be significantly different than the contractual terms of the original loan agreement are considered impaired. Once a loan is identified as impaired, we measure the estimated impairment. The fair value of impaired loans is estimated using one of several methods, including the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, we utilize independent appraisals, broker price opinions, or internal evaluations. We review these valuations to determine whether an additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any specific reserves or charge-offs are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

The following tables list the quantitative fair value information about impaired loans as of:

| | | June 30, 2019 | |
|---|---|---|---|
| **Valuation Technique** | **Fair Value** | **Unobservable Input** | **Actual Range** |
| | | **Discount applied to collateral:** | |
| | | Real Estate | 20% - 30% |
| | | Equipment | 20% - 50% |
| | | Cash crop inventory | 30% - 40% |
| **Discounted value** | **$18,788** | Livestock | 30% |
| | | Other inventory | 50% |
| | | Accounts receivable | 25% |
| | | Liquor license | 75% |
| | | Furniture, fixtures & equipment | 45% |

| | | December 31, 2018 | |
|---|---|---|---|
| **Valuation Technique** | **Fair Value** | **Unobservable Input** | **Actual Range** |
| | | **Discount applied to collateral:** | |
| | | Real Estate | 20% - 30% |
| | | Equipment | 20% - 40% |
| | | Cash crop inventory | 30% - 40% |
| **Discounted value** | **$20,045** | Livestock | 30% |
| | | Other inventory | 45% - 50% |
| | | Accounts receivable | 50% |
| | | Liquor license | 75% |
| | | Furniture, fixtures & equipment | 35% - 45% |

Collateral discount rates may have ranges to accommodate differences in the age of the independent appraisal, broker price opinion, or internal evaluation.

*Derivative instruments:* Derivative instruments, consisting solely of interest rate swaps, are recorded at fair value on a recurring basis. Derivatives qualifying as cash flow hedges, when highly effective, are reported at fair value in other assets or other liabilities on our Consolidated Balance Sheets with changes in value recorded in OCI. Should the hedge no longer be considered effective, the ineffective portion of the change in fair value is recorded directly in earnings in the period in which the change occurs. The fair value of a derivative is determined by quoted market prices and model-based valuation techniques. As such, we classify derivative instruments as Level 2.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement.

**Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis**

Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis were as follows as of:

| | June 30, 2019 | | | | |
|---|---|---|---|---|---|
| | Carrying Value | Estimated Fair Value | Level 1 | Level 2 | Level 3 |
| **ASSETS** | | | | | |
| Cash and cash equivalents | $ 35,962 | $ 35,962 | $ 35,962 | $ — | $ — |
| Mortgage loans AFS | 1,372 | 1,384 | — | 1,384 | — |
| Gross loans | 1,176,622 | 1,157,377 | — | — | 1,157,377 |
| Less allowance for loan and lease losses | 8,037 | 8,037 | — | — | 8,037 |
| Net loans | 1,168,585 | 1,149,340 | — | — | 1,149,340 |
| Accrued interest receivable | 6,193 | 6,193 | 6,193 | — | — |
| Equity securities without readily determinable fair values [(1)] | 25,024 | N/A | — | — | — |
| OMSR | 2,397 | 2,397 | — | 2,397 | — |
| **LIABILITIES** | | | | | |
| Deposits without stated maturities | 851,932 | 851,932 | 851,932 | — | — |
| Deposits with stated maturities | 429,486 | 429,361 | — | 429,361 | — |
| Borrowed funds | 320,462 | 321,483 | — | 321,483 | — |
| Accrued interest payable | 885 | 885 | 885 | — | — |

| | December 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Carrying Value | Estimated Fair Value | Level 1 | Level 2 | Level 3 |
| **ASSETS** | | | | | |
| Cash and cash equivalents | $ 73,471 | $ 73,471 | $ 73,471 | $ — | $ — |
| Mortgage loans AFS | 358 | 365 | — | 365 | — |
| Gross loans | 1,128,707 | 1,099,645 | — | — | 1,099,645 |
| Less allowance for loan and lease losses | 8,375 | 8,375 | — | — | 8,375 |
| Net loans | 1,120,332 | 1,091,270 | — | — | 1,091,270 |
| Accrued interest receivable | 6,928 | 6,928 | 6,928 | — | — |
| Equity securities without readily determinable fair values [(1)] | 24,948 | N/A | — | — | — |
| OMSR | 2,434 | 2,602 | — | 2,602 | — |
| **LIABILITIES** | | | | | |
| Deposits without stated maturities | 859,073 | 859,073 | 859,073 | — | — |
| Deposits with stated maturities | 433,620 | 425,993 | — | 425,993 | — |
| Borrowed funds | 340,299 | 333,829 | — | 333,829 | — |
| Accrued interest payable | 826 | 826 | 826 | — | — |

[(1)] Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under a specific fair value hierarchy. If we were to record an impairment adjustment related to these securities, such amount would be classified as a nonrecurring Level 3 fair value adjustment.

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**Financial Instruments Recorded at Fair Value**

The table below presents the recorded amount of assets and liabilities measured at fair value on:

| | June 30, 2019 | | | | December 31, 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 |
| **Recurring items** | | | | | | | | |
| AFS securities | | | | | | | | |
| Government-sponsored enterprises | $ 160 | $ — | $ 160 | $ — | $ 170 | $ — | $ 170 | $ — |
| States and political subdivisions | 176,742 | — | 176,742 | — | 190,866 | — | 190,866 | — |
| Auction rate money market preferred | 2,849 | — | 2,849 | — | 2,554 | — | 2,554 | — |
| Mortgage-backed securities | 173,340 | — | 173,340 | — | 184,484 | — | 184,484 | — |
| Collateralized mortgage obligations | 117,358 | — | 117,358 | — | 116,760 | — | 116,760 | — |
| Total AFS securities | 470,449 | — | 470,449 | — | 494,834 | — | 494,834 | — |
| Derivative instruments | 115 | — | 115 | — | 323 | — | 323 | — |
| **Nonrecurring items** | | | | | | | | |
| Impaired loans (net of the ALLL) | 18,788 | — | — | 18,788 | 20,045 | — | — | 20,045 |
| **Total** | **$ 489,352** | **$ —** | **$ 470,564** | **$ 18,788** | **$ 515,202** | **$ —** | **$ 495,157** | **$ 20,045** |
| Percent of assets and liabilities measured at fair value | | —% | 96.16% | 3.84% | | —% | 96.11% | 3.89% |

We had no assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a recurring basis or nonrecurring basis, as of June 30, 2019.

**Note 13 – Parent Company Only Financial Information**

**Interim Condensed Balance Sheets**

| | June 30 2019 | December 31 2018 |
|---|---|---|
| **ASSETS** | | |
| Cash on deposit at the Bank | $ 2,009 | $ 2,499 |
| Investments in subsidiaries | 153,204 | 143,942 |
| Premises and equipment | 1,562 | 1,912 |
| Other assets | 51,973 | 51,674 |
| **TOTAL ASSETS** | **$ 208,748** | **$ 200,027** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Other liabilities | $ 634 | $ 4,508 |
| Shareholders' equity | 208,114 | 195,519 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 208,748** | **$ 200,027** |

**Interim Condensed Statements of Income**

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| **Income** | | | | |
| Dividends from subsidiaries | $ 2,100 | $ 3,900 | $ 3,100 | $ 6,000 |
| Interest income | 2 | — | 4 | — |
| Other income | 232 | 855 | 213 | 1,530 |
| **Total income** | **2,334** | **4,755** | **3,317** | **7,530** |
| **Expenses** | | | | |
| Compensation and benefits | — | 1,175 | — | 2,159 |
| Occupancy and equipment | 14 | 126 | 29 | 249 |
| Audit, consulting, and legal fees | 115 | 208 | 245 | 432 |
| Director fees | 89 | 104 | 187 | 207 |
| Other | 328 | 172 | 618 | 308 |
| **Total expenses** | **546** | **1,785** | **1,079** | **3,355** |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 1,788 | 2,970 | 2,238 | 4,175 |
| Federal income tax benefit | 64 | 192 | 179 | 380 |
| Income before equity in undistributed earnings of subsidiaries | 1,852 | 3,162 | 2,417 | 4,555 |
| Undistributed earnings of subsidiaries | 2,336 | 171 | 5,267 | 2,240 |
| **Net income** | **$ 4,188** | **$ 3,333** | **$ 7,684** | **$ 6,795** |

**Interim Condensed Statements of Cash Flows**

| | Six Months Ended June 30 | |
|---|---|---|
| | 2019 | 2018 |
| **Operating activities** | | |
| Net income | $ 7,684 | $ 6,795 |
| Adjustments to reconcile net income to cash provided by operations | | |
| Undistributed earnings of subsidiaries | (5,267) | (2,240) |
| Undistributed earnings of equity securities without readily determinable fair values | (76) | (64) |
| Share-based payment awards under equity compensation plan | 271 | 304 |
| Depreciation | 23 | 64 |
| Changes in operating assets and liabilities which provided (used) cash | | |
| Other assets | 5 | 1,084 |
| Other liabilities | 682 | (837) |
| **Net cash provided by (used in) operating activities** | **3,322** | **5,106** |
| **Investing activities** | | |
| Sales (purchases) of premises and equipment | — | (16) |
| **Net cash provided by (used in) investing activities** | **—** | **(16)** |
| **Financing activities** | | |
| Cash dividends paid on common stock | (4,093) | (4,096) |
| Proceeds from the issuance of common stock | 2,436 | 3,272 |
| Common stock repurchased | (1,339) | (1,238) |
| Common stock purchased for deferred compensation obligations | (816) | (205) |
| **Net cash provided by (used in) financing activities** | **(3,812)** | **(2,267)** |
| **Increase (decrease) in cash and cash equivalents** | (490) | 2,823 |
| Cash and cash equivalents at beginning of period | 2,499 | 185 |
| **Cash and cash equivalents at end of period** | **$ 2,009** | **$ 3,008** |

On January 1, 2019, there was a transaction to restructure the Bank and the parent holding company for the purpose of better-organizing the entities for present and future needs. The transaction is expected to produce future benefits for us in the form of reduced operational costs and better-managed risk. Assets and liabilities transferred from the parent company to the Bank relate primarily to capital assets, net deferred income tax asset, prepaid assets, employee benefits payable, accrued expenses, and a pension plan. Effective January 1, 2019, all employee compensation and benefit expenses will be recognized by the Bank, where expenses related to certain administrative functions were previously recognized by the parent holding company. Similarly, expenses related to most capital assets will be recognized by the Bank.

**Note 14 – Operating Segments**

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of June 30, 2019 and 2018 and each of the three and six month periods then ended, represent approximately 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**ISABELLA BANK CORPORATION FINANCIAL REVIEW**

(Dollars in thousands except per share amounts)

This section is a review of our financial condition and the results of our operations for the unaudited three and six month periods ended June 30, 2019 and 2018. This analysis should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2018 and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

**Executive Summary**

During the three and six months ended June 30, 2019, we reported net income of $4,188 and $7,684 and earnings per common share of $0.53 and $0.97, respectively. Net income and earnings per common share for the same periods of 2018 were $3,333 and $6,795 and $0.42 and $0.86, respectively. A combination of improved yields and growth in our loan portfolio over the past twelve months were large drivers of a $2,462 increase in interest income for the first six months of 2019 compared to the same period in 2018. Interest expense on deposits and borrowings increased $1,677 for the six month period ended June 30, 2019 when compared to the same period in 2018. Credit quality improvements resulted in a negative loan loss provision expense of $145 for the first six months of 2019. Noninterest income increased $252 during the first six months of 2019 when compared to the same period in 2018 largely due to Investment and Trust advisory fees. Noninterest expenses for the first six months of 2019 exceeded noninterest expenses for the same period in 2018 by $643. Employee merit increases, loan expenses related to growth initiatives, and recent changes to our incentive plans account for a significant portion of the increase.

As of June 30, 2019, total assets and assets under management were $1,824,592 and $2,568,834, respectively. Assets under management include loans sold and serviced of $257,062 and assets managed by our Investment and Trust Services Department of $487,180, in addition to assets on our consolidated balance sheet. As a result of the flat yield curve that has existed for several months, the opportunity to fund the purchase of new investment securities, with either new borrowings or excess liquidity, at an acceptable margin has been minimal. Consequently, we utilized available cash flows to pay down maturing borrowings and other higher cost funding sources, resulting in a decline in total assets as of June 30, 2019 when compared to December 31, 2018. Loans outstanding as of June 30, 2019 totaled $1,176,622. During the first six months of 2019, gross loans increased $47,915 which was largely driven by growth in our commercial loan portfolio. Total deposits declined $11,275 during the year due to a decline in Trust related savings deposits and totaled $1,281,418 as of June 30, 2019. All regulatory capital ratios for the Bank exceeded the minimum thresholds to be considered a “well capitalized” institution.

Our net yield on interest earning assets (FTE) was 3.04% and 3.02% for the three and six months ended June 30, 2019, respectively. Management has implemented various initiatives which, over time, are expected to improve our net yield on interest earning assets. These initiatives include transitioning a larger percentage of assets from lower yielding investment securities to higher yielding loan opportunities, continued growth of the loan portfolio, and enhanced pricing strategies related to loan and deposit products. We are committed to increasing earnings and shareholder value through growth in our loan portfolio, growth in our investment and trust services, increasing our presence within our geographical footprint, and managing operating costs.

**Recent Legislation**

On December 22, 2017, the Tax Act was enacted. The new law establishes a flat corporate federal statutory income tax rate of 21%, a decline from 34%, and eliminates the corporate alternative minimum tax. The new tax law provides for a wide array of changes with only some believed to have a direct impact on our federal income tax expense. Some of these changes include, but are not limited to, the following items: limits to the deductions for net interest expense, immediate expense (for tax purposes) for certain qualified depreciable assets, elimination or reduction of certain deductions related to meals and entertainment expenses, and limits to the deductibility of deposit insurance premiums.

**Reclassifications**

Certain amounts reported in the interim 2018 consolidated financial statements have been reclassified to conform to the 2019 presentation. Other assets and other liabilities on the interim condensed consolidated balance sheets were increased by $5,195 as of December 31, 2018 to reclassify pension and income tax related liabilities (pension: $3,470, income taxes $1,725). This resulted in a $5,195 increase in total assets as of December 31, 2018. All other balances and ratios were not materially impacted.

**Results of Operations**

The following table outlines our quarter-to-date results of operations and provides certain performance measures as of, and for the three month periods ended:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| **INCOME STATEMENT DATA** | | | | | |
| Interest income | $ 16,815 | $ 16,481 | $ 16,611 | $ 16,419 | $ 15,713 |
| Interest expense | 4,527 | 4,292 | 4,258 | 4,231 | 3,741 |
| Net interest income | 12,288 | 12,189 | 12,353 | 12,188 | 11,972 |
| Provision for loan losses | (179) | 34 | 342 | (76) | 328 |
| Noninterest income | 3,011 | 2,479 | 2,860 | 2,863 | 2,740 |
| Noninterest expenses | 10,749 | 10,789 | 10,865 | 11,072 | 10,788 |
| Federal income tax expense | 541 | 349 | 476 | 359 | 263 |
| Net income | $ 4,188 | $ 3,496 | $ 3,530 | $ 3,696 | $ 3,333 |
| **PER SHARE** | | | | | |
| Basic earnings | $ 0.53 | $ 0.44 | $ 0.45 | $ 0.47 | $ 0.42 |
| Diluted earnings | $ 0.52 | $ 0.43 | $ 0.44 | $ 0.46 | $ 0.41 |
| Dividends | $ 0.26 | $ 0.26 | $ 0.26 | $ 0.26 | $ 0.26 |
| Tangible book value [1] | $ 20.17 | $ 19.47 | $ 18.68 | $ 17.89 | $ 18.09 |
| Quoted market value | | | | | |
| High | $ 23.75 | $ 24.50 | $ 27.00 | $ 27.65 | $ 27.25 |
| Low | $ 22.25 | $ 22.25 | $ 22.50 | $ 26.05 | $ 26.25 |
| Close [2] | $ 23.25 | $ 23.75 | $ 22.56 | $ 26.75 | $ 26.65 |
| Common shares outstanding [2] | 7,918,494 | 7,906,078 | 7,870,969 | 7,830,940 | 7,933,250 |
| **PERFORMANCE RATIOS** | | | | | |
| Return on average total assets | 0.93% | 0.77% | 0.77% | 0.80% | 0.74% |
| Return on average shareholders' equity | 8.13% | 7.00% | 7.35% | 7.67% | 6.89% |
| Return on average tangible shareholders' equity | 10.61% | 8.97% | 9.20% | 9.75% | 8.75% |
| Net interest margin yield (FTE) | 3.04% | 3.01% | 3.01% | 2.95% | 2.95% |
| **BALANCE SHEET DATA [2]** | | | | | |
| Gross loans | $ 1,176,622 | $ 1,144,832 | $ 1,128,707 | $ 1,139,930 | $ 1,151,756 |
| AFS securities | $ 470,449 | $ 494,842 | $ 494,834 | $ 501,139 | $ 524,108 |
| Total assets | $ 1,824,592 | $ 1,806,371 | $ 1,842,502 | $ 1,833,663 | $ 1,836,955 |
| Deposits | $ 1,281,418 | $ 1,277,963 | $ 1,292,693 | $ 1,276,806 | $ 1,274,762 |
| Borrowed funds | $ 320,462 | $ 311,684 | $ 340,299 | $ 359,776 | $ 362,496 |
| Shareholders' equity | $ 208,114 | $ 202,413 | $ 195,519 | $ 188,536 | $ 191,949 |
| Gross loans to deposits | 91.82% | 89.58% | 87.31% | 89.28% | 90.35% |
| **ASSETS UNDER MANAGEMENT [2]** | | | | | |
| Loans sold with servicing retained | $ 257,062 | $ 259,127 | $ 259,481 | $ 257,400 | $ 257,865 |
| Assets managed by our Investment and Trust Services Department | $ 487,180 | $ 475,560 | $ 447,487 | $ 504,371 | $ 494,533 |
| Total assets under management | $ 2,568,834 | $ 2,541,058 | $ 2,549,470 | $ 2,595,434 | $ 2,589,353 |
| **ASSET QUALITY [2]** | | | | | |
| Nonperforming loans to gross loans | 0.70% | 0.64% | 0.65% | 0.65% | 0.58% |
| Nonperforming assets to total assets | 0.48% | 0.43% | 0.42% | 0.42% | 0.37% |
| ALLL to gross loans | 0.68% | 0.73% | 0.74% | 0.71% | 0.71% |
| **CAPITAL RATIOS [2]** | | | | | |
| Shareholders' equity to assets | 11.41% | 11.20% | 10.64% | 10.28% | 10.45% |
| Tier 1 leverage | 9.03% | 8.91% | 8.72% | 8.49% | 8.71% |
| Common equity tier 1 capital | 12.43% | 12.45% | 12.58% | 12.18% | 12.11% |
| Tier 1 risk-based capital | 12.43% | 12.45% | 12.58% | 12.18% | 12.11% |
| Total risk-based capital | 13.06% | 13.12% | 13.26% | 12.83% | 12.76% |

(1) Tangible book value calculations include unrealized gain/loss on AFS securities.
(2) At end of period

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The following table outlines our year-to-date results of operations and provides certain performance measures as of, and for the six month periods ended:

| | June 30 2019 | June 30 2018 | June 30 2017 | June 30 2016 | June 30 2015 |
|---|---|---|---|---|---|
| **INCOME STATEMENT DATA** | | | | | |
| Interest income | $ 33,296 | $ 30,834 | $ 28,359 | $ 26,299 | $ 25,512 |
| Interest expense | 8,819 | 7,142 | 5,859 | 5,292 | 5,006 |
| Net interest income | 24,477 | 23,692 | 22,500 | 21,007 | 20,506 |
| Provision for loan losses | (145) | 712 | 36 | 168 | (1,261) |
| Noninterest income | 5,490 | 5,238 | 5,404 | 4,975 | 4,757 |
| Noninterest expenses | 21,538 | 20,895 | 19,458 | 18,298 | 17,005 |
| Federal income tax expense [1] | 890 | 528 | 1,430 | 1,092 | 1,748 |
| Net income | $ 7,684 | $ 6,795 | $ 6,980 | $ 6,424 | $ 7,771 |
| **PER SHARE** | | | | | |
| Basic earnings | $ 0.97 | $ 0.86 | $ 0.89 | $ 0.82 | $ 1.00 |
| Diluted earnings | $ 0.95 | $ 0.84 | $ 0.87 | $ 0.80 | $ 0.98 |
| Dividends | $ 0.52 | $ 0.52 | $ 0.50 | $ 0.48 | $ 0.46 |
| Tangible book value [2] | $ 20.17 | $ 18.09 | $ 18.63 | $ 18.68 | $ 16.92 |
| Quoted market value | | | | | |
| High | $ 24.50 | $ 28.25 | $ 29.00 | $ 29.90 | $ 23.80 |
| Low | $ 22.25 | $ 26.11 | $ 27.60 | $ 27.25 | $ 22.00 |
| Close [3] | $ 23.25 | $ 26.65 | $ 28.00 | $ 27.90 | $ 23.75 |
| Common shares outstanding [3] | 7,918,494 | 7,933,250 | 7,862,553 | 7,836,442 | 7,797,188 |
| **PERFORMANCE RATIOS** | | | | | |
| Return on average total assets | 0.85% | 0.75% | 0.80% | 0.77% | 1.00% |
| Return on average shareholders' equity | 7.58% | 7.00% | 7.21% | 6.71% | 8.69% |
| Return on average tangible shareholders' equity | 9.73% | 8.92% | 9.67% | 9.37% | 11.71% |
| Net interest margin yield (FTE) [1] | 3.02% | 2.95% | 3.01% | 2.97% | 3.15% |
| **BALANCE SHEET DATA [3]** | | | | | |
| Gross loans | $ 1,176,622 | $ 1,151,756 | $ 1,048,497 | $ 919,594 | $ 831,831 |
| AFS securities | $ 470,449 | $ 524,108 | $ 564,197 | $ 602,463 | $ 595,318 |
| Total assets | $ 1,824,592 | $ 1,836,955 | $ 1,777,298 | $ 1,680,359 | $ 1,586,975 |
| Deposits | $ 1,281,418 | $ 1,274,762 | $ 1,210,152 | $ 1,156,870 | $ 1,090,469 |
| Borrowed funds | $ 320,462 | $ 362,496 | $ 360,940 | $ 318,596 | $ 307,599 |
| Shareholders' equity | $ 208,114 | $ 191,949 | $ 195,070 | $ 195,133 | $ 178,025 |
| Gross loans to deposits | 91.82% | 90.35% | 86.64% | 79.49% | 76.28% |
| **ASSETS UNDER MANAGEMENT [3]** | | | | | |
| Loans sold with servicing retained | $ 257,062 | $ 257,865 | $ 269,595 | $ 275,958 | $ 289,089 |
| Assets managed by our Investment and Trust Services Department | $ 487,180 | $ 494,533 | $ 454,294 | $ 415,762 | $ 400,827 |
| Total assets under management | $ 2,568,834 | $ 2,589,353 | $ 2,501,187 | $ 2,372,079 | $ 2,276,891 |
| **ASSET QUALITY [3]** | | | | | |
| Nonperforming loans to gross loans | 0.70% | 0.58% | 0.26% | 0.13% | 0.19% |
| Nonperforming assets to total assets | 0.48% | 0.37% | 0.17% | 0.09% | 0.15% |
| ALLL to gross loans | 0.68% | 0.71% | 0.72% | 0.83% | 1.08% |
| **CAPITAL RATIOS [3]** | | | | | |
| Shareholders' equity to assets | 11.41% | 10.45% | 10.98% | 11.61% | 11.22% |
| Tier 1 leverage | 9.03% | 8.71% | 8.50% | 8.50% | 8.77% |
| Common equity tier 1 capital | 12.43% | 12.11% | 12.43% | 13.08% | 13.94% |
| Tier 1 risk-based capital | 12.43% | 12.11% | 12.43% | 13.08% | 13.94% |
| Total risk-based capital | 13.06% | 12.76% | 13.07% | 13.80% | 14.88% |

[1] Calculations are based on a federal income tax rate of 21% in 2018 and 2019 and 34% for all prior periods.
[2] Tangible book value calculations include unrealized gain/loss on AFS securities.
[3] At end of period

**Average Balances, Interest Rates, and Net Interest Income**

The following schedules present the daily average amount outstanding for each major category of interest earning assets, non-earning assets, interest bearing liabilities, and noninterest bearing liabilities. These schedules also present an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a federal income tax rate of 21%. Loans in nonaccrual status, for the purpose of the following computations, are included in the average loan balances. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

| | Three Months Ended | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2019 | | | March 31, 2019 | | | June 30, 2018 | | |
| | Average Balance | Tax Equivalent Interest | Average Yield / Rate | Average Balance | Tax Equivalent Interest | Average Yield / Rate | Average Balance | Tax Equivalent Interest | Average Yield / Rate |
| INTEREST EARNING ASSETS | | | | | | | | | |
| Loans | $ 1,155,284 | $ 13,587 | 4.70% | $ 1,131,093 | $ 12,891 | 4.56% | $ 1,114,669 | $ 12,076 | 4.33% |
| Taxable investment securities | 309,650 | 1,873 | 2.42% | 319,962 | 1,958 | 2.45% | 350,449 | 2,110 | 2.41% |
| Nontaxable investment securities | 172,400 | 1,623 | 3.77% | 179,887 | 1,687 | 3.75% | 196,773 | 1,809 | 3.68% |
| Fed funds sold | — | — | —% | 26 | — | —% | 1 | — | —% |
| Other | 32,655 | 148 | 1.81% | 48,319 | 379 | 3.14% | 24,095 | 196 | 3.25% |
| Total earning assets | 1,669,989 | 17,231 | 4.13% | 1,679,287 | 16,915 | 4.03% | 1,685,987 | 16,191 | 3.84% |
| NONEARNING ASSETS | | | | | | | | | |
| Allowance for loan losses | (8,349) | | | (8,406) | | | (8,240) | | |
| Cash and demand deposits due from banks | 19,089 | | | 19,194 | | | 18,744 | | |
| Premises and equipment | 27,326 | | | 27,710 | | | 28,473 | | |
| Accrued income and other assets | 99,514 | | | 92,248 | | | 86,441 | | |
| Total assets | $ 1,807,569 | | | $ 1,810,033 | | | $ 1,811,405 | | |
| INTEREST BEARING LIABILITIES | | | | | | | | | |
| Interest bearing demand deposits | $ 230,238 | $ 83 | 0.14% | $ 236,074 | $ 68 | 0.12% | $ 226,309 | $ 61 | 0.11% |
| Savings deposits | 374,750 | 586 | 0.63% | 381,134 | 615 | 0.65% | 363,842 | 397 | 0.44% |
| Time deposits | 430,098 | 2,196 | 2.04% | 436,448 | 2,035 | 1.87% | 465,745 | 1,772 | 1.52% |
| Borrowed funds | 321,958 | 1,662 | 2.06% | 321,445 | 1,574 | 1.96% | 334,573 | 1,511 | 1.81% |
| Total interest bearing liabilities | 1,357,044 | 4,527 | 1.33% | 1,375,101 | 4,292 | 1.25% | 1,390,469 | 3,741 | 1.08% |
| NONINTEREST BEARING LIABILITIES | | | | | | | | | |
| Demand deposits | 230,203 | | | 226,425 | | | 220,293 | | |
| Other | 14,288 | | | 8,878 | | | 7,108 | | |
| Shareholders’ equity | 206,034 | | | 199,629 | | | 193,535 | | |
| Total liabilities and shareholders’ equity | $ 1,807,569 | | | $ 1,810,033 | | | $ 1,811,405 | | |
| Net interest income (FTE) | | $ 12,704 | | | $ 12,623 | | | $ 12,450 | |
| **Net yield on interest earning assets (FTE)** | | | **3.04%** | | | **3.01%** | | | **2.95%** |

| | Six Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2019 | | | June 30, 2018 | | |
| | Average Balance | Tax Equivalent Interest | Average Yield / Rate | Average Balance | Tax Equivalent Interest | Average Yield / Rate |
| INTEREST EARNING ASSETS | | | | | | |
| Loans | $ 1,143,255 | $ 26,478 | 4.63% | $ 1,095,773 | $ 23,372 | 4.27% |
| Taxable investment securities | 314,778 | 3,831 | 2.43% | 353,143 | 4,232 | 2.40% |
| Nontaxable investment securities | 176,123 | 3,310 | 3.76% | 197,144 | 3,701 | 3.75% |
| Fed funds sold | 13 | — | —% | — | — | —% |
| Other | 40,444 | 527 | 2.61% | 25,639 | 517 | 4.03% |
| Total earning assets | 1,674,613 | 34,146 | 4.08% | 1,671,699 | 31,822 | 3.81% |
| NONEARNING ASSETS | | | | | | |
| Allowance for loan losses | (8,378) | | | (8,009) | | |
| Cash and demand deposits due from banks | 19,140 | | | 19,068 | | |
| Premises and equipment | 27,517 | | | 28,525 | | |
| Accrued income and other assets | 95,952 | | | 88,945 | | |
| Total assets | $ 1,808,844 | | | $ 1,800,228 | | |
| INTEREST BEARING LIABILITIES | | | | | | |
| Interest bearing demand deposits | $ 233,139 | $ 151 | 0.13% | $ 228,794 | $ 132 | 0.12% |
| Savings deposits | 377,926 | 1,201 | 0.64% | 359,170 | 719 | 0.40% |
| Time deposits | 433,255 | 4,231 | 1.95% | 464,497 | 3,425 | 1.47% |
| Borrowed funds | 321,703 | 3,236 | 2.01% | 327,222 | 2,866 | 1.75% |
| Total interest bearing liabilities | 1,366,023 | 8,819 | 1.29% | 1,379,683 | 7,142 | 1.04% |
| NONINTEREST BEARING LIABILITIES | | | | | | |
| Demand deposits | 228,382 | | | 218,977 | | |
| Other | 11,594 | | | 7,461 | | |
| Shareholders' equity | 202,845 | | | 194,107 | | |
| Total liabilities and shareholders' equity | $ 1,808,844 | | | $ 1,800,228 | | |
| Net interest income (FTE) | | $ 25,327 | | | $ 24,680 | |
| **Net yield on interest earning assets (FTE)** | | | **3.02%** | | | **2.95%** |

Net interest income is the amount by which interest income on earning assets exceeds the interest expense on interest bearing liabilities. Net interest income is influenced by changes in the balance and mix of assets and liabilities, as well as market interest rates. We exert some control over these factors; however, FRB monetary policy and competition have a significant impact. For analytical purposes, net interest income is adjusted to an FTE basis by including the income tax savings from interest on tax exempt loans, and nontaxable investment securities, thus making year to year comparisons more meaningful.

**Volume and Rate Variance Analysis**

The following table sets forth the effect of volume and rate changes on interest income and expense for the periods indicated. For the purpose of this table, changes in interest due to volume and rate were determined as follows:

Volume—change in volume multiplied by the previous period's rate.

Rate—change in the FTE rate multiplied by the previous period's volume.

The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

| | Three Months Ended June 30, 2019 Compared to March 31, 2019 Increase (Decrease) Due to | | | Three Months Ended June 30, 2019 Compared to June 30, 2018 Increase (Decrease) Due to | | | Six Months Ended June 30, 2019 Compared to June 30, 2018 Increase (Decrease) Due to | | |
|---|---|---|---|---|---|---|---|---|---|
| | Volume | Rate | Net | Volume | Rate | Net | Volume | Rate | Net |
| **Changes in interest income** | | | | | | | | | |
| Loans | $ 279 | $ 417 | $ 696 | $ 451 | $ 1,060 | $ 1,511 | $ 1,042 | $ 2,064 | $ 3,106 |
| Taxable investment securities | (63) | (22) | (85) | (247) | 10 | (237) | (466) | 65 | (401) |
| Nontaxable investment securities | (70) | 6 | (64) | (229) | 43 | (186) | (395) | 4 | (391) |
| Other | (100) | (131) | (231) | 56 | (104) | (48) | 233 | (223) | 10 |
| Total changes in interest income | 46 | 270 | 316 | 31 | 1,009 | 1,040 | 414 | 1,910 | 2,324 |
| **Changes in interest expense** | | | | | | | | | |
| Interest bearing demand deposits | (2) | 17 | 15 | 1 | 21 | 22 | 3 | 16 | 19 |
| Savings deposits | (10) | (19) | (29) | 12 | 177 | 189 | 39 | 443 | 482 |
| Time deposits | (30) | 191 | 161 | (144) | 568 | 424 | (243) | 1,049 | 806 |
| Borrowed funds | 3 | 85 | 88 | (59) | 210 | 151 | (49) | 419 | 370 |
| Total changes in interest expense | (39) | 274 | 235 | (190) | 976 | 786 | (250) | 1,927 | 1,677 |
| **Net change in interest margin (FTE)** | **$ 85** | **$ (4)** | **$ 81** | **$ 221** | **$ 33** | **$ 254** | **$ 664** | **$ (17)** | **$ 647** |

Our net yield on interest earning assets has increased in recent periods. The continuing flattening of the yield curve and rising deposit rates combined with our current yield on AFS securities has placed pressure on our net interest margin. Despite this pressure, we experienced improvement as a result of improved loan yields and a decline in high-cost deposits and borrowings.

| | Average Yield / Rate for the Three Month Periods Ended: | | | | |
|---|---|---|---|---|---|
| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
| Total earning assets | 4.13% | 4.03% | 4.01% | 3.94% | 3.84% |
| Total interest bearing liabilities | 1.33% | 1.25% | 1.23% | 1.20% | 1.08% |
| **Net yield on interest earning assets (FTE)** | **3.04%** | **3.01%** | **3.01%** | **2.95%** | **2.95%** |

| | Quarter to Date Net Interest Income (FTE) | | | | |
|---|---|---|---|---|---|
| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
| Total interest income (FTE) | $ 17,231 | $ 16,915 | $ 17,005 | $ 16,873 | $ 16,191 |
| Total interest expense | 4,527 | 4,292 | 4,258 | 4,231 | 3,741 |
| **Net interest income (FTE)** | **$ 12,704** | **$ 12,623** | **$ 12,747** | **$ 12,642** | **$ 12,450** |

**Allowance for Loan and Lease Losses**

The viability of any financial institution is ultimately determined by its management of credit risk. Loans represent our single largest concentration of risk. The ALLL is our estimation of incurred losses within the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment valuation allowances, historical charge-offs, internally assigned credit risk ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a representation of other qualitative risks that reflect the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The following table summarizes our charge-offs, recoveries, provision for loan losses, and ALLL balances as of, and for the:

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| ALLL at beginning of period | $ 8,398 | $ 8,200 | $ 8,375 | $ 7,700 |
| Charge-offs | | | | |
| Commercial | 164 | 489 | 172 | 494 |
| Agricultural | — | — | — | — |
| Residential real estate | 94 | 29 | 96 | 39 |
| Consumer | 75 | 48 | 203 | 136 |
| **Total charge-offs** | **333** | **566** | **471** | **669** |
| Recoveries | | | | |
| Commercial | 22 | 101 | 74 | 204 |
| Agricultural | — | — | — | — |
| Residential real estate | 91 | 69 | 118 | 125 |
| Consumer | 38 | 68 | 86 | 128 |
| **Total recoveries** | **151** | **238** | **278** | **457** |
| **Net loan charge-offs (recoveries)** | **182** | **328** | **193** | **212** |
| Provision for loan losses | (179) | 328 | (145) | 712 |
| **ALLL at end of period** | **$ 8,037** | **$ 8,200** | **$ 8,037** | **$ 8,200** |
| **Net loan charge-offs (recoveries) to average loans outstanding** | **0.02%** | **0.03%** | **0.02%** | **0.02%** |

The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the three month periods ended:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Total charge-offs | $ 333 | $ 138 | $ 253 | $ 179 | $ 566 |
| Total recoveries | 151 | 127 | 186 | 155 | 238 |
| **Net loan charge-offs (recoveries)** | **182** | **11** | **67** | **24** | **328** |
| **Net loan charge-offs (recoveries) to average loans outstanding** | **0.02 %** | **—%** | **0.01%** | **— %** | **0.03%** |
| Provision for loan losses | **$ (179)** | **$ 34** | **$ 342** | **$ (76)** | **$ 328** |
| **Provision for loan losses to average loans outstanding** | **(0.02)%** | **—%** | **0.03%** | **(0.01)%** | **0.03%** |
| ALLL | **$ 8,037** | **$ 8,398** | **$ 8,375** | **$ 8,100** | **$ 8,200** |
| **ALLL as a % of loans at end of period** | **0.68 %** | **0.73%** | **0.74%** | **0.71 %** | **0.71%** |

We experienced a higher level of charge-offs in the second quarter of 2018 which was substantially related to one borrower and is therefore, not indicative of a trend in charge-off activity. While we have experienced fluctuations in credit quality indicators in recent periods, credit quality remains strong and has improved. Overall, our level of required reserve is modest due to strong credit quality indicators, low historical loss factors, and a low amount of net charge-offs.

The following table illustrates our changes within the two main components of the ALLL as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| ALLL | | | | | |
| Individually evaluated for impairment | $ 1,479 | $ 1,509 | $ 1,938 | $ 2,074 | $ 2,059 |
| Collectively evaluated for impairment | 6,558 | 6,889 | 6,437 | 6,026 | 6,141 |
| **Total** | **$ 8,037** | **$ 8,398** | **$ 8,375** | **$ 8,100** | **$ 8,200** |
| ALLL to gross loans | | | | | |
| Individually evaluated for impairment | 0.13% | 0.13% | 0.17% | 0.18% | 0.18% |
| Collectively evaluated for impairment | 0.55% | 0.60% | 0.57% | 0.53% | 0.53% |
| **Total** | **0.68%** | **0.73%** | **0.74%** | **0.71%** | **0.71%** |

For further discussion of the allocation of the ALLL, see "Note 4 – Loans and ALLL" of our interim condensed consolidated financial statements.

**Loans Past Due and Loans in Nonaccrual Status**

Fluctuations in past due and nonaccrual status loans can have a significant impact on the ALLL. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due greater than 30 days and nonaccrual status loans for indications of additional deterioration.

| | Total Past Due and Nonaccrual Loans | | | | |
|---|---|---|---|---|---|
| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
| Commercial | $ 2,243 | $ 5,299 | $ 2,722 | $ 3,084 | $ 4,929 |
| Agricultural | 6,672 | 6,854 | 5,377 | 5,663 | 5,051 |
| Residential real estate | 1,690 | 6,063 | 3,208 | 3,137 | 2,452 |
| Consumer | 94 | 152 | 105 | 68 | 43 |
| **Total** | **$ 10,699** | **$ 18,368** | **$ 11,412** | **$ 11,952** | **$ 12,475** |
| **Total past due and nonaccrual loans to gross loans** | **0.91%** | **1.60%** | **1.01%** | **1.05%** | **1.08%** |

Past due and nonaccrual status loans have generally improved over the last year and continue to be at low levels as a result of strong repayment performance. We experienced an increase in past due commercial and residential real estate loans during the first quarter of 2019. This activity was closely monitored by management and a high level of delinquent loan repayments were received in early April 2019. As such, levels normalized by the end of the second quarter of 2019 and management feels the increase in commercial and residential mortgage loans past due as of March 31, 2019 was not indicative of a trend. A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual status loans by type, is included in "Note 4 – Loans and ALLL" of our interim condensed consolidated financial statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. This approach has permitted certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure. The modifications have been successful for us and our customers as very few of the modified loans have resulted in foreclosures. The majority of new modifications result in terms that satisfy our criteria for continued interest accrual. TDRs that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance and achievement of current payment status.

We restructure debt with borrowers who, due to financial difficulties, are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, allow interest only payment structures, forgive principal, forgive interest, or grant a combination of these modifications. Typically, the modifications are for a period of three years or less. There were no TDRs that were government sponsored as of June 30, 2019 or December 31, 2018.

Losses associated with TDRs, if any, are included in the estimation of the ALLL during the quarter in which a loan is identified as a TDR, and we review the analysis of the ALLL estimation each reporting period thereafter to ensure its continued appropriateness.

The following tables provide a roll-forward of TDRs for the:

| | Three Months Ended June 30, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing Interest | | Nonaccrual | | Total | |
| | Number of Loans | Balance | Number of Loans | Balance | Number of Loans | Balance |
| **April 1, 2019** | **128** | **$ 22,305** | **26** | **$ 3,825** | **154** | **$ 26,130** |
| New modifications | 2 | 1,348 | — | — | 2 | 1,348 |
| Principal advances (payments) | — | (380) | — | (133) | — | (513) |
| Loans paid off | (6) | (394) | (6) | (541) | (12) | (935) |
| Partial charge-offs | — | — | — | (65) | — | (65) |
| Transfers to OREO | — | — | — | — | — | — |
| Transfers to accrual status | 1 | 77 | (1) | (77) | — | — |
| Transfers to nonaccrual status | (3) | (2,646) | 3 | 2,646 | — | — |
| **June 30, 2019** | **122** | **$ 20,310** | **22** | **$ 5,655** | **144** | **$ 25,965** |

| | Six Months Ended June 30, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing Interest | | Nonaccrual | | Total | |
| | Number of Loans | Balance | Number of Loans | Balance | Number of Loans | Balance |
| **January 1, 2019** | **133** | **$ 23,400** | **28** | **$ 3,551** | **161** | **$ 26,951** |
| New modifications | 5 | 2,018 | — | — | 5 | 2,018 |
| Principal advances (payments) | — | (720) | — | (260) | — | (980) |
| Loans paid off | (12) | (1,193) | (9) | (718) | (21) | (1,911) |
| Partial charge-offs | — | — | — | (65) | — | (65) |
| Transfers to OREO | — | — | (1) | (48) | (1) | (48) |
| Transfers to accrual status | 1 | 77 | (1) | (77) | — | — |
| Transfers to nonaccrual status | (5) | (3,272) | 5 | 3,272 | — | — |
| **June 30, 2019** | **122** | **$ 20,310** | **22** | **$ 5,655** | **144** | **$ 25,965** |

| | Three Months Ended June 30, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing Interest | | Nonaccrual | | Total | |
| | Number of Loans | Balance | Number of Loans | Balance | Number of Loans | Balance |
| **April 1, 2018** | **143** | **$ 24,350** | **15** | **$ 3,190** | **158** | **$ 27,540** |
| New modifications | 15 | 3,081 | 4 | 657 | 19 | 3,738 |
| Principal advances (payments) | — | 66 | — | (483) | — | (417) |
| Loans paid off | (13) | (3,037) | (1) | (23) | (14) | (3,060) |
| Transfers to accrual status | — | — | — | — | — | — |
| Transfers to nonaccrual status | (3) | (730) | 3 | 730 | — | — |
| **June 30, 2018** | **142** | **$ 23,730** | **21** | **$ 4,071** | **163** | **$ 27,801** |

| | Six Months Ended June 30, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing Interest | | Nonaccrual | | Total | |
| | Number of Loans | Balance | Number of Loans | Balance | Number of Loans | Balance |
| **January 1, 2018** | **147** | **$ 23,284** | **13** | **$ 2,913** | **160** | **$ 26,197** |
| New modifications | 22 | 5,564 | 4 | 657 | 26 | 6,221 |
| Principal advances (payments) | — | (321) | — | (575) | — | (896) |
| Loans paid off | (22) | (3,698) | (1) | (23) | (23) | (3,721) |
| Transfers to accrual status | — | — | — | — | — | — |
| Transfers to nonaccrual status | (5) | (1,099) | 5 | 1,099 | — | — |
| **June 30, 2018** | **142** | **$ 23,730** | **21** | **$ 4,071** | **163** | **$ 27,801** |

The following table summarizes our TDRs as of:

| | June 30, 2019 | | | December 31, 2018 | | | |
|---|---|---|---|---|---|---|---|
| | Accruing Interest | Nonaccrual | Total | Accruing Interest | Nonaccrual | Total | Total Change |
| Current | $ 19,802 | $ 3,738 | $ 23,540 | $ 21,794 | $ 2,673 | $ 24,467 | $ (927) |
| Past due 30-59 days | 508 | 1,917 | 2,425 | 899 | — | 899 | 1,526 |
| Past due 60-89 days | — | — | — | 707 | — | 707 | (707) |
| Past due 90 days or more | — | — | — | — | 878 | 878 | (878) |
| **Total** | **$ 20,310** | **$ 5,655** | **$ 25,965** | **$ 23,400** | **$ 3,551** | **$ 26,951** | **$ (986)** |

Additional disclosures about TDRs are included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Impaired Loans**

The following is a summary of information pertaining to impaired loans as of:

| | June 30, 2019 | | | December 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Recorded Balance | Unpaid Principal Balance | Valuation Allowance | Recorded Balance | Unpaid Principal Balance | Valuation Allowance |
| **TDRs** | | | | | | |
| Commercial real estate | $ 6,194 | $ 6,513 | $ 53 | $ 6,507 | $ 6,840 | $ 437 |
| Commercial other | 1,455 | 1,455 | — | 1,713 | 1,713 | — |
| Agricultural real estate | 8,497 | 8,497 | 97 | 7,452 | 7,452 | 112 |
| Agricultural other | 4,539 | 4,539 | 5 | 5,288 | 5,331 | — |
| Residential real estate senior liens | 5,231 | 5,513 | 1,069 | 5,923 | 6,205 | 1,181 |
| Residential real estate junior liens | 12 | 12 | 2 | 12 | 12 | 2 |
| Home equity lines of credit | 30 | 330 | — | 47 | 347 | — |
| Consumer secured | 7 | 7 | — | 9 | 9 | — |
| **Total TDRs** | **25,965** | **26,866** | **1,226** | **26,951** | **27,909** | **1,732** |
| **Other impaired loans** | | | | | | |
| Commercial real estate | 138 | 199 | — | 256 | 318 | — |
| Commercial other | 1,242 | 1,242 | 5 | 1,423 | 1,530 | 6 |
| Agricultural real estate | — | — | — | 557 | 558 | — |
| Agricultural other | 436 | 436 | 21 | 1,001 | 1,000 | 20 |
| Residential real estate senior liens | 1,116 | 1,305 | 227 | 911 | 1,084 | 180 |
| Residential real estate junior liens | — | — | — | — | — | — |
| Home equity lines of credit | — | — | — | — | — | — |
| Consumer secured | — | — | — | — | — | — |
| **Total other impaired loans** | **2,932** | **3,182** | **253** | **4,148** | **4,490** | **206** |
| **Total impaired loans** | **$ 28,897** | **$ 30,048** | **$ 1,479** | **$ 31,099** | **$ 32,399** | **$ 1,938** |

Additional disclosures related to impaired loans are included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Nonperforming Assets**

The following table summarizes our nonperforming assets as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Nonaccrual status loans | $ 8,107 | $ 7,260 | $ 7,260 | $ 7,136 | $ 6,492 |
| Accruing loans past due 90 days or more | 110 | 30 | 113 | 274 | 154 |
| **Total nonperforming loans** | **8,217** | **7,290** | **7,373** | **7,410** | **6,646** |
| Foreclosed assets | 513 | 401 | 355 | 305 | 167 |
| **Total nonperforming assets** | **$ 8,730** | **$ 7,691** | **$ 7,728** | **$ 7,715** | **$ 6,813** |
| **Nonperforming loans as a % of total loans** | **0.70%** | **0.64%** | **0.65%** | **0.65%** | **0.58%** |
| **Nonperforming assets as a % of total assets** | **0.48%** | **0.43%** | **0.42%** | **0.42%** | **0.37%** |

The accrual of interest on commercial and agricultural loans, as well as residential real estate loans, is discontinued at the time a loan is 90 days or more past due unless the credit is well-secured and in the process of short-term collection. Upon transferring a loan to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if a charge-off is necessary. Consumer loans are typically charged-off no later than 180 days past due. Loans may be placed back on accrual status after six months of continued performance and achievement of current payment status. While the level of nonperforming loans has increased in recent periods, it remains low in comparison to peer banks. Recent increases in nonaccrual loans have been concentrated in our agricultural portfolio as a result of the challenges facing much of the agricultural industry.

The following tables summarize nonaccrual loans as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Commercial | $ 1,692 | $ 1,931 | $ 1,757 | $ 1,140 | $ 1,946 |
| Agricultural | 5,532 | 4,757 | 4,949 | 5,298 | 3,757 |
| Residential real estate | 883 | 572 | 554 | 698 | 789 |
| **Total** | **$ 8,107** | **$ 7,260** | **$ 7,260** | **$ 7,136** | **$ 6,492** |

Included in the nonaccrual loan balances above were loans currently classified as TDR as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Commercial | $ 450 | $ 515 | $ 160 | $ 723 | $ 692 |
| Agricultural | 5,096 | 3,199 | 3,391 | 3,237 | 2,797 |
| Residential real estate | 109 | 111 | — | 282 | 582 |
| **Total** | **$ 5,655** | **$ 3,825** | **$ 3,551** | **$ 4,242** | **$ 4,071** |

Additional disclosures about nonaccrual status loans are included in “Note 4 – Loans and ALLL” of our interim condensed consolidated financial statements.

We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge-off. We have identified all impaired loans as of June 30, 2019.

The level of the ALLL is appropriate as of June 30, 2019. We closely monitor overall credit quality indicators and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains at an appropriate level.

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**Noninterest Income and Noninterest Expenses**

Significant noninterest income balances are highlighted in the following tables for the:

| | Three Months Ended June 30 | | | |
|---|---|---|---|---|
| | | | Change | |
| | 2019 | 2018 | $ | % |
| Service charges and fees | $ 1,540 | $ 1,488 | $ 52 | 3.49% |
| Investment and Trust advisory fees | 780 | 738 | 42 | 5.69% |
| Earnings on corporate owned life insurance policies | 201 | 185 | 16 | 8.65% |
| Net gain on sale of mortgage loans | 116 | 87 | 29 | 33.33% |
| Other | 374 | 242 | 132 | 54.55% |
| **Total noninterest income** | **$ 3,011** | **$ 2,740** | **$ 271** | **9.89%** |

| | Six Months Ended June 30 | | | |
|---|---|---|---|---|
| | | | Change | |
| | 2019 | 2018 | $ | % |
| Service charges and fees | $ 3,001 | $ 2,976 | $ 25 | 0.84% |
| Investment and Trust advisory fees | 1,457 | 1,396 | 61 | 4.37% |
| Earnings on corporate owned life insurance policies | 374 | 366 | 8 | 2.19% |
| Net gain on sale of mortgage loans | 209 | 168 | 41 | 24.40% |
| Other | 449 | 332 | 117 | 35.24% |
| **Total noninterest income** | **$ 5,490** | **$ 5,238** | **$ 252** | **4.81%** |

Service charges and fees include ATM and debit card fees, NSF and overdraft fees, loan servicing fee income, OMSR income and other deposit account fees. ATM and debit card fees fluctuate from period-to-period based primarily on usage of ATM and debit cards. OMSR income results are driven, in part, by changes in offering rates on residential mortgage loans, anticipated prepayments in the servicing-retained portfolio, and the volume of loans within the servicing-retained portfolio. As such, OMSR income during 2019 could experience fluctuations and may not exceed 2018 OMSR income.

In recent periods, we have invested considerable efforts to increase our market share in Investment and Trust advisory services through marketing efforts and talent acquisition. We anticipate that fee income will continue to increase during the remainder of 2019 and exceed 2018 levels.

The fluctuations in all other income are spread throughout various categories, none of which are individually significant.

Significant noninterest expense balances are highlighted in the following tables for the:

| | Three Months Ended June 30 | | | |
|---|---|---|---|---|
| | | | Change | |
| | 2019 | 2018 | $ | % |
| Compensation and benefits | $ 5,957 | $ 5,679 | $ 278 | 4.90 % |
| Furniture and equipment | 1,409 | 1,537 | (128) | (8.33)% |
| Occupancy | 834 | 807 | 27 | 3.35 % |
| Other | | | | |
| Audit, consulting, and legal fees | 461 | 661 | (200) | (30.26)% |
| ATM and debit card fees | 298 | 234 | 64 | 27.35 % |
| Loan underwriting fees | 168 | 165 | 3 | 1.82 % |
| Director fees | 190 | 222 | (32) | (14.41)% |
| Memberships and subscriptions | 176 | 146 | 30 | 20.55 % |
| FDIC insurance premiums | 162 | 156 | 6 | 3.85 % |
| Donations and community relations | 190 | 210 | (20) | (9.52)% |
| Marketing costs | 171 | 149 | 22 | 14.77 % |
| Education and travel | 56 | 101 | (45) | (44.55)% |
| All other | 677 | 721 | (44) | (6.10)% |
| Total other | 2,549 | 2,765 | (216) | (7.81)% |
| **Total noninterest expenses** | **$ 10,749** | **$ 10,788** | **$ (39)** | **(0.36)%** |

| | Six Months Ended June 30 | | | |
|---|---|---|---|---|
| | | | Change | |
| | 2019 | 2018 | $ | % |
| Compensation and benefits | $ 11,679 | $ 11,173 | $ 506 | 4.53 % |
| Furniture and equipment | 2,903 | 2,986 | (83) | (2.78)% |
| Occupancy | 1,764 | 1,631 | 133 | 8.15 % |
| Other | | | | |
| Audit, consulting, and legal fees | 916 | 1,179 | (263) | (22.31)% |
| ATM and debit card fees | 546 | 466 | 80 | 17.17 % |
| Loan underwriting fees | 484 | 314 | 170 | 54.14 % |
| Director fees | 397 | 431 | (34) | (7.89)% |
| Memberships and subscriptions | 343 | 269 | 74 | 27.51 % |
| FDIC insurance premiums | 332 | 320 | 12 | 3.75 % |
| Donations and community relations | 330 | 361 | (31) | (8.59)% |
| Marketing costs | 313 | 259 | 54 | 20.85 % |
| Education and travel | 213 | 216 | (3) | (1.39)% |
| All other | 1,318 | 1,290 | 28 | 2.17 % |
| Total other | 5,192 | 5,105 | 87 | 1.70 % |
| **Total noninterest expenses** | **$ 21,538** | **$ 20,895** | **$ 643** | **3.08 %** |

The increase in compensation and benefits expense is primarily related to merit increases, increased health care and employee benefit costs, and recent changes to our incentive plans which required additional expenses during the second quarter of 2019. Compensation and benefits expense in 2019 is expected to exceed 2018 levels as a result of these factors.

Occupancy expenses increased due to property taxes and maintenance costs. Occupancy expenses are expected to exceed 2018 levels for the remainder of 2019.

Audit, consulting, and legal fees in 2018 included one-time charges related to income tax strategies. As a result, 2019 expenses were less than 2018 year-to-date and this trend is expected for the remainder of 2019.

Loan underwriting fees increased during the second half of 2018 and continued in the first quarter of 2019 as a result of new loan products, including first time home buyer and down payment assistance programs designed to generate residential mortgage growth. Loan underwriting fees in 2019 are not expected to exceed 2018 levels based on availability of products during 2019.

The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.

**Analysis of Changes in Financial Condition**

| | June 30 2019 | December 31 2018 | $ Change | % Change (unannualized) |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash and cash equivalents | $ 35,962 | $ 73,471 | $ (37,509) | (51.05)% |
| AFS securities | | | | |
| Amortized cost of AFS securities | 466,030 | 501,245 | (35,215) | (7.03)% |
| Unrealized gains (losses) on AFS securities | 4,419 | (6,411) | 10,830 | N/M |
| AFS securities | 470,449 | 494,834 | (24,385) | (4.93)% |
| Mortgage loans AFS | 1,372 | 358 | 1,014 | N/M |
| Loans | | | | |
| Gross loans | 1,176,622 | 1,128,707 | 47,915 | 4.25 % |
| Less allowance for loan and lease losses | 8,037 | 8,375 | (338) | (4.04)% |
| Net loans | 1,168,585 | 1,120,332 | 48,253 | 4.31 % |
| Premises and equipment | 26,954 | 27,815 | (861) | (3.10)% |
| Corporate owned life insurance policies | 28,090 | 27,733 | 357 | 1.29 % |
| Accrued interest receivable | 6,193 | 6,928 | (735) | (10.61)% |
| Equity securities without readily determinable fair values | 25,024 | 24,948 | 76 | 0.30 % |
| Goodwill and other intangible assets | 48,413 | 48,451 | (38) | (0.08)% |
| Other assets | 13,550 | 17,632 | (4,082) | (23.15)% |
| **TOTAL ASSETS** | **$ 1,824,592** | **$ 1,842,502** | **$ (17,910)** | **(0.97)%** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | |
| **Liabilities** | | | | |
| Deposits | $ 1,281,418 | $ 1,292,693 | $ (11,275) | (0.87)% |
| Borrowed funds | 320,462 | 340,299 | (19,837) | (5.83)% |
| Accrued interest payable and other liabilities | 14,598 | 13,991 | 607 | 4.34 % |
| **Total liabilities** | **1,616,478** | **1,646,983** | **(30,505)** | **(1.85)%** |
| **Shareholders' equity** | **208,114** | **195,519** | **12,595** | **6.44 %** |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 1,824,592** | **$ 1,842,502** | **$ (17,910)** | **(0.97)%** |

As shown above, total assets have declined $17,910 since December 31, 2018 which was primarily driven by a decline in cash and cash equivalents, due primarily to reduced borrowings. In the current interest rate environment, we have elected to use excess funds to lend and pay down borrowed funds versus acquiring investment securities. As a result, the investment portfolio declined due to normal calls and maturities. We experienced loan growth of $47,915 during the first six months of 2019 which was largely driven by growth in our commercial loan portfolio.

The following table outlines the changes in loans:

| | June 30 2019 | December 31 2018 | $ Change | % Change (unannualized) |
|---|---|---|---|---|
| Commercial | $ 701,954 | $ 659,529 | $ 42,425 | 6.43 % |
| Agricultural | 120,363 | 127,161 | (6,798) | (5.35)% |
| Residential real estate | 283,285 | 275,343 | 7,942 | 2.88 % |
| Consumer | 71,020 | 66,674 | 4,346 | 6.52 % |
| **Total** | **$ 1,176,622** | **$ 1,128,707** | **$ 47,915** | **4.25 %** |

The following table displays loan balances as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Commercial | $ 701,954 | $ 677,554 | $ 659,529 | $ 668,915 | $ 691,623 |
| Agricultural | 120,363 | 123,393 | 127,161 | 129,232 | 125,249 |
| Residential real estate | 283,285 | 276,776 | 275,343 | 276,904 | 273,607 |
| Consumer | 71,020 | 67,109 | 66,674 | 64,879 | 61,277 |
| **Total** | **$ 1,176,622** | **$ 1,144,832** | **$ 1,128,707** | **$ 1,139,930** | **$ 1,151,756** |

While competition for commercial loan opportunities continues to be strong, we experienced growth in this segment of the portfolio during the last 12 months. While the commercial loan portfolio declined during the last half of 2018, we experienced growth in the first half of 2019 and expect this growth to continue during the remainder of 2019. The decline in the third quarter of 2018 was largely related to an expected payoff from one customer. Despite a decline in agricultural loans during the last three quarters, we expect modest change in the agricultural portfolio in 2019. Residential real estate and consumer loans have experienced growth over the last year and this trend is expected to continue to increase during the remainder of 2019.

The following table outlines the changes in deposits:

| | June 30 2019 | December 31 2018 | $ Change | % Change (unannualized) |
|---|---|---|---|---|
| Noninterest bearing demand deposits | $ 244,240 | $ 236,534 | $ 7,706 | 3.26 % |
| Interest bearing demand deposits | 228,704 | 235,287 | (6,583) | (2.80)% |
| Savings deposits | 378,988 | 387,252 | (8,264) | (2.13)% |
| Certificates of deposit | 359,945 | 358,127 | 1,818 | 0.51 % |
| Brokered certificates of deposit | 57,773 | 62,148 | (4,375) | (7.04)% |
| Internet certificates of deposit | 11,768 | 13,345 | (1,577) | (11.82)% |
| **Total** | **$ 1,281,418** | **$ 1,292,693** | **$ (11,275)** | **(0.87)%** |

The following table displays deposit balances as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Noninterest bearing demand deposits | $ 244,240 | $ 229,865 | $ 236,534 | $ 229,269 | $ 234,377 |
| Interest bearing demand deposits | 228,704 | 236,997 | 235,287 | 235,529 | 222,678 |
| Savings deposits | 378,988 | 385,617 | 387,252 | 359,720 | 364,387 |
| Certificates of deposit | 359,945 | 361,716 | 358,127 | 353,974 | 352,147 |
| Brokered certificates of deposit | 57,773 | 50,273 | 62,148 | 84,720 | 86,834 |
| Internet certificates of deposit | 11,768 | 13,495 | 13,345 | 13,594 | 14,339 |
| **Total** | **$ 1,281,418** | **$ 1,277,963** | **$ 1,292,693** | **$ 1,276,806** | **$ 1,274,762** |

In the past 12 months, we experienced growth in non-contractual deposits, such as demand and savings deposits. We also experienced growth in certificates of deposit over the past year. Brokered certificates of deposit offer another source of funding and may fluctuate from period-to-period based on our funding needs, including changes in assets such as loans and investments. In recent periods, we used excess liquidity to reduce high-cost deposits.

The primary objective of our investing activities is to provide for safety of the principal invested. Secondary considerations include the need for earnings, liquidity, and our overall exposure to changes in interest rates. The current flat yield curve encourages using excess liquidity to reduce high-cost borrowings and therefore, AFS securities balances are not expected to rise significantly in the near term. The following table displays fair values of AFS securities as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| Government sponsored enterprises | $ 160 | $ 165 | $ 170 | $ 180 | $ 190 |
| States and political subdivisions | 176,742 | 191,266 | 190,866 | 193,957 | 202,273 |
| Auction rate money market preferred | 2,849 | 2,819 | 2,554 | 3,108 | 3,135 |
| Mortgage-backed securities | 173,340 | 181,138 | 184,484 | 188,136 | 197,637 |
| Collateralized mortgage obligations | 117,358 | 119,454 | 116,760 | 115,758 | 120,873 |
| **Total** | **$ 470,449** | **$ 494,842** | **$ 494,834** | **$ 501,139** | **$ 524,108** |

Borrowed funds include FHLB advances, securities sold under agreements to repurchase, and federal funds purchased. The balance of borrowed funds fluctuates from period-to-period based on our funding needs that arise from changes in loans, investments, and deposits. The following table displays borrowed funds balances as of:

| | June 30 2019 | March 31 2019 | December 31 2018 | September 30 2018 | June 30 2018 |
|---|---|---|---|---|---|
| FHLB advances | $ 295,000 | $ 280,000 | $ 300,000 | $ 320,000 | $ 315,000 |
| Securities sold under agreements to repurchase without stated maturity dates | 25,462 | 29,824 | 40,299 | 39,776 | 31,296 |
| Federal funds purchased | — | 1,860 | — | — | 16,200 |
| **Total** | **$ 320,462** | **$ 311,684** | **$ 340,299** | **$ 359,776** | **$ 362,496** |

**Contractual Obligations and Loan Commitments**

We are party to credit related financial instruments with off-balance-sheet risk. These financial instruments are entered into in the normal course of business to meet the financing needs of our customers. These financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contractual or notional amounts of these instruments reflect the extent of involvement we have in a particular class of financial instrument.

The following table summarizes our credit related financial instruments with off-balance-sheet risk as of:

| | June 30 2019 | December 31 2018 |
|---|---|---|
| Unfunded commitments under lines of credit | $ 187,904 | $ 199,652 |
| Commitments to grant loans | 21,821 | 13,225 |
| Commercial and standby letters of credit | 1,730 | 1,723 |
| **Total** | **$ 211,455** | **$ 214,600** |

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. These commitments may expire without being drawn upon and do not necessarily represent future cash requirements. Advances to mortgage brokers are also included in unfunded commitments under lines of credit. The unfunded commitment amount is the difference between our outstanding balances and the maximum outstanding aggregate amount.

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if it is deemed necessary, is based on management’s credit evaluation of the customer. Commitments to grant loans include residential mortgage loans that may be committed to be sold to the secondary market.

Commercial and standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements, including commercial paper, bond financing, and similar transactions. These commitments to extend credit and letters of credit generally mature within one year. The credit risk involved in these transactions is essentially the same as that involved in extending loans to customers. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon the extension of credit, is based on a credit evaluation of the borrower. While we consider standby letters of credit to be guarantees, the amount of the liability related to such guarantees on the commitment date is not significant and a liability related to such guarantees is not recorded on the consolidated balance sheets.

Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are anticipated as a result of these commitments.

**Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income (loss). We are authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 104,598 shares or $2,436 of common stock during the first six months of 2019, as compared to 121,437 shares or $3,272 of common stock during the same period in 2018. We also offer the Directors Plan in which participants purchase stock units through deferred fees, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by $271 and $304 during the six month periods ended June 30, 2019 and 2018, respectively.

We have publicly announced a common stock repurchase plan. Pursuant to this plan, we repurchased 57,073 shares or $1,339 of common stock during the first six months of 2019 and 45,480 shares or $1,238 during the first six months of 2018. As of June 30, 2019, we were authorized to repurchase up to an additional 110,582 shares of common stock.

The FRB has established minimum risk based capital guidelines. Pursuant to these guidelines, a framework has been established that assigns risk weights to each category of on and off-balance-sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. On July 2, 2013, the FRB published revised BASEL III Capital standards for banks. The final rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital conservation buffer. The rules, which are being gradually phased in between 2015 and 2019, are not expected to have a material impact on the Corporation but will require us to hold more capital than has historically been required.

Effective January 1, 2015, the minimum standard for primary, or Tier 1 capital, increased from 4.00% to 6.00%. The minimum standard for total capital is 8.00%. Also effective January 1, 2015 was the new common equity tier 1 capital ratio which had a minimum requirement of 4.50%. Beginning on January 1, 2016 the capital conservation buffer went into effect which increases the required levels each year through 2019. The following table sets forth the minimum percentages required under the Risk Based Capital guidelines and our ratios as of:

| | June 30, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Actual | Minimum Required | Actual | Minimum Required |
| Common equity tier 1 capital | 12.43% | 7.00% | 12.58% | 6.375% |
| Tier 1 capital | 12.43% | 8.50% | 12.58% | 7.875% |
| Total capital | 13.06% | 10.50% | 13.26% | 9.875% |

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.00%. Our primary capital to adjusted average assets, or tier 1 leverage ratio, was 9.03% as of June 30, 2019. At June 30, 2019, all regulatory capital ratios for the Bank exceeded the minimum thresholds to be considered a "well capitalized" institution.

**Fair Value**

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. AFS securities, cash flow hedge derivative instruments and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time-to-time, we may be required to record at fair value other assets on a nonrecurring basis, such as mortgage loans AFS, impaired loans, goodwill, foreclosed assets, OMSR, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write downs of individual assets.

For further information regarding fair value measurements see “Note 12 – Fair Value” of our interim condensed consolidated financial statements.

**Liquidity**

Liquidity is monitored regularly by our Market Risk Committee, which consists of members of senior management. The committee reviews projected cash flows, key ratios, and liquidity available from both primary and secondary sources.

Our primary sources of liquidity are cash and cash equivalents and unencumbered AFS securities. These categories totaled $254,960 or 13.97% of assets as of June 30, 2019, compared to $256,583 or 13.93% as of December 31, 2018. The increase in the percentage of primary liquidity is a direct result of our unencumbered AFS securities' maturity and principal payment activity during 2019. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity could vary significantly daily, based on customer activity.

Deposit accounts are our primary source of funds. Our secondary sources include the ability to borrow from the FHLB, from the FRB, and through various correspondent banks in the form of federal funds purchased and a line of credit. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB advances, FRB Discount Window advances, and repurchase agreements, require us to pledge assets, typically in the form of AFS securities or loans, as collateral. As of June 30, 2019, we had available lines of credit of $153,006.

The following table summarizes our sources and uses of cash for the six month period ended June 30:

| | 2019 | 2018 | $ Variance |
|---|---|---|---|
| Net cash provided by (used in) operating activities | $ 12,112 | $ 11,605 | $ 507 |
| Net cash provided by (used in) investing activities | (14,697) | (45,095) | 30,398 |
| Net cash provided by (used in) financing activities | (34,924) | 24,855 | (59,779) |
| Increase (decrease) in cash and cash equivalents | (37,509) | (8,635) | (28,874) |
| Cash and cash equivalents January 1 | 73,471 | 30,848 | 42,623 |
| **Cash and cash equivalents June 30** | **$ 35,962** | **$ 22,213** | **$ 13,749** |

**Market Risk**

Our primary market risks are interest rate risk and liquidity risk. IRR is the exposure of our net interest income to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. IRR is the fundamental method by which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to our earnings and capital.

The FRB has adopted a policy requiring us to effectively manage the various risks that can have a material impact on our safety and soundness. The risks include credit, interest rate, liquidity, operational, and reputational. We have policies, procedures, and internal controls for measuring and managing these risks. Specifically, our Funds Management policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long-term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to our Board.

The primary technique to measure IRR is simulation analysis. Simulation analysis forecasts the effects on the balance sheet structure and net interest income under a variety of scenarios that incorporate changes in interest rates, the shape of yield curves, interest rate relationships, loan prepayments, and funding sources. These forecasts are compared against net interest income projected in a stable interest rate environment. While many assets and liabilities reprice either at maturity or in accordance with their contractual terms, several balance sheet components demonstrate characteristics that require an evaluation to more accurately reflect their repricing behavior. Key assumptions in the simulation analysis include prepayments on loans, probable calls of investment securities, changes in market conditions, loan volumes and loan pricing, deposit sensitivity, and customer preferences. These assumptions are inherently uncertain as they are subject to fluctuation and revision in a dynamic rate environment. As a result, the simulation analysis cannot precisely forecast the impact of rising and falling interest rates on net interest income. Actual results will differ from simulated results due to many other factors, including changes in balance sheet components, interest rate changes, changes in market conditions, and management strategies.

Our interest rate sensitivity is estimated by first forecasting the next 12 and 24 months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At June 30, 2019, we projected the change in net interest income during the next 12 and 24 months assuming market interest rates were to immediately decrease by 100 and 200 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. These projections were based on our assets and liabilities remaining static over the next 12 and 24 months, while factoring in probable calls and prepayments of certain investment securities and residential real estate and consumer loans. While it is extremely unlikely that interest rates would immediately increase to these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our projected net interest income sensitivity to ensure that it remains within established limits. As of June 30, 2019, our interest rate sensitivity results were within Board approved limits.

The following tables summarize our interest rate sensitivity for the next 12 and 24 months as of:

| | June 30, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | 12 Months | | | | | |
| Immediate basis point change assumption (short-term) | -200 | -100 | +100 | +200 | +300 | +400 |
| Percent change in net interest income vs. constant rates | (4.05)% | (3.22)% | 3.34% | 6.78% | 10.51% | 13.75% |
| | 24 Months | | | | | |
| Immediate basis point change assumption (short-term) | -200 | -100 | +100 | +200 | +300 | +400 |
| Percent change in net interest income vs. constant rates | (4.20)% | (3.98)% | 4.43% | 8.68% | 13.06% | 16.51% |

| | December 31, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | 12 Months | | | | | |
| Immediate basis point change assumption (short-term) | -200 | -100 | +100 | +200 | +300 | +400 |
| Percent change in net interest income vs. constant rates | (4.90)% | (2.85)% | 1.06% | 2.67% | 5.15% | 6.22% |
| | 24 Months | | | | | |
| Immediate basis point change assumption (short-term) | -200 | -100 | +100 | +200 | +300 | +400 |
| Percent change in net interest income vs. constant rates | (6.76)% | (4.04)% | 1.83% | 3.82% | 6.53% | 6.54% |

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of June 30, 2019 and December 31, 2018. The principal amounts of investments, loans, other interest earning assets, borrowings, and time deposits maturing were calculated based on the contractual maturity dates. Fair values for loans do not reflect the exit price notion as previously disclosed. Estimated cash flows for savings and NOW accounts are based on our estimated deposit decay rates.

| | June 30, 2019 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2020 | 2021 | 2022 | 2023 | 2024 | Thereafter | Total | Fair Value |
| Rate sensitive assets | | | | | | | | |
| Other interest bearing assets | $ 14,027 | $ — | $ — | $ — | $ — | $ — | $ 14,027 | $ 14,027 |
| Average interest rates | 2.21% | —% | —% | —% | —% | —% | 2.21% | |
| AFS securities | $ 102,527 | $ 74,065 | $ 66,872 | $ 73,695 | $ 36,504 | $ 116,786 | $ 470,449 | $ 470,449 |
| Average interest rates | 2.13% | 2.50% | 2.42% | 2.48% | 2.49% | 2.55% | 2.42% | |
| Fixed interest rate loans [1] | $ 184,710 | $ 128,555 | $ 134,304 | $ 120,605 | $ 95,374 | $ 165,426 | $ 828,974 | $ 807,946 |
| Average interest rates | 4.19% | 4.46% | 4.43% | 4.53% | 4.38% | 4.23% | 4.35% | |
| Variable interest rate loans [1] | $ 62,522 | $ 38,689 | $ 54,831 | $ 23,449 | $ 21,807 | $ 146,350 | $ 347,648 | $ 340,782 |
| Average interest rates | 6.37% | 5.75% | 5.85% | 5.24% | 4.95% | 4.55% | 5.29% | |
| Rate sensitive liabilities | | | | | | | | |
| Fixed rate borrowed funds | $ 115,462 | $ 25,000 | $ 50,000 | $ 40,000 | $ 60,000 | $ 20,000 | $ 310,462 | $ 311,462 |
| Average interest rates | 1.65% | 1.54% | 2.07% | 2.72% | 2.70% | 2.06% | 2.07% | |
| Variable rate borrowed funds | $ — | $ 10,000 | $ — | $ — | $ — | $ — | $ 10,000 | $ 10,021 |
| Average interest rates | —% | 2.82% | —% | —% | —% | —% | 2.82% | |
| Savings and NOW accounts | $ 53,890 | $ 49,036 | $ 43,961 | $ 39,447 | $ 35,431 | $ 385,927 | $ 607,692 | $ 607,692 |
| Average interest rates | 0.50% | 0.49% | 0.48% | 0.48% | 0.47% | 0.44% | 0.46% | |
| Fixed interest rate certificates of deposit | $ 204,994 | $ 80,256 | $ 78,121 | $ 30,856 | $ 26,157 | $ 3,776 | $ 424,160 | $ 424,062 |
| Average interest rates | 1.90% | 2.15% | 2.37% | 2.17% | 2.39% | 2.03% | 2.09% | |
| Variable interest rate certificates of deposit | $ 4,068 | $ 1,258 | $ — | $ — | $ — | $ — | $ 5,326 | $ 5,299 |
| Average interest rates | 1.72% | 1.54% | —% | —% | —% | —% | 1.68% | |

[1] The fair value reported is exclusive of the allocation of the ALLL.

| | December 31, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2022 | 2023 | Thereafter | Total | Fair Value |
| Rate sensitive assets | | | | | | | | |
| Other interest bearing assets | $ 49,837 | $ 100 | $ — | $ — | $ — | $ — | $ 49,937 | $ 49,937 |
| Average interest rates | 1.85% | 1.72% | —% | —% | —% | —% | 1.85% | |
| AFS securities | $ 84,691 | $ 77,165 | $ 70,081 | $ 70,033 | $ 59,541 | $ 133,323 | $ 494,834 | $ 494,834 |
| Average interest rates | 2.49% | 2.62% | 2.60% | 2.43% | 2.52% | 2.75% | 2.59% | |
| Fixed interest rate loans (1) | $ 152,336 | $ 118,585 | $ 142,107 | $ 113,587 | $ 119,069 | $ 188,082 | $ 833,766 | $ 792,394 |
| Average interest rates | 4.44% | 4.37% | 4.34% | 4.46% | 4.49% | 4.23% | 4.38% | |
| Variable interest rate loans (1) | $ 70,336 | $ 30,855 | $ 42,968 | $ 22,766 | $ 18,685 | $ 109,331 | $ 294,941 | $ 287,196 |
| Average interest rates | 6.14% | 5.75% | 5.76% | 5.22% | 5.01% | 4.16% | 5.16% | |
| Rate sensitive liabilities | | | | | | | | |
| Fixed rate borrowed funds | $ 140,299 | $ 55,000 | $ 50,000 | $ 20,000 | $ 35,000 | $ 30,000 | $ 330,299 | $ 323,903 |
| Average interest rates | 1.41% | 2.18% | 1.91% | 1.97% | 3.17% | 2.36% | 1.92% | |
| Variable rate borrowed funds | $ — | $ — | $ 10,000 | $ — | $ — | $ — | $ 10,000 | $ 9,926 |
| Average interest rates | —% | —% | 2.62% | —% | —% | —% | 2.62% | |
| Savings and NOW accounts | $ 55,248 | $ 49,944 | $ 44,783 | $ 40,191 | $ 36,105 | $ 396,268 | $ 622,539 | $ 622,539 |
| Average interest rates | 0.52% | 0.51% | 0.50% | 0.50% | 0.49% | 0.44% | 0.46% | |
| Fixed interest rate certificates of deposit | $ 227,451 | $ 54,051 | $ 65,036 | $ 41,502 | $ 31,714 | $ 6,968 | $ 426,722 | $ 419,116 |
| Average interest rates | 1.63% | 1.90% | 2.09% | 1.99% | 2.23% | 2.14% | 1.82% | |
| Variable interest rate certificates of deposit | $ 4,898 | $ 2,000 | $ — | $ — | $ — | $ — | $ 6,898 | $ 6,877 |
| Average interest rates | 2.32% | 2.61% | —% | —% | —% | —% | 2.40% | |

(1) The fair value reported is exclusive of the allocation of the ALLL.

We do not believe there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. We do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term and we do not expect to make material changes to our market risk methods in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

The information presented in the section captioned “Market Risk” in Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

**Item 4. Controls and Procedures.**

**DISCLOSURE CONTROLS AND PROCEDURES**

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of June 30, 2019, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of June 30, 2019, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

During the most recent fiscal quarter, no change occurred in our internal control over financial reporting that materially affected, or is likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

**Item 1. Legal Proceedings.**

We are not involved in any material legal proceedings. We are involved in ordinary, routine litigation incidental to our business; however, no such routine proceedings are expected to result in any material adverse effect on operations, earnings, financial condition, or cash flows.

**Item 1A. Risk Factors.**

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2018.

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

**(A) None**

**(B) None**

**(C) Repurchases of Common Stock**

We have adopted and publicly announced a common stock repurchase plan. The plan was last amended on August 22, 2018, to allow for the repurchase of an additional 200,000 shares of common stock after that date. These authorizations do not have expiration dates. As common shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued common shares.

The following table provides information for the three month period ended June 30, 2019, with respect to this plan:

| | Common Shares Repurchased | | Total Number of Common Shares Purchased as Part of Publicly Announced Plan or Program | Maximum Number of Common Shares That May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| | Number | Average Price Per Common Share | | |
| Balance, March 31 | | | | 141,358 |
| April 1 - 30 | 2,096 | $ 23.38 | 2,096 | 139,262 |
| May 1 - 31 | 3,038 | 22.71 | 3,038 | 136,224 |
| June 1 - 30 | 25,642 | 22.97 | 25,642 | 110,582 |
| **Balance, June 30** | **30,776** | **$ 22.97** | **30,776** | **110,582** |

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Item 5. Other Information.**

Not applicable.

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**Item 6. Exhibits.**

(a) Exhibits

| Exhibit Number | Exhibits |
| --- | --- |
| 31(a) | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer |
| 31(b) | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer |
| 32 | Section 1350 Certification of Principal Executive Officer and Principal Financial Officer |
| 101.1* | 101.INS (XBRL Instance Document) |
| | 101.SCH (XBRL Taxonomy Extension Schema Document) |
| | 101.CAL (XBRL Calculation Linkbase Document) |
| | 101.LAB (XBRL Taxonomy Label Linkbase Document) |
| | 101.DEF (XBRL Taxonomy Linkbase Document) |
| | 101.PRE (XBRL Taxonomy Presentation Linkbase Document) |

*In accordance with Rule 406T of Regulations S-T, the XBRL related information shall not be deemed to be “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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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.

Isabella Bank Corporation

Date: August 7, 2019

/s/ Jae A. Evans
Jae A. Evans
President, Chief Executive Officer
(Principal Executive Officer)

Date: August 7, 2019

/s/ Neil M. McDonnell
Neil M. McDonnell
Chief Financial Officer
(Principal Financial Officer)



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# Section 2: EX-31.A (EXHIBIT 31.A)

**Exhibit 31(a)**

I, Jae A. Evans, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Isabella Bank Corporation (the “registrant”).

2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report.

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Quarterly Report.

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;

   b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles;

   c) evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over

financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

| | |
|---|---|
| Date: August 7, 2019 | /s/ Jae A. Evans |
| | President, Chief Executive Officer |
| | (Principal Executive Officer) |

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# Section 3: EX-31.B (EXHIBIT 31.B)

**Exhibit 31(b)**

I, Neil M. McDonnell, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Isabella Bank Corporation (the "registrant").

2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report.

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Quarterly Report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;

   b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles;

   c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2019

/s/ Neil M. McDonnell
Chief Financial Officer
(Principal Financial Officer)

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# Section 4: EX-32 (EXHIBIT 32)

**Exhibit 32**

**CERTIFICATION PURSUANT TO**
**18 U.S.C. SECTION 1350,**
**AS ADOPTED PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Isabella Bank Corporation (the “Corporation”) on Form 10-Q for the quarterly period ended June 30, 2019 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), Jae A. Evans, President and Chief Executive Officer and Neil M. McDonnell, Chief Financial Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the consolidated financial condition and results of operations of the Corporation.

/s/ Jae A. Evans
President, Chief Executive Officer
(Principal Executive Officer)
August 7, 2019

/s/ Neil M. McDonnell
Chief Financial Officer
(Principal Financial Officer)
August 7, 2019

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