

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

Commission file number 0-7818

INDEPENDENT BANK CORPORATION

(Exact name of registrant as specified in its charter)

Michigan

(State or jurisdiction of Incorporation or Organization)

38-2032782

(I.R.S. Employer Identification Number)

4200 East Beltline, Grand Rapids, Michigan 49525

(Address of principal executive offices)

(616) 527-5820

(Registrant's telephone number, including area code)

NONE

Former name, address and fiscal year, if changed since last report.

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

| Title of each Class | Trading Symbol | Name of each exchange which registered |
|----------------------------|----------------|--|
| Common stock, no par value | IBCP | The Nasdaq Stock Market, LLC |

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

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

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

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: common stock, no par value, 22,499,498 as of August 1, 2019.

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

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FORWARD-LOOKING STATEMENTS

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

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

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all-inclusive. The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2018, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

Part I - Item 1.

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Financial Condition

| | June 30, 2019 | December 31, 2018 |
|--|---|----------------------|
| | (unaudited) | |
| | (In thousands, except share amounts) | |
| Assets | | |
| Cash and due from banks | \$ 34,461 | \$ 23,350 |
| Interest bearing deposits | 20,676 | 46,894 |
| | Cash and Cash Equivalents 55,137 | 70,244 |
| Interest bearing deposits - time | 498 | 595 |
| Equity securities at fair value | - | 393 |
| Securities available for sale | 430,305 | 427,926 |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 18,359 | 18,359 |
| Loans held for sale, carried at fair value | 62,883 | 44,753 |
| Loans held for sale, carried at lower of cost or fair value | - | 41,471 |
| Loans | | |
| Commercial | 1,175,970 | 1,144,481 |
| Mortgage | 1,086,309 | 1,042,890 |
| Installment | 444,247 | 395,149 |
| | Total Loans 2,706,526 | 2,582,520 |
| Allowance for loan losses | (25,903) | (24,888) |
| | Net Loans 2,680,623 | 2,557,632 |
| Other real estate and repossessed assets, net | 1,990 | 1,299 |
| Property and equipment, net | 37,703 | 38,777 |
| Bank-owned life insurance | 55,580 | 55,068 |
| Deferred tax assets, net | 2,746 | 5,779 |
| Capitalized mortgage loan servicing rights, carried at fair value | 17,894 | 21,400 |
| Other intangibles | 5,870 | 6,415 |
| Goodwill | 28,300 | 28,300 |
| Accrued income and other assets | 40,414 | 34,870 |
| | Total Assets \$ 3,438,302 | \$ 3,353,281 |
| Liabilities and Shareholders' Equity | | |
| Deposits | | |
| Non-interest bearing | \$ 864,481 | \$ 879,549 |
| Savings and interest-bearing checking | 1,158,910 | 1,194,865 |
| Reciprocal | 326,326 | 182,072 |
| Time | 384,477 | 385,981 |
| Brokered time | 244,691 | 270,961 |
| | Total Deposits 2,978,885 | 2,913,428 |
| Other borrowings | 41,144 | 25,700 |
| Subordinated debentures | 39,422 | 39,388 |
| Accrued expenses and other liabilities | 48,005 | 35,771 |
| | Total Liabilities 3,107,456 | 3,014,287 |
| Commitments and contingent liabilities | | |
| Shareholders' Equity | | |
| Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding | - | - |
| Common stock, no par value, 500,000,000 shares authorized; issued and outstanding: 22,498,776 shares at June 30, 2019 and 23,579,725 shares at December 31, 2018 | 351,894 | 377,372 |
| Accumulated deficit | (16,617) | (28,270) |
| Accumulated other comprehensive loss | (4,431) | (10,108) |
| | Total Shareholders' Equity 330,846 | 338,994 |
| | Total Liabilities and Shareholders' Equity \$ 3,438,302 | \$ 3,353,281 |

See notes to interim condensed consolidated financial statements (unaudited)

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Operations

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--|-----------------|------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (unaudited) | | (unaudited) | |
| | (In thousands, except per share amounts) | | | |
| Interest Income | | | | |
| Interest and fees on loans | \$ 33,836 | \$ 29,674 | \$ 66,517 | \$ 53,027 |
| Interest on securities | | | | |
| Taxable | 3,034 | 2,720 | 6,040 | 5,355 |
| Tax-exempt | 324 | 444 | 698 | 923 |
| Other investments | 379 | 265 | 954 | 595 |
| Total Interest Income | <u>37,573</u> | <u>33,103</u> | <u>74,209</u> | <u>59,900</u> |
| Interest Expense | | | | |
| Deposits | 6,021 | 3,209 | 11,702 | 5,496 |
| Other borrowings and subordinated debentures | 796 | 914 | 1,508 | 1,488 |
| Total Interest Expense | <u>6,817</u> | <u>4,123</u> | <u>13,210</u> | <u>6,984</u> |
| Net Interest Income | <u>30,756</u> | <u>28,980</u> | <u>60,999</u> | <u>52,916</u> |
| Provision for loan losses | 652 | 650 | 1,316 | 965 |
| Net Interest Income After Provision for Loan Losses | <u>30,104</u> | <u>28,330</u> | <u>59,683</u> | <u>51,951</u> |
| Non-interest Income | | | | |
| Service charges on deposit accounts | 2,800 | 3,095 | 5,440 | 6,000 |
| Interchange income | 2,604 | 2,504 | 4,959 | 4,750 |
| Net gains (losses) on assets | | | | |
| Mortgage loans | 4,302 | 3,255 | 7,913 | 5,826 |
| Securities | - | 9 | 304 | (164) |
| Mortgage loan servicing, net | (1,907) | 1,235 | (3,122) | 3,456 |
| Other | 2,106 | 2,217 | 4,370 | 4,160 |
| Total Non-interest Income | <u>9,905</u> | <u>12,315</u> | <u>19,864</u> | <u>24,028</u> |
| Non-interest Expense | | | | |
| Compensation and employee benefits | 15,931 | 15,869 | 32,282 | 30,337 |
| Occupancy, net | 2,131 | 2,170 | 4,636 | 4,434 |
| Data processing | 2,171 | 2,251 | 4,315 | 4,129 |
| Furniture, fixtures and equipment | 1,006 | 1,019 | 2,035 | 1,986 |
| Communications | 717 | 704 | 1,486 | 1,384 |
| Interchange expense | 753 | 661 | 1,441 | 1,259 |
| Loan and collection | 628 | 692 | 1,262 | 1,369 |
| Advertising | 627 | 543 | 1,299 | 984 |
| Legal and professional | 371 | 456 | 740 | 834 |
| FDIC deposit insurance | 342 | 250 | 710 | 480 |
| Merger related expenses | - | 3,082 | - | 3,256 |
| Other | 1,915 | 2,064 | 4,376 | 3,444 |
| Total Non-interest Expense | <u>26,592</u> | <u>29,761</u> | <u>54,582</u> | <u>53,896</u> |
| Income Before Income Tax | <u>13,417</u> | <u>10,884</u> | <u>24,965</u> | <u>22,083</u> |
| Income tax expense | 2,687 | 2,067 | 4,854 | 4,105 |
| Net Income | <u>\$ 10,730</u> | <u>\$ 8,817</u> | <u>\$ 20,111</u> | <u>\$ 17,978</u> |
| Net Income Per Common Share | | | | |
| Basic | <u>\$ 0.47</u> | <u>\$ 0.37</u> | <u>\$ 0.86</u> | <u>\$ 0.79</u> |
| Diluted | <u>\$ 0.46</u> | <u>\$ 0.36</u> | <u>\$ 0.85</u> | <u>\$ 0.78</u> |

See notes to interim condensed consolidated financial statements (unaudited)

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Comprehensive Income

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|----------|------------------------------|-----------|
| | 2019 | 2018 | 2019 | 2018 |
| | (unaudited - In thousands) | | | |
| Net income | \$ 10,730 | \$ 8,817 | \$ 20,111 | \$ 17,978 |
| Other comprehensive income (loss) | | | | |
| Securities available for sale | | | | |
| Unrealized gains (losses) arising during period | 3,920 | (1,198) | 9,284 | (5,063) |
| Change in unrealized losses for which a portion of other than temporary impairment has been recognized in earnings | - | (2) | (2) | (3) |
| Reclassification adjustments for (gains) losses included in earnings | - | 26 | (137) | 45 |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale | 3,920 | (1,174) | 9,145 | (5,021) |
| Income tax expense (benefit) | 823 | (246) | 1,920 | (1,054) |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale, net of tax | 3,097 | (928) | 7,225 | (3,967) |
| Derivative instruments | | | | |
| Unrealized gain (loss) arising during period | (756) | 327 | (1,668) | 1,011 |
| Reclassification adjustment for income recognized in earnings | (142) | (53) | (291) | (59) |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on derivative instruments | (898) | 274 | (1,959) | 952 |
| Income tax expense (benefit) | (187) | 58 | (411) | 200 |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on derivative instruments, net of tax | (711) | 216 | (1,548) | 752 |
| Other comprehensive income (loss) | 2,386 | (712) | 5,677 | (3,215) |
| Comprehensive income | \$ 13,116 | \$ 8,105 | \$ 25,788 | \$ 14,763 |

See notes to interim condensed consolidated financial statements (unaudited)

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows

| | Six months ended June 30, | |
|---|----------------------------|-------------|
| | 2019 | 2018 |
| | (unaudited - In thousands) | |
| Net Income | \$ 20,111 | \$ 17,978 |
| Adjustments to Reconcile Net Income to Net Cash From Operating Activities | | |
| Proceeds from the sale of equity securities at fair value | 560 | - |
| Proceeds from sales of loans held for sale | 222,953 | 210,641 |
| Disbursements for loans held for sale | (233,170) | (214,952) |
| Provision for loan losses | 1,316 | 965 |
| Deferred income tax expense | 1,524 | 4,518 |
| Deferred loan fees and costs | (1,947) | (2,457) |
| Net depreciation, amortization of intangible assets and premiums and accretion of discounts on securities, loans and interest bearing deposits - time | 2,906 | 3,192 |
| Net gains on mortgage loans | (7,913) | (5,826) |
| Net (gains) losses on securities | (304) | 164 |
| Share based compensation | 888 | 848 |
| Increase in accrued income and other assets | (3,112) | (3,377) |
| Increase in accrued expenses and other liabilities | 10,125 | 1,604 |
| Total Adjustments | (6,174) | (4,680) |
| Net Cash From Operating Activities | 13,937 | 13,298 |
| Cash Flow Used in Investing Activities | | |
| Proceeds from the sale of securities available for sale | 42,236 | 31,445 |
| Proceeds from maturities, prepayments and calls of securities available for sale | 76,579 | 88,131 |
| Purchases of securities available for sale | (81,639) | (47,054) |
| Proceeds from the sale of interest bearing deposits - time | - | 2,474 |
| Proceeds from the maturity of interest bearing deposits - time | 100 | 1,842 |
| Net increase in portfolio loans (loans originated, net of principal payments) | (152,256) | (181,365) |
| Proceeds from the sale of portfolio loans | 40,630 | 16,460 |
| Acquisition of TCSB Bancorp Inc., less cash received | - | 23,516 |
| Proceeds from bank-owned life insurance | - | 474 |
| Proceeds from the sale of other real estate and repossessed assets | 808 | 889 |
| Capital expenditures | (1,542) | (2,033) |
| Net Cash Used in Investing Activities | (75,084) | (65,221) |
| Cash Flow From Financing Activities | | |
| Net increase in total deposits | 65,457 | 92,273 |
| Net increase (decrease) in other borrowings | 550 | (3,093) |
| Proceeds from Federal Home Loan Bank Advances | 27,000 | 1,044,000 |
| Payments of Federal Home Loan Bank Advances | (12,143) | (1,069,287) |
| Dividends paid | (8,458) | (6,823) |
| Proceeds from issuance of common stock | 282 | 147 |
| Repurchase of common stock | (25,782) | - |
| Share based compensation withholding obligation | (866) | (1,321) |
| Net Cash From Financing Activities | 46,040 | 55,896 |
| Net Increase (Decrease) in Cash and Cash Equivalents | (15,107) | 3,973 |
| Cash and Cash Equivalents at Beginning of Period | 70,244 | 54,738 |
| Cash and Cash Equivalents at End of Period | \$ 55,137 | \$ 58,711 |
| Cash paid during the period for | | |
| Interest | \$ 13,188 | \$ 6,545 |
| Income taxes | 2,457 | 120 |
| Operating leases | 1,127 | - |
| Transfers to other real estate and repossessed assets | 1,420 | 641 |
| Purchase of securities available for sale not yet settled | 645 | - |
| Securitization of portfolio loans | 29,790 | - |
| Right of use assets obtained in exchange for lease obligations | 7,703 | - |
| Transfer of loans to held for sale | - | 13,216 |

See notes to interim condensed consolidated financial statements (unaudited)

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Shareholders' Equity

| | Common Stock | Accumulated Deficit | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|--|-------------------|------------------------|---|----------------------------------|
| (Dollars in thousands, except per share amounts) | | | | |
| Balances at April 1, 2019 | \$ 374,678 | \$ (23,135) | \$ (6,817) | \$ 344,726 |
| Net income, three months ended June 30, 2019 | - | 10,730 | - | 10,730 |
| Cash dividends declared, \$.18 per share | - | (4,212) | - | (4,212) |
| Repurchase of 1,063,901 shares of common stock | (23,252) | - | - | (23,252) |
| Share based compensation (issuance of 2,498 shares of common stock) | 468 | - | - | 468 |
| Other comprehensive income | - | - | 2,386 | 2,386 |
| Balances at June 30, 2019 | <u>\$ 351,894</u> | <u>\$ (16,617)</u> | <u>\$ (4,431)</u> | <u>\$ 330,846</u> |
| Balances at April 1, 2018 | \$ 324,518 | \$ (48,099) | \$ (8,502) | \$ 267,917 |
| Net income, three months ended June 30, 2018 | - | 8,817 | - | 8,817 |
| Cash dividends declared, \$.15 per share | - | (3,617) | - | (3,617) |
| Acquisition of TCSB Bancorp, Inc. | 64,536 | - | - | 64,536 |
| Issuance of 101,408 shares of common stock | 134 | - | - | 134 |
| Share based compensation (issuance of 7,444 shares of common stock) | 441 | - | - | 441 |
| Share based compensation withholding obligation (withholding of 50,057 shares of common stock) | (433) | - | - | (433) |
| Other comprehensive loss | - | - | (712) | (712) |
| Balances at June 30, 2018 | <u>\$ 389,196</u> | <u>\$ (42,899)</u> | <u>\$ (9,214)</u> | <u>\$ 337,083</u> |
| Balances at January 1, 2019 | \$ 377,372 | \$ (28,270) | \$ (10,108) | \$ 338,994 |
| Net income, six months ended June 30, 2019 | - | 20,111 | - | 20,111 |
| Cash dividends declared, \$.36 per share | - | (8,458) | - | (8,458) |
| Repurchase of 1,179,688 shares of common stock | (25,782) | - | - | (25,782) |
| Issuance of 68,399 shares of common stock | 282 | - | - | 282 |
| Share based compensation (issuance of 86,626 shares of common stock) | 888 | - | - | 888 |
| Share based compensation withholding obligation (withholding of 56,286 shares of common stock) | (866) | - | - | (866) |
| Other comprehensive income | - | - | 5,677 | 5,677 |
| Balances at June 30, 2019 | <u>\$ 351,894</u> | <u>\$ (16,617)</u> | <u>\$ (4,431)</u> | <u>\$ 330,846</u> |
| Balances at January 1, 2018 | \$ 324,986 | \$ (54,054) | \$ (5,999) | \$ 264,933 |
| Net income, six months ended June 30, 2018 | - | 17,978 | - | 17,978 |
| Cash dividends declared, \$.30 per share | - | (6,823) | - | (6,823) |
| Acquisition of TCSB Bancorp, Inc. | 64,536 | - | - | 64,536 |
| Issuance of 105,208 shares of common stock | 147 | - | - | 147 |
| Share based compensation (issuance of 81,919 shares of common stock) | 848 | - | - | 848 |
| Share based compensation withholding obligation (withholding of 87,385 shares of common stock) | (1,321) | - | - | (1,321) |
| Other comprehensive loss | - | - | (3,215) | (3,215) |
| Balances at June 30, 2018 | <u>\$ 389,196</u> | <u>\$ (42,899)</u> | <u>\$ (9,214)</u> | <u>\$ 337,083</u> |

See notes to interim condensed consolidated financial statements (unaudited)

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Preparation of Financial Statements

The condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2018 included in our Annual Report on Form 10-K.

In our opinion, the accompanying unaudited condensed consolidated financial statements contain all the adjustments necessary to present fairly our consolidated financial condition as of June 30, 2019 and December 31, 2018, and the results of operations for the three and six-month periods ended June 30, 2019 and 2018. The results of operations for the three and six-month periods ended June 30, 2019, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the determination of the allowance for loan losses and the valuation of capitalized mortgage loan servicing rights. Refer to our 2018 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In June 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-13, “Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments”. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU:

- Replaces the existing incurred loss impairment guidance and establishes a single allowance framework for financial assets carried at amortized cost, which will reflect our estimate of credit losses over the full remaining expected life of the financial assets and will consider expected future changes in macroeconomic conditions.
- Eliminates existing guidance for purchase credit impaired (“PCI”) loans, and requires recognition of the nonaccretable difference as an increase to the allowance for expected credit losses on financial assets purchased with more than insignificant credit deterioration since origination, which will be offset by an increase in the recorded investment of the related loans.
- Requires inclusion of expected recoveries, limited to the cumulative amount of prior write-offs, when estimating the allowance for credit losses for in scope financial assets (including collateral dependent assets).
- Amends existing impairment guidance for securities available for sale to incorporate an allowance, which will allow for reversals of credit impairments in the event that the credit of an issuer improves. Credit losses on securities available for sale are limited to the amount of the decline in fair value regardless of what the credit loss model would show for impairment.
- Generally requires a cumulative-effect adjustment to retained earnings as of the beginning of the reporting period of adoption.
- Is effective for us on January 1, 2020.

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

We began evaluating this ASU in 2016 and established a company-wide, cross-discipline governance structure, which provides implementation oversight. We continue to test and refine our current expected credit loss models that satisfy the requirements of this ASU. Oversight and testing, as well as efforts to meet expanded disclosure requirements, will extend through the remainder of 2019. We expect that the allowance related to our loans will increase as it will cover credit losses over the full remaining expected life of the portfolio. We currently intend to estimate losses over approximately a two year forecast period using the Federal Open Market Committee median economic projections (which are typically published in March of each year) as well as considering other economic forecast sources, and then revert to longer term historical loss experience to estimate losses over more extended periods. We currently expect the increase in the allowance for loan losses to be in the range of \$9.5 million to \$11.5 million, primarily driven by the longer contractual maturities of our mortgage and consumer installment loan segments. This estimated range is based on our June 30, 2019 loan portfolio and currently available economic forecasts. The mid-point of the range utilizes a two year forecast period and a two year reversion period. This estimated range also includes a qualitative adjustment to the allowance for loan losses. In addition, we currently expect this ASU to increase the allowance for losses related to unfunded loan commitments between \$0.5 million and \$1.5 million. These estimates are subject to further refinement based on continuing reviews, testing, enhancements and approvals of models, methodologies and judgments. The ultimate impact will depend upon the nature and characteristics of our loan portfolio at the adoption date, the macroeconomic conditions and forecasts at that date, further regulatory or accounting guidance and other management judgments. We currently do not expect to record any allowance for loss on available for sale securities. The ultimate impact will depend upon the nature and characteristics of our securities available for sale (including issuer specific matters) at the adoption date, the macroeconomic conditions and forecasts at that date, and other management judgments.

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820), Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement”. This new ASU amends disclosure requirements in Topic 820 to eliminate, add and modify certain disclosure requirements for fair value measurements as part of its disclosure framework project. The amended guidance eliminates the requirements to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, the entity’s policy for the timing of transfers between levels of the fair value hierarchy and the entity’s valuation processes for Level 3 fair value measurements. The amended guidance adds the requirements to disclose the changes in unrealized gains and losses for the period included in other comprehensive income (loss) for recurring Level 3 fair value measurements of instruments held at the end of the reporting period and for recurring and nonrecurring Level 3 fair value measurements, the range and weighted average used to develop significant unobservable inputs and how the weighted average was calculated, with certain exceptions. This amended guidance is effective for us on January 1, 2020, and is not expected to have a material impact on our consolidated operating results or financial condition.

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

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)”. This ASU amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the balance sheet while recognizing expense on the income statement in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. This amended guidance was effective for us on January 1, 2019 and did not have a material impact on our consolidated operating results or financial condition. Based on our operating leases that we currently have in place we do not expect a material change in the recognition, measurement and presentation of lease expense or impact on cash flow. The primary impact was the recognition of certain operating leases on our Condensed Consolidated Statements of Financial Condition which resulted in the recording of right of use (“ROU”) assets and offsetting lease liabilities each totaling approximately \$7.7 million at January 1, 2019. See note #16.

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

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

3. Securities

Securities available for sale consist of the following:

| | Amortized Cost | Unrealized | | Fair Value |
|--|-------------------|-----------------|-----------------|-------------------|
| | | Gains | Losses | |
| (In thousands) | | | | |
| June 30, 2019 | | | | |
| U.S. agency | \$ 16,997 | \$ 200 | \$ 14 | \$ 17,183 |
| U.S. agency residential mortgage-backed | 135,853 | 1,541 | 377 | 137,017 |
| U.S. agency commercial mortgage-backed | 12,183 | 99 | 44 | 12,238 |
| Private label mortgage-backed | 29,617 | 588 | 76 | 30,129 |
| Other asset backed | 91,196 | 186 | 231 | 91,151 |
| Obligations of states and political subdivisions | 103,652 | 1,378 | 203 | 104,827 |
| Corporate | 32,964 | 929 | 11 | 33,882 |
| Trust preferred | 1,966 | - | 115 | 1,851 |
| Foreign government | 2,030 | 1 | 4 | 2,027 |
| Total | <u>\$ 426,458</u> | <u>\$ 4,922</u> | <u>\$ 1,075</u> | <u>\$ 430,305</u> |
| December 31, 2018 | | | | |
| U.S. agency | \$ 20,198 | \$ 9 | \$ 193 | \$ 20,014 |
| U.S. agency residential mortgage-backed | 124,777 | 817 | 1,843 | 123,751 |
| U.S. agency commercial mortgage-backed | 5,909 | 1 | 184 | 5,726 |
| Private label mortgage-backed | 29,735 | 321 | 637 | 29,419 |
| Other asset backed | 83,481 | 86 | 248 | 83,319 |
| Obligations of states and political subdivisions | 130,244 | 257 | 2,946 | 127,555 |
| Corporate | 34,866 | 29 | 586 | 34,309 |
| Trust preferred | 1,964 | - | 145 | 1,819 |
| Foreign government | 2,050 | - | 36 | 2,014 |
| Total | <u>\$ 433,224</u> | <u>\$ 1,520</u> | <u>\$ 6,818</u> | <u>\$ 427,926</u> |

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

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

| | Less Than Twelve Months | | Twelve Months or More | | Total | |
|--|-------------------------|-------------------|-----------------------|-------------------|-------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In thousands) | | | | | |
| June 30, 2019 | | | | | | |
| U.S. agency | \$ - | \$ - | \$ 4,427 | \$ 14 | \$ 4,427 | \$ 14 |
| U.S. agency residential mortgage-backed | 5,109 | 11 | 36,367 | 366 | 41,476 | 377 |
| U.S. agency commercial mortgage-backed | - | - | 4,322 | 44 | 4,322 | 44 |
| Private label mortgage-backed | 2,682 | 3 | 3,273 | 73 | 5,955 | 76 |
| Other asset backed | 38,729 | 140 | 9,794 | 91 | 48,523 | 231 |
| Obligations of states and political subdivisions | 9,211 | 15 | 27,595 | 188 | 36,806 | 203 |
| Corporate | 288 | 1 | 3,188 | 10 | 3,476 | 11 |
| Trust preferred | 941 | 60 | 910 | 55 | 1,851 | 115 |
| Foreign government | - | - | 1,526 | 4 | 1,526 | 4 |
| Total | <u>\$ 56,960</u> | <u>\$ 230</u> | <u>\$ 91,402</u> | <u>\$ 845</u> | <u>\$ 148,362</u> | <u>\$ 1,075</u> |
| December 31, 2018 | | | | | | |
| U.S. agency | \$ 7,150 | \$ 46 | \$ 11,945 | \$ 147 | \$ 19,095 | \$ 193 |
| U.S. agency residential mortgage-backed | 18,374 | 180 | 48,184 | 1,663 | 66,558 | 1,843 |
| U.S. agency commercial mortgage-backed | 566 | 3 | 5,094 | 181 | 5,660 | 184 |
| Private label mortgage-backed | 8,273 | 57 | 16,145 | 580 | 24,418 | 637 |
| Other asset backed | 53,043 | 160 | 10,235 | 88 | 63,278 | 248 |
| Obligations of states and political subdivisions | 25,423 | 262 | 80,701 | 2,684 | 106,124 | 2,946 |
| Corporate | 17,758 | 343 | 9,222 | 243 | 26,980 | 586 |
| Trust preferred | 939 | 61 | 880 | 84 | 1,819 | 145 |
| Foreign government | - | - | 2,014 | 36 | 2,014 | 36 |
| Total | <u>\$ 131,526</u> | <u>\$ 1,112</u> | <u>\$ 184,420</u> | <u>\$ 5,706</u> | <u>\$ 315,946</u> | <u>\$ 6,818</u> |

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

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

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at June 30, 2019, we had 22 U.S. agency, 104 U.S. agency residential mortgage-backed and nine U.S. agency commercial mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to increases in interest rates since acquisition and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label mortgage backed securities — at June 30, 2019, we had 11 of this type of security whose fair value is less than amortized cost. Unrealized losses are primarily due to credit spread widening and increases in interest rates since their acquisition.

Two private label mortgage-backed securities (including two of the three securities discussed further below) were reviewed for other than temporary impairment (“OTTI”) utilizing a cash flow projection. The cash flow analysis forecasts cash flow from the underlying loans in each transaction and then applies these cash flows to the bonds in the securitization. See further discussion below.

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

Other asset backed — at June 30, 2019, we had 65 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at June 30, 2019, we had 86 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to wider benchmark pricing spreads and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at June 30, 2019, we had five corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

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

Trust preferred securities — at June 30, 2019, we had two trust preferred securities whose fair value is less than amortized cost. Both of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities has suffered from credit spread widening. One of the securities is rated by a major rating agency as investment grade while the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.94 million as of June 30, 2019, continues to have satisfactory credit metrics and make interest payments. As management does not intend to liquidate this security and it is more likely than not that we will not be required to sell this security prior to recovery of the unrealized loss, this decline is not deemed to be other than temporary.

Foreign government — at June 30, 2019, we had one foreign government security whose fair value is less than amortized cost. The unrealized loss is primarily due to increases in interest rates since acquisition. As management does not intend to liquidate this security and it is more likely than not that we will not be required to sell this security prior to recovery of this unrealized loss, this decline is not deemed to be other than temporary.

We recorded no credit related OTTI charges in our Condensed Consolidated Statements of Operations related to securities available for sale during the three and six month periods ended June 30, 2019 and 2018, respectively.

At June 30, 2019, three private label mortgage-backed securities had credit related OTTI and are summarized as follows:

| | <u>Senior Security</u> | <u>Super Senior Security</u> | <u>Senior Support Security</u> | <u>Total</u> |
|--------------------------------|----------------------------|--------------------------------------|--|--------------|
| | (In thousands) | | | |
| Fair value | \$ 713 | \$ 700 | \$ 17 | \$ 1,430 |
| Amortized cost | 595 | 521 | - | 1,116 |
| Non-credit unrealized loss | - | - | - | - |
| Unrealized gain | 118 | 179 | 17 | 314 |
| Cumulative credit related OTTI | 757 | 457 | 380 | 1,594 |

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. All three of these securities have unrealized gains at June 30, 2019. The original amortized cost (current amortized cost excluding cumulative credit related OTTI) for each of these securities has been permanently adjusted downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for these securities is now less than previously recorded credit related OTTI amounts.

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|-----------------|------------------------------|-----------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands) | | (In thousands) | |
| Balance at beginning of period | \$ 1,594 | \$ 1,594 | \$ 1,594 | \$ 1,594 |
| Additions to credit losses on securities for which no previous OTTI was recognized | - | - | - | - |
| Increases to credit losses on securities for which OTTI was previously recognized | - | - | - | - |
| Balance at end of period | <u>\$ 1,594</u> | <u>\$ 1,594</u> | <u>\$ 1,594</u> | <u>\$ 1,594</u> |

The amortized cost and fair value of securities available for sale at June 30, 2019, by contractual maturity, follow:

| | Amortized Cost | Fair Value |
|--|-------------------|-------------------|
| | (In thousands) | |
| Maturing within one year | \$ 13,478 | \$ 13,481 |
| Maturing after one year but within five years | 55,186 | 55,754 |
| Maturing after five years but within ten years | 50,659 | 51,759 |
| Maturing after ten years | 38,286 | 38,776 |
| | <u>157,609</u> | <u>159,770</u> |
| U.S. agency residential mortgage-backed | 135,853 | 137,017 |
| U.S. agency commercial mortgage-backed | 12,183 | 12,238 |
| Private label mortgage-backed | 29,617 | 30,129 |
| Other asset backed | 91,196 | 91,151 |
| Total | <u>\$ 426,458</u> | <u>\$ 430,305</u> |

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

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

| | Proceeds | Realized | |
|------|----------------|----------|--------|
| | | Gains | Losses |
| | (In thousands) | | |
| 2019 | \$ 42,236 | \$ 169 | \$ 32 |
| 2018 | \$ 31,445 | \$ 81 | \$ 126 |

Certain preferred stocks which were all sold during the first quarter of 2019 had been classified as equity securities at fair value in our Condensed Consolidated Statement of Financial Condition. During the six months ended June 30, 2019 and 2018 we recognized gains (losses) on these preferred stocks of \$0.167 million and \$(0.119) million, respectively, that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. Zero and \$(0.119) million of these gains (losses) during the six months ended June 30, 2019 and 2018, respectively relate to preferred stock still held at each respective period end.

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

4. Loans

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

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

| | <u>Commercial</u> | <u>Mortgage</u> | <u>Installment</u> (In thousands) | <u>Subjective Allocation</u> | <u>Total</u> |
|--------------------------------------|-------------------|-----------------|--------------------------------------|----------------------------------|------------------|
| 2019 | | | | | |
| Balance at beginning of period | \$ 7,518 | \$ 8,412 | \$ 1,251 | \$ 8,073 | \$ 25,254 |
| Additions (deductions) | | | | | |
| Provision for loan losses | 475 | (386) | 209 | 354 | 652 |
| Recoveries credited to the allowance | 378 | 327 | 184 | - | 889 |
| Loans charged against the allowance | (250) | (291) | (351) | - | (892) |
| Balance at end of period | <u>\$ 8,121</u> | <u>\$ 8,062</u> | <u>\$ 1,293</u> | <u>\$ 8,427</u> | <u>\$ 25,903</u> |
| 2018 | | | | | |
| Balance at beginning of period | \$ 6,026 | \$ 8,621 | \$ 795 | \$ 7,629 | \$ 23,071 |
| Additions (deductions) | | | | | |
| Provision for loan losses | (362) | 216 | 138 | 658 | 650 |
| Recoveries credited to the allowance | 434 | 177 | 235 | - | 846 |
| Loans charged against the allowance | (25) | (718) | (320) | - | (1,063) |
| Balance at end of period | <u>\$ 6,073</u> | <u>\$ 8,296</u> | <u>\$ 848</u> | <u>\$ 8,287</u> | <u>\$ 23,504</u> |

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

| | <u>Commercial</u> | <u>Mortgage</u> | <u>Installment</u> (In thousands) | <u>Subjective Allocation</u> | <u>Total</u> |
|--------------------------------------|-------------------|-----------------|--------------------------------------|----------------------------------|------------------|
| 2019 | | | | | |
| Balance at beginning of period | \$ 7,090 | \$ 7,978 | \$ 895 | \$ 8,925 | \$ 24,888 |
| Additions (deductions) | | | | | |
| Provision for loan losses | 895 | 187 | 732 | (498) | 1,316 |
| Recoveries credited to the allowance | 505 | 551 | 401 | - | 1,457 |
| Loans charged against the allowance | (369) | (654) | (735) | - | (1,758) |
| Balance at end of period | <u>\$ 8,121</u> | <u>\$ 8,062</u> | <u>\$ 1,293</u> | <u>\$ 8,427</u> | <u>\$ 25,903</u> |
| 2018 | | | | | |
| Balance at beginning of period | \$ 5,595 | \$ 8,733 | \$ 864 | \$ 7,395 | \$ 22,587 |
| Additions (deductions) | | | | | |
| Provision for loan losses | (497) | 363 | 207 | 892 | 965 |
| Recoveries credited to the allowance | 1,040 | 357 | 463 | - | 1,860 |
| Loans charged against the allowance | (65) | (1,157) | (686) | - | (1,908) |
| Balance at end of period | <u>\$ 6,073</u> | <u>\$ 8,296</u> | <u>\$ 848</u> | <u>\$ 8,287</u> | <u>\$ 23,504</u> |

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

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

| | <u>Commercial</u> | <u>Mortgage</u> | <u>Installment</u> | <u>Subjective Allocation</u> | <u>Total</u> |
|--|---------------------|---------------------|--------------------|----------------------------------|---------------------|
| | (In thousands) | | | | |
| June 30, 2019 | | | | | |
| Allowance for loan losses: | | | | | |
| Individually evaluated for impairment | \$ 1,047 | \$ 4,715 | \$ 265 | \$ - | \$ 6,027 |
| Collectively evaluated for impairment | 7,074 | 3,347 | 1,028 | 8,427 | 19,876 |
| Loans acquired with deteriorated credit quality | - | - | - | - | - |
| Total ending allowance for loan losses balance | <u>\$ 8,121</u> | <u>\$ 8,062</u> | <u>\$ 1,293</u> | <u>\$ 8,427</u> | <u>\$ 25,903</u> |
| Loans | | | | | |
| Individually evaluated for impairment | \$ 8,082 | \$ 44,095 | \$ 3,258 | | \$ 55,435 |
| Collectively evaluated for impairment | 1,169,792 | 1,046,177 | 441,859 | | 2,657,828 |
| Loans acquired with deteriorated credit quality | 1,490 | 587 | 324 | | 2,401 |
| Total loans recorded investment | <u>1,179,364</u> | <u>1,090,859</u> | <u>445,441</u> | | <u>2,715,664</u> |
| Accrued interest included in recorded investment | 3,394 | 4,550 | 1,194 | | 9,138 |
| Total loans | <u>\$ 1,175,970</u> | <u>\$ 1,086,309</u> | <u>\$ 444,247</u> | | <u>\$ 2,706,526</u> |
| December 31, 2018 | | | | | |
| Allowance for loan losses: | | | | | |
| Individually evaluated for impairment | \$ 1,305 | \$ 4,799 | \$ 206 | \$ - | \$ 6,310 |
| Collectively evaluated for impairment | 5,785 | 3,179 | 689 | 8,925 | 18,578 |
| Loans acquired with deteriorated credit quality | - | - | - | - | - |
| Total ending allowance for loan losses balance | <u>\$ 7,090</u> | <u>\$ 7,978</u> | <u>\$ 895</u> | <u>\$ 8,925</u> | <u>\$ 24,888</u> |
| Loans | | | | | |
| Individually evaluated for impairment | \$ 8,697 | \$ 46,394 | \$ 3,370 | | \$ 58,461 |
| Collectively evaluated for impairment | 1,137,586 | 1,000,038 | 392,460 | | 2,530,084 |
| Loans acquired with deteriorated credit quality | 1,609 | 555 | 349 | | 2,513 |
| Total loans recorded investment | <u>1,147,892</u> | <u>1,046,987</u> | <u>396,179</u> | | <u>2,591,058</u> |
| Accrued interest included in recorded investment | 3,411 | 4,097 | 1,030 | | 8,538 |
| Total loans | <u>\$ 1,144,481</u> | <u>\$ 1,042,890</u> | <u>\$ 395,149</u> | | <u>\$ 2,582,520</u> |

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

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

| | 90+ and Still Accruing | Non- Accrual (In thousands) | Total Non- Performing Loans |
|---|------------------------------|-----------------------------------|-----------------------------------|
| June 30, 2019 | | | |
| Commercial | | | |
| Income producing - real estate | \$ - | \$ - | \$ - |
| Land, land development and construction - real estate | - | - | - |
| Commercial and industrial | - | 803 | 803 |
| Mortgage | | | |
| 1-4 family | - | 4,142 | 4,142 |
| Resort lending | - | 720 | 720 |
| Home equity - 1st lien | - | 196 | 196 |
| Home equity - 2nd lien | - | 600 | 600 |
| Installment | | | |
| Home equity - 1st lien | - | 168 | 168 |
| Home equity - 2nd lien | - | 220 | 220 |
| Boat lending | - | 278 | 278 |
| Recreational vehicle lending | - | 2 | 2 |
| Other | - | 234 | 234 |
| Total recorded investment | <u>\$ -</u> | <u>\$ 7,363</u> | <u>\$ 7,363</u> |
| Accrued interest included in recorded investment | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |
| December 31, 2018 | | | |
| Commercial | | | |
| Income producing - real estate | \$ - | \$ - | \$ - |
| Land, land development and construction - real estate | - | - | - |
| Commercial and industrial | - | 2,220 | 2,220 |
| Mortgage | | | |
| 1-4 family | 5 | 4,695 | 4,700 |
| Resort lending | - | 755 | 755 |
| Home equity - 1st lien | - | 159 | 159 |
| Home equity - 2nd lien | - | 419 | 419 |
| Installment | | | |
| Home equity - 1st lien | - | 178 | 178 |
| Home equity - 2nd lien | - | 226 | 226 |
| Boat lending | - | 166 | 166 |
| Recreational vehicle lending | - | 7 | 7 |
| Other | - | 204 | 204 |
| Total recorded investment | <u>\$ 5</u> | <u>\$ 9,029</u> | <u>\$ 9,034</u> |
| Accrued interest included in recorded investment | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |

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

An aging analysis of loans by class follows:

| | Loans Past Due | | | | Loans not Past Due | Total Loans |
|--|-----------------|-----------------|-----------------|------------------|-----------------------|---------------------|
| | 30-59 days | 60-89 days | 90+ days | Total | | |
| (In thousands) | | | | | | |
| June 30, 2019 | | | | | | |
| Commercial | | | | | | |
| Income producing - real estate | \$ 50 | \$ - | \$ - | \$ 50 | \$ 398,697 | \$ 398,747 |
| Land, land development and construction - real estate | - | - | - | - | 93,213 | 93,213 |
| Commercial and industrial | 132 | 37 | 705 | 874 | 686,530 | 687,404 |
| Mortgage | | | | | | |
| 1-4 family | 4,488 | 1,663 | 1,734 | 7,885 | 851,775 | 859,660 |
| Resort lending | 484 | 238 | 433 | 1,155 | 73,578 | 74,733 |
| Home equity - 1st lien | 178 | 96 | 51 | 325 | 36,201 | 36,526 |
| Home equity - 2nd lien | 458 | 234 | 195 | 887 | 119,053 | 119,940 |
| Installment | | | | | | |
| Home equity - 1st lien | 97 | 1 | 11 | 109 | 6,320 | 6,429 |
| Home equity - 2nd lien | 188 | 19 | 113 | 320 | 5,431 | 5,751 |
| Boat lending | 287 | 24 | 32 | 343 | 197,315 | 197,658 |
| Recreational vehicle lending | 72 | 3 | 2 | 77 | 144,403 | 144,480 |
| Other | 200 | 46 | 172 | 418 | 90,705 | 91,123 |
| Total recorded investment | <u>\$ 6,634</u> | <u>\$ 2,361</u> | <u>\$ 3,448</u> | <u>\$ 12,443</u> | <u>\$ 2,703,221</u> | <u>\$ 2,715,664</u> |
| Accrued interest included in recorded investment | <u>\$ 66</u> | <u>\$ 32</u> | <u>\$ -</u> | <u>\$ 98</u> | <u>\$ 9,040</u> | <u>\$ 9,138</u> |
| December 31, 2018 | | | | | | |
| Commercial | | | | | | |
| Income producing - real estate | \$ 44 | \$ - | \$ - | \$ 44 | \$ 388,729 | \$ 388,773 |
| Land, land development and construction - real estate | - | - | - | - | 84,458 | 84,458 |
| Commercial and industrial | 1,538 | - | - | 1,538 | 673,123 | 674,661 |
| Mortgage | | | | | | |
| 1-4 family | 1,608 | 194 | 4,882 | 6,684 | 833,760 | 840,444 |
| Resort lending | 252 | - | 755 | 1,007 | 80,774 | 81,781 |
| Home equity - 1st lien | 176 | - | 159 | 335 | 38,909 | 39,244 |
| Home equity - 2nd lien | 446 | 100 | 419 | 965 | 84,553 | 85,518 |
| Installment | | | | | | |
| Home equity - 1st lien | 200 | 55 | 197 | 452 | 6,985 | 7,437 |
| Home equity - 2nd lien | 111 | 24 | 226 | 361 | 6,683 | 7,044 |
| Boat lending | 316 | 295 | 166 | 777 | 169,117 | 169,894 |
| Recreational vehicle lending | 28 | 21 | 7 | 56 | 125,780 | 125,836 |
| Other | 241 | 131 | 204 | 576 | 85,392 | 85,968 |
| Total recorded investment | <u>\$ 4,960</u> | <u>\$ 820</u> | <u>\$ 7,015</u> | <u>\$ 12,795</u> | <u>\$ 2,578,263</u> | <u>\$ 2,591,058</u> |
| Accrued interest included in recorded investment | <u>\$ 44</u> | <u>\$ 11</u> | <u>\$ -</u> | <u>\$ 55</u> | <u>\$ 8,483</u> | <u>\$ 8,538</u> |

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

Impaired loans are as follows:

| | June 30, 2019 | December 31, 2018 |
|--|------------------|----------------------|
| | (In thousands) | |
| Impaired loans with no allocated allowance for loan losses | | |
| Troubled debt restructurings ("TDR") | \$ 266 | \$ - |
| Non - TDR | 500 | - |
| Impaired loans with an allocated allowance for loan losses | | |
| TDR - allowance based on collateral | 1,611 | 2,787 |
| TDR - allowance based on present value cash flow | 50,262 | 53,258 |
| Non - TDR - allowance based on collateral | 2,536 | 2,145 |
| Total impaired loans | <u>\$ 55,175</u> | <u>\$ 58,190</u> |
| Amount of allowance for loan losses allocated | | |
| TDR - allowance based on collateral | \$ 272 | \$ 769 |
| TDR - allowance based on present value cash flow | 4,874 | 4,849 |
| Non - TDR - allowance based on collateral | 881 | 692 |
| Total amount of allowance for loan losses allocated | <u>\$ 6,027</u> | <u>\$ 6,310</u> |

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

Impaired loans by class are as follows:

| | June 30, 2019 | | | December 31, 2018 | | |
|--|------------------------|--------------------------------|--|------------------------|--------------------------------|--|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance For Loan Losses | Recorded Investment | Unpaid Principal Balance | Related Allowance For Loan Losses |
| With no related allowance for loan losses recorded: | | | (In thousands) | | | |
| Commercial | | | | | | |
| Income producing - real estate | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Land, land development & construction-real estate | - | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - | - |
| Mortgage | | | | | | |
| 1-4 family | 613 | 800 | - | 3 | 474 | - |
| Resort lending | - | - | - | - | - | - |
| Home equity - 1st lien | - | - | - | - | - | - |
| Home equity - 2nd lien | - | - | - | - | - | - |
| Installment | | | | | | |
| Home equity - 1st lien | - | - | - | 1 | 122 | - |
| Home equity - 2nd lien | - | 16 | - | - | - | - |
| Boat lending | - | 5 | - | - | 5 | - |
| Recreational vehicle lending | - | - | - | - | - | - |
| Other | - | 15 | - | - | 15 | - |
| | <u>613</u> | <u>836</u> | <u>-</u> | <u>4</u> | <u>616</u> | <u>-</u> |
| With an allowance for loan losses recorded: | | | | | | |
| Commercial | | | | | | |
| Income producing - real estate | \$ 5,874 | \$ 5,863 | 518 | 4,770 | 4,758 | 303 |
| Land, land development & construction-real estate | 290 | 288 | 31 | 290 | 289 | 35 |
| Commercial and industrial | 1,918 | 2,184 | 498 | 3,637 | 3,735 | 967 |
| Mortgage | | | | | | |
| 1-4 family | 30,411 | 32,568 | 3,171 | 32,842 | 34,427 | 2,859 |
| Resort lending | 12,392 | 12,704 | 1,397 | 13,328 | 13,354 | 1,927 |
| Home equity - 1st lien | 125 | 187 | 26 | 65 | 64 | 4 |
| Home equity - 2nd lien | 554 | 564 | 121 | 156 | 155 | 9 |
| Installment | | | | | | |
| Home equity - 1st lien | 1,264 | 1,440 | 77 | 1,440 | 1,524 | 89 |
| Home equity - 2nd lien | 1,434 | 1,442 | 100 | 1,471 | 1,491 | 92 |
| Boat lending | 32 | 48 | 11 | - | - | - |
| Recreational vehicle lending | 51 | 51 | 4 | 79 | 79 | 4 |
| Other | 477 | 553 | 73 | 379 | 406 | 21 |
| | <u>54,822</u> | <u>57,892</u> | <u>6,027</u> | <u>58,457</u> | <u>60,282</u> | <u>6,310</u> |
| Total | | | | | | |
| Commercial | | | | | | |
| Income producing - real estate | 5,874 | 5,863 | 518 | 4,770 | 4,758 | 303 |
| Land, land development & construction-real estate | 290 | 288 | 31 | 290 | 289 | 35 |
| Commercial and industrial | 1,918 | 2,184 | 498 | 3,637 | 3,735 | 967 |
| Mortgage | | | | | | |
| 1-4 family | 31,024 | 33,368 | 3,171 | 32,845 | 34,901 | 2,859 |
| Resort lending | 12,392 | 12,704 | 1,397 | 13,328 | 13,354 | 1,927 |
| Home equity - 1st lien | 125 | 187 | 26 | 65 | 64 | 4 |
| Home equity - 2nd lien | 554 | 564 | 121 | 156 | 155 | 9 |
| Installment | | | | | | |
| Home equity - 1st lien | 1,264 | 1,440 | 77 | 1,441 | 1,646 | 89 |
| Home equity - 2nd lien | 1,434 | 1,458 | 100 | 1,471 | 1,491 | 92 |
| Boat lending | 32 | 53 | 11 | - | 5 | - |
| Recreational vehicle lending | 51 | 51 | 4 | 79 | 79 | 4 |
| Other | 477 | 568 | 73 | 379 | 421 | 21 |
| Total | <u>\$ 55,435</u> | <u>\$ 58,728</u> | <u>\$ 6,027</u> | <u>\$ 58,461</u> | <u>\$ 60,898</u> | <u>\$ 6,310</u> |
| Accrued interest included in recorded investment | <u>\$ 260</u> | | | <u>\$ 271</u> | | |

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

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

| | 2019 | | 2018 | |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| (In thousands) | | | | |
| With no related allowance for loan losses recorded: | | | | |
| Commercial | | | | |
| Income producing - real estate | \$ - | \$ - | \$ - | \$ - |
| Land, land development & construction-real estate | - | - | 1,201 | - |
| Commercial and industrial | - | - | 509 | 9 |
| Mortgage | | | | |
| 1-4 family | 484 | 2 | 138 | 3 |
| Resort lending | - | - | - | - |
| Home equity - 1st lien | - | - | - | - |
| Home equity - 2nd lien | - | - | - | - |
| Installment | | | | |
| Home equity - 1st lien | - | - | 1 | 2 |
| Home equity - 2nd lien | - | - | - | - |
| Boat lending | - | - | - | - |
| Recreational vehicle lending | - | - | - | - |
| Other | - | - | - | 1 |
| | <u>484</u> | <u>2</u> | <u>1,849</u> | <u>15</u> |
| With an allowance for loan losses recorded: | | | | |
| Commercial | | | | |
| Income producing - real estate | 5,297 | 81 | 5,142 | 70 |
| Land, land development & construction-real estate | 290 | 2 | 155 | 2 |
| Commercial and industrial | 2,418 | 16 | 2,522 | 34 |
| Mortgage | | | | |
| 1-4 family | 31,364 | 414 | 35,345 | 431 |
| Resort lending | 12,680 | 147 | 15,098 | 150 |
| Home equity - 1st lien | 122 | 2 | 111 | 1 |
| Home equity - 2nd lien | 556 | 3 | 167 | 1 |
| Installment | | | | |
| Home equity - 1st lien | 1,326 | 19 | 1,596 | 25 |
| Home equity - 2nd lien | 1,453 | 19 | 1,746 | 25 |
| Boat lending | 67 | - | 1 | - |
| Recreational vehicle lending | 67 | - | 86 | 1 |
| Other | 479 | 5 | 414 | 7 |
| | <u>56,119</u> | <u>708</u> | <u>62,383</u> | <u>747</u> |
| Total | | | | |
| Commercial | | | | |
| Income producing - real estate | 5,297 | 81 | 5,142 | 70 |
| Land, land development & construction-real estate | 290 | 2 | 1,356 | 2 |
| Commercial and industrial | 2,418 | 16 | 3,031 | 43 |
| Mortgage | | | | |
| 1-4 family | 31,848 | 416 | 35,483 | 434 |
| Resort lending | 12,680 | 147 | 15,098 | 150 |
| Home equity - 1st lien | 122 | 2 | 111 | 1 |
| Home equity - 2nd lien | 556 | 3 | 167 | 1 |
| Installment | | | | |
| Home equity - 1st lien | 1,326 | 19 | 1,597 | 27 |
| Home equity - 2nd lien | 1,453 | 19 | 1,746 | 25 |
| Boat lending | 67 | - | 1 | - |
| Recreational vehicle lending | 67 | - | 86 | 1 |
| Other | 479 | 5 | 414 | 8 |
| Total | <u>\$ 56,603</u> | <u>\$ 710</u> | <u>\$ 64,232</u> | <u>\$ 762</u> |

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

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

| | 2019 | | 2018 | |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| (In thousands) | | | | |
| With no related allowance for loan losses recorded: | | | | |
| Commercial | | | | |
| Income producing - real estate | \$ - | \$ - | \$ - | \$ - |
| Land, land development & construction-real estate | - | - | 801 | - |
| Commercial and industrial | - | - | 514 | 13 |
| Mortgage | | | | |
| 1-4 family | 324 | 2 | 92 | 9 |
| Resort lending | - | - | - | - |
| Home equity - 1st lien | - | - | - | - |
| Home equity - 2nd lien | - | - | - | - |
| Installment | | | | |
| Home equity - 1st lien | - | - | 1 | 4 |
| Home equity - 2nd lien | - | - | - | - |
| Boat lending | - | - | - | - |
| Recreational vehicle lending | - | - | - | - |
| Other | - | - | - | 1 |
| | <u>324</u> | <u>2</u> | <u>1,408</u> | <u>27</u> |
| With an allowance for loan losses recorded: | | | | |
| Commercial | | | | |
| Income producing - real estate | 5,121 | 146 | 5,160 | 138 |
| Land, land development & construction-real estate | 290 | 4 | 159 | 4 |
| Commercial and industrial | 2,824 | 36 | 2,526 | 66 |
| Mortgage | | | | |
| 1-4 family | 31,857 | 860 | 35,846 | 889 |
| Resort lending | 12,896 | 322 | 15,391 | 314 |
| Home equity - 1st lien | 103 | 3 | 131 | 3 |
| Home equity - 2nd lien | 423 | 6 | 171 | 3 |
| Installment | | | | |
| Home equity - 1st lien | 1,364 | 43 | 1,619 | 54 |
| Home equity - 2nd lien | 1,459 | 41 | 1,762 | 52 |
| Boat lending | 44 | - | 1 | - |
| Recreational vehicle lending | 71 | 1 | 87 | 2 |
| Other | 446 | 11 | 407 | 13 |
| | <u>56,898</u> | <u>1,473</u> | <u>63,260</u> | <u>1,538</u> |
| Total | | | | |
| Commercial | | | | |
| Income producing - real estate | 5,121 | 146 | 5,160 | 138 |
| Land, land development & construction-real estate | 290 | 4 | 960 | 4 |
| Commercial and industrial | 2,824 | 36 | 3,040 | 79 |
| Mortgage | | | | |
| 1-4 family | 32,181 | 862 | 35,938 | 898 |
| Resort lending | 12,896 | 322 | 15,391 | 314 |
| Home equity - 1st lien | 103 | 3 | 131 | 3 |
| Home equity - 2nd lien | 423 | 6 | 171 | 3 |
| Installment | | | | |
| Home equity - 1st lien | 1,364 | 43 | 1,620 | 58 |
| Home equity - 2nd lien | 1,459 | 41 | 1,762 | 52 |
| Boat lending | 44 | - | 1 | - |
| Recreational vehicle lending | 71 | 1 | 87 | 2 |
| Other | 446 | 11 | 407 | 14 |
| Total | <u>\$ 57,222</u> | <u>\$ 1,475</u> | <u>\$ 64,668</u> | <u>\$ 1,565</u> |

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

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

TDRs follow:

| | June 30, 2019 | | |
|-------------------------|-----------------|------------------|------------------|
| | Commercial | Retail (1) | Total |
| | (In thousands) | | |
| Performing TDRs | \$ 7,166 | \$ 42,136 | \$ 49,302 |
| Non-performing TDRs (2) | 54 | 2,783 (3) | 2,837 |
| Total | \$ 7,220 | \$ 44,919 | \$ 52,139 |

| | December 31, 2018 | | |
|-------------------------|-------------------|------------------|------------------|
| | Commercial | Retail (1) | Total |
| | (In thousands) | | |
| Performing TDRs | \$ 6,460 | \$ 46,627 | \$ 53,087 |
| Non-performing TDRs (2) | 74 | 2,884 (3) | 2,958 |
| Total | \$ 6,534 | \$ 49,511 | \$ 56,045 |

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

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

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

We allocated \$5.1 million and \$5.6 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2019 and December 31, 2018, respectively.

During the six months ended June 30, 2019 and 2018, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

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

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

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

| | Number of Contracts | Pre-modification Recorded Balance | Post-modification Recorded Balance |
|---|------------------------|---|--|
| | | (Dollars in thousands) | |
| 2019 | | | |
| Commercial | | | |
| Income producing - real estate | 2 | \$ 1,329 | \$ 1,329 |
| Land, land development & construction-real estate | - | - | - |
| Commercial and industrial | - | - | - |
| Mortgage | | | |
| 1-4 family | 1 | 506 | 505 |
| Resort lending | - | - | - |
| Home equity - 1st lien | - | - | - |
| Home equity - 2nd lien | - | - | - |
| Installment | | | |
| Home equity - 1st lien | 1 | 25 | 26 |
| Home equity - 2nd lien | 3 | 75 | 76 |
| Boat lending | - | - | - |
| Recreational vehicle lending | - | - | - |
| Other | - | - | - |
| Total | <u>7</u> | <u>\$ 1,935</u> | <u>\$ 1,936</u> |
| 2018 | | | |
| Commercial | | | |
| Income producing - real estate | - | \$ - | \$ - |
| Land, land development & construction-real estate | - | - | - |
| Commercial and industrial | 2 | 153 | 153 |
| Mortgage | | | |
| 1-4 family | 1 | 66 | 69 |
| Resort lending | - | - | - |
| Home equity - 1st lien | - | - | - |
| Home equity - 2nd lien | - | - | - |
| Installment | | | |
| Home equity - 1st lien | 2 | 90 | 91 |
| Home equity - 2nd lien | 1 | 32 | 32 |
| Boat lending | - | - | - |
| Recreational vehicle lending | - | - | - |
| Other | 1 | 41 | 41 |
| Total | <u>7</u> | <u>\$ 382</u> | <u>\$ 386</u> |

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

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

| | Number of Contracts | Pre-modification Recorded Balance | Post-modification Recorded Balance |
|---|------------------------|---|--|
| | | (Dollars in thousands) | |
| 2019 | | | |
| Commercial | | | |
| Income producing - real estate | 2 | \$ 1,329 | \$ 1,329 |
| Land, land development & construction-real estate | - | - | - |
| Commercial and industrial | 1 | 49 | 49 |
| Mortgage | | | |
| 1-4 family | 2 | 787 | 786 |
| Resort lending | - | - | - |
| Home equity - 1st lien | - | - | - |
| Home equity - 2nd lien | - | - | - |
| Installment | | | |
| Home equity - 1st lien | 2 | 49 | 51 |
| Home equity - 2nd lien | 4 | 111 | 112 |
| Boat lending | - | - | - |
| Recreational vehicle lending | - | - | - |
| Other | - | - | - |
| Total | <u>11</u> | <u>\$ 2,325</u> | <u>\$ 2,327</u> |
| 2018 | | | |
| Commercial | | | |
| Income producing - real estate | 1 | \$ 67 | \$ 67 |
| Land, land development & construction-real estate | - | - | - |
| Commercial and industrial | 5 | 587 | 587 |
| Mortgage | | | |
| 1-4 family | 4 | 294 | 280 |
| Resort lending | - | - | - |
| Home equity - 1st lien | - | - | - |
| Home equity - 2nd lien | - | - | - |
| Installment | | | |
| Home equity - 1st lien | 5 | 188 | 190 |
| Home equity - 2nd lien | 2 | 93 | 93 |
| Boat lending | - | - | - |
| Recreational vehicle lending | - | - | - |
| Other | 2 | 76 | 73 |
| Total | <u>19</u> | <u>\$ 1,305</u> | <u>\$ 1,290</u> |

The troubled debt restructurings described above for 2019 increased the allowance for loan losses by \$0.04 million and resulted in zero charge offs during the three months ended June 30, 2019, and increased the allowance for loan losses by \$0.05 million and resulted in zero charge offs during the six months ended June 30, 2019.

The troubled debt restructurings described above for 2018 increased the allowance for loan losses by \$0.04 million and resulted in zero charge offs during the three months ended June 30, 2018, and increased the allowance for loan losses by \$0.01 million and resulted in zero charge offs during the six months ended June 30, 2018.

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

There were no troubled debt restructurings that subsequently defaulted within twelve months following the modification during the three and six months periods ended June 30, 2019 and 2018.

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

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

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

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

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

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

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

Rating 10 and 11: These loans are generally referred to as our “substandard - non-accrual” and “doubtful” commercial credits. Our doubtful rating includes a sub classification for a loss rate other than 50% (which is the standard doubtful loss rate). These ratings include loans to borrowers with weaknesses that make collection of debt in full, on the basis of current facts, conditions and values at best questionable and at worst improbable. All of these loans are placed in non-accrual.

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

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

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

| | Commercial | | | | Total |
|---|---------------------|------------------|-----------------------------|--------------------------|---------------------|
| | Non-watch 1-6 | Watch 7-8 | Substandard Accrual 9 | Non- Accrual 10-11 | |
| | (In thousands) | | | | |
| June 30, 2019 | | | | | |
| Income producing - real estate | \$ 382,198 | \$ 15,777 | \$ 772 | \$ - | \$ 398,747 |
| Land, land development and construction - real estate | 83,971 | 8,467 | 775 | - | 93,213 |
| Commercial and industrial | 634,098 | 48,598 | 3,905 | 803 | 687,404 |
| Total | <u>\$ 1,100,267</u> | <u>\$ 72,842</u> | <u>\$ 5,452</u> | <u>\$ 803</u> | <u>\$ 1,179,364</u> |
| Accrued interest included in total | <u>\$ 3,158</u> | <u>\$ 219</u> | <u>\$ 17</u> | <u>\$ -</u> | <u>\$ 3,394</u> |
| December 31, 2018 | | | | | |
| Income producing - real estate | \$ 375,142 | \$ 13,387 | \$ 200 | \$ 44 | \$ 388,773 |
| Land, land development and construction - real estate | 76,120 | 8,328 | - | 10 | 84,458 |
| Commercial and industrial | 631,248 | 35,469 | 5,577 | 2,367 | 674,661 |
| Total | <u>\$ 1,082,510</u> | <u>\$ 57,184</u> | <u>\$ 5,777</u> | <u>\$ 2,421</u> | <u>\$ 1,147,892</u> |
| Accrued interest included in total | <u>\$ 3,107</u> | <u>\$ 174</u> | <u>\$ 130</u> | <u>\$ -</u> | <u>\$ 3,411</u> |

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

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

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

| | Mortgage (1) | | | | Total |
|------------------------------------|-------------------|------------------|----------------------|----------------------|---------------------|
| | 1-4 Family | Resort Lending | Home Equity 1st Lien | Home Equity 2nd Lien | |
| | (In thousands) | | | | |
| June 30, 2019 | | | | | |
| 800 and above | \$ 110,599 | \$ 11,748 | \$ 5,783 | \$ 12,623 | \$ 140,753 |
| 750-799 | 391,241 | 32,894 | 15,624 | 52,785 | 492,544 |
| 700-749 | 195,867 | 15,747 | 9,584 | 33,377 | 254,575 |
| 650-699 | 89,819 | 8,074 | 3,623 | 13,055 | 114,571 |
| 600-649 | 31,668 | 2,597 | 663 | 4,212 | 39,140 |
| 550-599 | 16,755 | 1,465 | 652 | 1,929 | 20,801 |
| 500-549 | 11,333 | 684 | 325 | 1,148 | 13,490 |
| Under 500 | 4,192 | 81 | 272 | 392 | 4,937 |
| Unknown | 8,186 | 1,443 | - | 419 | 10,048 |
| Total | <u>\$ 859,660</u> | <u>\$ 74,733</u> | <u>\$ 36,526</u> | <u>\$ 119,940</u> | <u>\$ 1,090,859</u> |
| Accrued interest included in total | <u>\$ 3,503</u> | <u>\$ 367</u> | <u>\$ 176</u> | <u>\$ 504</u> | <u>\$ 4,550</u> |
| December 31, 2018 | | | | | |
| 800 and above | \$ 94,492 | \$ 10,898 | \$ 6,784 | \$ 8,838 | \$ 121,012 |
| 750-799 | 384,344 | 36,542 | 17,303 | 38,295 | 476,484 |
| 700-749 | 202,440 | 17,282 | 9,155 | 23,249 | 252,126 |
| 650-699 | 91,847 | 9,945 | 3,987 | 8,681 | 114,460 |
| 600-649 | 34,342 | 3,088 | 959 | 3,359 | 41,748 |
| 550-599 | 13,771 | 1,867 | 427 | 1,236 | 17,301 |
| 500-549 | 8,439 | 106 | 418 | 826 | 9,789 |
| Under 500 | 2,533 | 143 | 98 | 381 | 3,155 |
| Unknown | 8,236 | 1,910 | 113 | 653 | 10,912 |
| Total | <u>\$ 840,444</u> | <u>\$ 81,781</u> | <u>\$ 39,244</u> | <u>\$ 85,518</u> | <u>\$ 1,046,987</u> |
| Accrued interest included in total | <u>\$ 3,079</u> | <u>\$ 363</u> | <u>\$ 199</u> | <u>\$ 456</u> | <u>\$ 4,097</u> |

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

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

| | Installment(1) | | | | | |
|------------------------------------|----------------------------|----------------------------|-------------------|------------------------------------|------------------|-------------------|
| | Home Equity 1st Lien | Home Equity 2nd Lien | Boat Lending | Recreational Vehicle Lending | Other | Total |
| | (In thousands) | | | | | |
| June 30, 2019 | | | | | | |
| 800 and above | \$ 449 | \$ 231 | \$ 26,585 | \$ 22,213 | \$ 6,683 | \$ 56,161 |
| 750-799 | 1,219 | 1,517 | 115,402 | 85,635 | 34,760 | 238,533 |
| 700-749 | 1,390 | 1,224 | 41,608 | 28,261 | 23,945 | 96,428 |
| 650-699 | 1,496 | 1,161 | 10,612 | 5,728 | 10,426 | 29,423 |
| 600-649 | 993 | 730 | 1,879 | 1,767 | 2,954 | 8,323 |
| 550-599 | 550 | 573 | 831 | 653 | 853 | 3,460 |
| 500-549 | 313 | 217 | 486 | 181 | 859 | 2,056 |
| Under 500 | 19 | 55 | 229 | 42 | 187 | 532 |
| Unknown | - | 43 | 26 | - | 10,456 | 10,525 |
| Total | <u>\$ 6,429</u> | <u>\$ 5,751</u> | <u>\$ 197,658</u> | <u>\$ 144,480</u> | <u>\$ 91,123</u> | <u>\$ 445,441</u> |
| Accrued interest included in total | <u>\$ 23</u> | <u>\$ 19</u> | <u>\$ 493</u> | <u>\$ 368</u> | <u>\$ 291</u> | <u>\$ 1,194</u> |
| December 31, 2018 | | | | | | |
| 800 and above | \$ 555 | \$ 235 | \$ 20,767 | \$ 20,197 | \$ 6,272 | \$ 48,026 |
| 750-799 | 1,502 | 1,642 | 100,191 | 74,154 | 31,483 | 208,972 |
| 700-749 | 1,582 | 1,682 | 35,455 | 24,890 | 24,369 | 87,978 |
| 650-699 | 1,606 | 1,217 | 10,581 | 4,918 | 9,840 | 28,162 |
| 600-649 | 996 | 1,272 | 1,657 | 992 | 2,751 | 7,668 |
| 550-599 | 759 | 658 | 652 | 453 | 838 | 3,360 |
| 500-549 | 384 | 229 | 286 | 225 | 651 | 1,775 |
| Under 500 | 51 | 6 | 266 | 7 | 218 | 548 |
| Unknown | 2 | 103 | 39 | - | 9,546 | 9,690 |
| Total | <u>\$ 7,437</u> | <u>\$ 7,044</u> | <u>\$ 169,894</u> | <u>\$ 125,836</u> | <u>\$ 85,968</u> | <u>\$ 396,179</u> |
| Accrued interest included in total | <u>\$ 28</u> | <u>\$ 25</u> | <u>\$ 403</u> | <u>\$ 311</u> | <u>\$ 263</u> | <u>\$ 1,030</u> |

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

Foreclosed residential real estate properties included in other real estate and repossessed assets on our Condensed Consolidated Statements of Financial Condition totaled \$1.2 million at both June 30, 2019 and December 31, 2018, respectively. Retail mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements totaled \$0.6 million and \$0.3 million at June 30, 2019 and December 31, 2018, respectively.

During the first quarter of 2019, we sold \$40.6 million, of residential adjustable rate mortgage loans servicing released (classified on the Condensed Consolidated Statements of Financial Condition as held for sale, carried at the lower of cost or fair value at December 31, 2018) to another financial institution and recognized a gain on sale of \$0.01 million. During the first quarter of 2019 we also securitized \$29.8 million, of portfolio residential fixed rate mortgage loans servicing retained with Freddie Mac and recognized a gain on sale of \$0.53 million. These transactions were done primarily for asset/liability management purposes.

During the first quarter of 2018, we sold \$16.5 million, of residential fixed and adjustable rate portfolio mortgage loans servicing retained to another financial institution and recognized a gain on sale of \$0.05 million. These mortgage loans were sold primarily for asset/liability management purposes.

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

Purchase Credit Impaired (“PCI”) Loans

Loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan losses. In determining the estimated fair value of purchased loans, we consider a number of factors including, among others, the remaining life of the acquired loans, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, and net present value of cash flows expected to be received. Purchased loans are accounted for in accordance with guidance for certain loans acquired in a transfer (ASC 310-30), when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which would have a positive impact on interest income.

As a result of our acquisition of TCSB Bancorp, Inc. (“TCSB”) (see note #17) we purchased loans for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. For these loans that meet the criteria of ASC 310-30 treatment, the carrying amount was as follows:

| | June 30, 2019 | December 31, 2018 |
|---|------------------|----------------------|
| | (In thousands) | |
| Commercial | \$ 1,490 | \$ 1,609 |
| Mortgage | 587 | 555 |
| Installment | 324 | 349 |
| Total carrying amount | 2,401 | 2,513 |
| Allowance for loan losses | - | - |
| Carrying amount, net of allowance for loan losses | <u>\$ 2,401</u> | <u>\$ 2,513</u> |

The accretable difference on PCI loans is the difference between the expected cash flows and the net present value of expected cash flows with such difference accreted into earnings using the effective yield method over the term of the loans. Accretion recorded as loan interest income is included in the table below. Accretable yield of PCI loans, or income expected to be collected follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|---------------|------------------------------|---------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (unaudited) | | (unaudited) | |
| | (In thousands) | | (In thousands) | |
| Balance at beginning of period | \$ 788 | \$ - | \$ 462 | \$ - |
| New loans purchased | - | 568 | - | 568 |
| Accretion recorded as loan interest income | (39) | (35) | (78) | (35) |
| Reclassification from (to) nonaccretable difference | - | - | 365 | - |
| Disposals/other adjustments | - | - | - | - |
| Balance at end of period | <u>\$ 749</u> | <u>\$ 533</u> | <u>\$ 749</u> | <u>\$ 533</u> |

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

5. Shareholders' Equity and Earnings Per Common Share

In December, 2018, our Board of Directors authorized a share repurchase plan (the "Repurchase Plan") to buy back up to 5% of our outstanding common stock through December 31, 2019. During the first six months of 2019, we completed the repurchase of 5% of our outstanding common shares. In June 2019, our Board of Directors authorized a 300,000 share expansion of the 2019 repurchase plan. We expect to accomplish any remaining repurchases through open market transactions, though we could execute repurchases through other means, such as privately negotiated transactions. The timing and amount of any share repurchases will depend on a variety of factors, including, among others, securities law restrictions, the trading price of our common stock, regulatory requirements, potential alternative uses for capital, and our financial performance. The Repurchase Plan does not obligate us to acquire any particular amount of common stock, and it may be modified or suspended at any time at our discretion. We expect to fund any repurchases from cash on hand. During the six month periods ended June 30, 2019 and 2018 repurchases were made totaling 1,179,688 shares and zero shares of common stock, respectively for an aggregate purchase price of \$25.8 million and zero, respectively.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---------------------------------------|----------|------------------------------|-----------|
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands, except per share data) | | | |
| Net income | \$ 10,730 | \$ 8,817 | \$ 20,111 | \$ 17,978 |
| Weighted average shares outstanding (1) | 23,036 | 24,109 | 23,310 | 22,745 |
| Stock units for deferred compensation plan for non-employee directors | 128 | 126 | 130 | 125 |
| Effect of stock options | 112 | 224 | 119 | 179 |
| Performance share units | 37 | 51 | 39 | 50 |
| Weighted average shares outstanding for calculation of diluted earnings per share | 23,313 | 24,510 | 23,598 | 23,099 |
| Net income per common share | | | | |
| Basic (1) | \$ 0.47 | \$ 0.37 | \$ 0.86 | \$ 0.79 |
| Diluted | \$ 0.46 | \$ 0.36 | \$ 0.85 | \$ 0.78 |

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

Weighted average stock options outstanding that were not considered in computing diluted net income per common share because they were anti-dilutive were zero for the three and six month periods ended June 30, 2019 and 2018, respectively.

6. Derivative Financial Instruments

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

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

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

| | June 30, 2019 | | |
|--|------------------------|--------------------------------|-----------------|
| | Notional Amount | Average Maturity (years) | Fair Value |
| | (Dollars in thousands) | | |
| Fair value hedge designation - Pay-fixed interest rate swap agreements | \$ 7,117 | 9.9 | \$ (203) |
| Cash flow hedge designation | | | |
| Pay-fixed interest rate swap agreements | \$ 25,000 | 2.1 | \$ (171) |
| Interest rate cap agreements | 150,000 | 3.1 | 576 |
| Total | <u>\$ 175,000</u> | <u>3.0</u> | <u>\$ 405</u> |
| No hedge designation | | | |
| Rate-lock mortgage loan commitments | \$ 81,784 | 0.1 | \$ 2,147 |
| Mandatory commitments to sell mortgage loans | 141,434 | 0.1 | (334) |
| Pay-fixed interest rate swap agreements - commercial | 108,895 | 5.3 | (3,179) |
| Pay-variable interest rate swap agreements - commercial | 108,895 | 5.3 | 3,179 |
| Purchased options | 3,095 | 2.0 | 171 |
| Written options | 3,035 | 2.0 | (170) |
| Total | <u>\$ 447,138</u> | <u>2.7</u> | <u>\$ 1,814</u> |
| December 31, 2018 | | | |
| | Notional Amount | Average Maturity (years) | Fair Value |
| (Dollars in thousands) | | | |
| Cash flow hedge designation | | | |
| Pay-fixed interest rate swap agreements | \$ 25,000 | 2.6 | \$ 280 |
| Interest rate cap agreements | 150,000 | 3.6 | 2,245 |
| Total | <u>\$ 175,000</u> | <u>3.5</u> | <u>\$ 2,525</u> |
| No hedge designation | | | |
| Rate-lock mortgage loan commitments | \$ 32,473 | 0.1 | \$ 687 |
| Mandatory commitments to sell mortgage loans | 57,583 | 0.1 | (383) |
| Pay-fixed interest rate swap agreements - commercial | 94,451 | 5.5 | 405 |
| Pay-variable interest rate swap agreements - commercial | 94,451 | 5.5 | (405) |
| Purchased options | 3,095 | 2.5 | 116 |
| Written options | 3,095 | 2.5 | (116) |
| Total | <u>\$ 285,148</u> | <u>3.7</u> | <u>\$ 304</u> |

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

We use variable-rate and short-term fixed-rate (less than 12 months) debt obligations to fund a portion of our Condensed Consolidated Statements of Financial Condition, which exposes us to variability in interest rates. To meet our asset/liability management objectives, we may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates (“Cash Flow Hedges”). Cash Flow Hedges included certain pay-fixed interest rate swaps and interest rate cap agreements. Pay-fixed interest rate swaps convert the variable-rate cash flows on debt obligations to fixed-rates. Under interest-rate cap agreements, we will receive cash if interest rates rise above a predetermined level. As a result, we effectively have variable-rate debt with an established maximum rate. We pay an upfront premium on interest rate caps which is recognized in earnings in the same period in which the hedged item affects earnings. Unrecognized premiums from interest rate caps aggregated to \$2.5 million at June 30, 2019 and \$2.7 million at December 31, 2018.

We record the fair value of Cash Flow Hedges in accrued income and other assets and accrued expenses and other liabilities on our Condensed Consolidated Statements of Financial Condition. On an ongoing basis, we adjust our Condensed Consolidated Statements of Financial Condition to reflect the then current fair value of Cash Flow Hedges. The related gains or losses are reported in other comprehensive income or loss and are subsequently reclassified into earnings, as a yield adjustment in the same period in which the related interest on the hedged items (variable-rate debt obligations) affect earnings. It is anticipated that approximately \$0.12 million, of unrealized gains on Cash Flow Hedges at June 30, 2019 will be reclassified to earnings over the next twelve months. To the extent that the Cash Flow Hedges are not effective, the ineffective portion of the Cash Flow Hedges is immediately recognized in interest expense. The maximum term of the Cash Flow Hedge at June 30, 2019 is 4.3 years.

Beginning in the second quarter of 2019 we entered into a pay-fixed interest rate swap to protect a portion of the fair value of a certain fixed rate commercial loan (“Fair Value Hedge”). As a result, changes in the fair value of the pay-fixed interest rate swap is expected to offset changes in the fair value of the fixed rate commercial loan due to fluctuations in interest rates. We record the fair value of Fair Value Hedges in accrued income and other assets and accrued expenses and other liabilities on our Condensed Consolidated Statements of Financial Condition. The hedged item (fixed rate commercial loan) is also recorded at fair value which offsets the adjustment to the Fair Value Hedge. On an ongoing basis, we adjust our Condensed Consolidated Statements of Financial Condition to reflect the then current fair value of both the Fair Value Hedge and the hedged item. The related gains or losses are reported in interest income – interest and fees on loans in our Condensed Consolidated Statements of Operations.

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

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

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

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

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

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

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

Fair Values of Derivative Instruments

| | Asset Derivatives | | | | Liability Derivatives | | | |
|---|------------------------------|-----------------|------------------------------|-----------------|------------------------------|-----------------|------------------------------|-----------------|
| | June 30, 2019 | | December 31, 2018 | | June 30, 2019 | | December 31, 2018 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| | (In thousands) | | | | | | | |
| Derivatives designated as hedging instruments | | | | | | | | |
| Pay-fixed interest rate swap agreements | Other assets | \$ - | Other assets | \$ 280 | Other liabilities | \$ 374 | Other liabilities | \$ - |
| Interest rate cap agreements | Other assets | 576 | Other assets | 2,245 | Other liabilities | - | Other liabilities | - |
| | | <u>576</u> | | <u>2,525</u> | | <u>374</u> | | <u>-</u> |
| Derivatives not designated as hedging instruments | | | | | | | | |
| Rate-lock mortgage loan commitments | Other assets | 2,147 | Other assets | 687 | Other liabilities | - | Other liabilities | - |
| Mandatory commitments to sell mortgage loans | Other assets | - | Other assets | - | Other liabilities | 334 | Other liabilities | 383 |
| Pay-fixed interest rate swap agreements - commercial | Other assets | 80 | Other assets | 1,116 | Other liabilities | 3,259 | Other liabilities | 711 |
| Pay-variable interest rate swap agreements - commercial | Other assets | 3,259 | Other assets | 711 | Other liabilities | 80 | Other liabilities | 1,116 |
| Purchased options | Other assets | 171 | Other assets | 116 | Other liabilities | - | Other liabilities | - |
| Written options | Other assets | - | Other assets | - | Other liabilities | 170 | Other liabilities | 116 |
| | | <u>5,657</u> | | <u>2,630</u> | | <u>3,843</u> | | <u>2,326</u> |
| Total derivatives | | <u>\$ 6,233</u> | | <u>\$ 5,155</u> | | <u>\$ 4,217</u> | | <u>\$ 2,326</u> |

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

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

| | | Three Month Periods Ended June 30, | | | | | | | |
|---|--|--|---------------|---|--|-----------------------------|---|--|----------------|
| | | Gain (Loss) Recognized in Other Comprehensive Income (Loss) (Effective Portion) | | Location of Gain Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) | Gain Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) | | Location of Gain (Loss) Recognized in Income (1) | Gain (Loss) Recognized in Income (1) | |
| | | 2019 | 2018 | 2019 | 2018 | 2019 | 2018 | 2019 | 2018 |
| | | (In thousands) | | | | | | | |
| Fair Value Hedges | | | | | | | | | |
| Pay-fixed interest rate swap agreements | | | | | | Interest income | \$ (203) | \$ | - |
| Cash Flow Hedges | | | | | | | | | |
| Interest rate cap agreements | | \$ (489) | \$ 244 | Interest expense | \$ 115 | \$ 45 | Interest expense | \$ - | \$ - |
| Pay-fixed interest rate swap agreements | | (267) | 83 | Interest expense | 27 | 8 | Interest expense | - | (24) |
| Total | | <u>\$ (756)</u> | <u>\$ 327</u> | | <u>\$ 142</u> | <u>\$ 53</u> | | <u>\$ -</u> | <u>\$ (24)</u> |
| No hedge designation | | | | | | | | | |
| Rate-lock mortgage loan commitments | | | | | | Net gains on mortgage loans | \$ 831 | \$ | 244 |
| Mandatory commitments to sell mortgage loans | | | | | | Net gains on mortgage loans | (125) | | (110) |
| Pay-fixed interest rate swap agreements - commercial | | | | | | Interest income | (2,437) | | 487 |
| Pay-variable interest rate swap agreements - commercial | | | | | | Interest income | 2,437 | | (487) |
| Pay-variable interest rate swap agreements | | | | | | Interest expense | - | | 36 |
| Purchased options | | | | | | Interest expense | (31) | | (6) |
| Written options | | | | | | Interest expense | 30 | | 6 |
| Total | | | | | | | <u>\$ 705</u> | | <u>\$ 170</u> |

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

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

Six Month Periods Ended June 30,

| | Gain (Loss) Recognized in Other Comprehensive Income (Loss) (Effective Portion) | | Location of Gain Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) | Gain Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion) | | Location of Gain (Loss) Recognized in Income (1) | Gain (Loss) Recognized in Income (1) | |
|---|--|-----------------|---|--|--------------|---|--|----------------|
| | 2019 | 2018 | (Effective Portion) | 2019 | 2018 | in Income (1) | 2019 | 2018 |
| (In thousands) | | | | | | | | |
| Fair Value Hedges | | | | | | | | |
| Pay-fixed interest rate swap agreements | | | | | | Interest income | \$ (203) | \$ - |
| Cash Flow Hedges | | | | | | | | |
| Interest rate cap agreements | \$ (1,274) | \$ 757 | Interest expense | \$ 233 | \$ 52 | Interest expense | \$ - | \$ - |
| Pay-fixed interest rate swap agreements | (394) | 254 | Interest expense | 58 | 7 | Interest expense | - | (12) |
| Total | <u>\$ (1,668)</u> | <u>\$ 1,011</u> | | <u>\$ 291</u> | <u>\$ 59</u> | | <u>\$ -</u> | <u>\$ (12)</u> |
| No hedge designation | | | | | | | | |
| Rate-lock mortgage loan commitments | | | | | | Net gains on mortgage loans | \$ 1,460 | \$ 672 |
| Mandatory commitments to sell mortgage loans | | | | | | Net gains on mortgage loans | 49 | (270) |
| Pay-fixed interest rate swap agreements - commercial | | | | | | Interest income | (3,584) | 1,543 |
| Pay-variable interest rate swap agreements - commercial | | | | | | Interest income | 3,584 | (1,543) |
| Pay-variable interest rate swap agreements | | | | | | Interest expense | - | 36 |
| Purchased options | | | | | | Interest expense | 55 | (99) |
| Written options | | | | | | Interest expense | (54) | 99 |
| Total | | | | | | | <u>\$ 1,510</u> | <u>\$ 438</u> |

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

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

7. Goodwill and other Intangibles

The following table summarizes intangible assets, net of amortization:

| | <u>June 30, 2019</u> | | <u>December 31, 2018</u> | |
|---|------------------------------|---------------------------------|------------------------------|---------------------------------|
| | <u>Gross Carrying Amount</u> | <u>Accumulated Amortization</u> | <u>Gross Carrying Amount</u> | <u>Accumulated Amortization</u> |
| | (In thousands) | | | |
| Amortized intangible assets - core deposits | \$ 11,916 | \$ 6,046 | \$ 11,916 | \$ 5,501 |
| Unamortized intangible assets - goodwill | \$ 28,300 | | \$ 28,300 | |

A summary of estimated core deposit intangible amortization at June 30, 2019 follows:

| | (In thousands) |
|-------------------------------------|-----------------|
| Six months ending December 31, 2019 | \$ 544 |
| 2020 | 1,020 |
| 2021 | 970 |
| 2022 | 785 |
| 2023 | 547 |
| 2024 and thereafter | 2,004 |
| Total | <u>\$ 5,870</u> |

8. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.5 million shares of common stock as of June 30, 2019. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of June 30, 2019. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but unissued shares.

During the three month periods ended June 30, 2019 and 2018 pursuant to our long-term incentive plan, we granted 0.004 million and 0.009 million shares of restricted stock to certain officers. For both six month periods ended June 30, 2019 and 2018, pursuant to our long-term incentive plan, we granted 0.05 million shares of restricted stock and 0.02 million performance stock units (“PSU”) to certain officers. Except for 0.002 million shares of restricted stock issued during the first quarters of 2019 and 2018 that vest ratably over three years, the shares of restricted stock and PSUs cliff vest after a period of three years. The performance feature of the PSUs is based on a comparison of our total shareholder return over the three year period starting on the grant date to the total shareholder return over that period for a banking index of our peers.

Our directors may elect to receive a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis pursuant to the non-employee director stock purchase plan referenced above). Shares equal in value to that portion of each director’s fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.005 million shares during each six month period ended June 30, 2019 and 2018 pursuant to this plan and expensed their value during those same periods.

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

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$0.4 million and \$0.8 million during the three and six month periods ended June 30, 2019, respectively, and was \$0.4 million and \$0.7 million during the same periods in 2018, respectively. The corresponding tax benefit relating to this expense was \$0.1 million and \$0.2 million for the three and six month periods ended June 30, 2019, respectively and \$0.1 million and \$0.2 million for the same periods in 2018. Total expense recognized for non-employee director share based payments was \$0.06 million and \$0.11 million during the three and six month periods ended June 30, 2019, respectively, and was \$0.05 million and \$0.11 million during the same periods in 2018, respectively. The corresponding tax benefit relating to this expense was \$0.01 million and \$0.02 million for the three and six month periods ended June 30, 2019, respectively and \$0.01 million and \$0.02 million during the same periods in 2018.

At June 30, 2019, the total expected compensation cost related to non-vested restricted stock and PSUs not yet recognized was \$2.7 million. The weighted-average period over which this amount will be recognized is 2.0 years.

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

| | Number of Shares | Average Exercise Price | Weighted- Average Remaining Contractual Term (Years) | Aggregated Intrinsic Value (In thousands) |
|---|---------------------|------------------------------|--|--|
| Outstanding at January 1, 2019 | 211,421 | \$ 6.48 | | |
| Granted | - | | | |
| Exercised | (68,399) | 10.16 | | |
| Forfeited | - | | | |
| Expired | (558) | 22.35 | | |
| Outstanding at June 30, 2019 | <u>142,464</u> | <u>\$ 4.66</u> | <u>3.5</u> | <u>\$ 2,442</u> |
| Vested and expected to vest at June 30, 2019 | <u>142,464</u> | <u>\$ 4.66</u> | <u>3.5</u> | <u>\$ 2,442</u> |
| Exercisable at June 30, 2019 | <u>142,464</u> | <u>\$ 4.66</u> | <u>3.5</u> | <u>\$ 2,442</u> |

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

| | Number of Shares | Weighted- Average Grant Date Fair Value |
|--------------------------------|---------------------|--|
| Outstanding at January 1, 2019 | 258,419 | \$ 19.00 |
| Granted | 78,283 | 22.98 |
| Vested | (85,788) | 14.55 |
| Forfeited | (11,475) | 22.91 |
| Outstanding at June 30, 2019 | <u>239,439</u> | <u>\$ 21.72</u> |

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

Certain information regarding options exercised during the periods follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------|--------------------------------|----------|------------------------------|----------|
| | 2019 | 2018 | 2019 | 2018 |
| Intrinsic value | \$ - | \$ 1,596 | \$ 836 | \$ 1,674 |
| Cash proceeds received | \$ - | \$ 971 | \$ 695 | \$ 984 |
| Tax benefit realized | \$ - | \$ 336 | \$ 176 | \$ 352 |

9. Income Tax

Income tax expense was \$2.7 million and \$2.1 million during the three month periods ended June 30, 2019 and 2018, respectively and \$4.9 million and \$4.1 million during the six months ended June 30, 2019 and 2018, respectively. Our actual federal income tax expense is different than the amount computed by applying our statutory income tax rate to our income before income tax primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance. In addition, the three and six month periods ending June 30, 2019 include reductions of zero and \$0.2 million, respectively, of income tax expense related to the impact of the excess value of stock awards that vested and stock options that were exercised as compared to the initial fair values that were expensed. These amounts during the same periods in 2018 were \$0.1 million and \$0.3 million, respectively.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at June 30, 2019, June 30, 2018 and December 31, 2018 that the realization of substantially all of our deferred tax assets continues to be more likely than not.

At both June 30, 2019 and December 31, 2018, we had approximately \$0.6 million, of gross unrecognized tax benefits. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease during the balance of 2019.

10. Regulatory Matters

Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank’s current year net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of June 30, 2019, the Bank had positive undivided profits of \$32.6 million. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total, Tier 1, and common equity Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can result in certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our interim condensed consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of June 30, 2019 and December 31, 2018, categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation (“FDIC”) categorization.

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

Our actual capital amounts and ratios follow (1):

| | Actual | | Minimum for Adequately Capitalized Institutions | | Minimum for Well-Capitalized Institutions | |
|---|------------|--------|---|-------|---|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (Dollars in thousands) | | | | | | |
| June 30, 2019 | | | | | | |
| Total capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 360,894 | 13.36% | \$ 216,166 | 8.00% | NA | NA |
| Independent Bank | 346,015 | 12.81 | 216,074 | 8.00 | \$ 270,093 | 10.00% |
| Tier 1 capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 333,508 | 12.34% | \$ 162,125 | 6.00% | NA | NA |
| Independent Bank | 318,629 | 11.80 | 162,056 | 6.00 | \$ 216,074 | 8.00% |
| Common equity tier 1 capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 295,310 | 10.93% | \$ 121,594 | 4.50% | NA | NA |
| Independent Bank | 318,629 | 11.80 | 121,542 | 4.50 | \$ 175,561 | 6.50% |
| Tier 1 capital to average assets | | | | | | |
| Consolidated | \$ 333,508 | 9.95% | \$ 134,131 | 4.00% | NA | NA |
| Independent Bank | 318,629 | 9.50 | 134,138 | 4.00 | \$ 167,673 | 5.00% |
| December 31, 2018 | | | | | | |
| Total capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 371,603 | 14.25% | \$ 208,572 | 8.00% | NA | NA |
| Independent Bank | 337,227 | 12.94 | 208,456 | 8.00 | \$ 260,569 | 10.00% |
| Tier 1 capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 345,419 | 13.25% | \$ 156,429 | 6.00% | NA | NA |
| Independent Bank | 311,043 | 11.94 | 156,342 | 6.00 | \$ 208,456 | 8.00% |
| Common equity tier 1 capital to risk-weighted assets | | | | | | |
| Consolidated | \$ 307,255 | 11.79% | \$ 117,322 | 4.50% | NA | NA |
| Independent Bank | 311,043 | 11.94 | 117,256 | 4.50 | \$ 169,370 | 6.50% |
| Tier 1 capital to average assets | | | | | | |
| Consolidated | \$ 345,419 | 10.47% | \$ 131,930 | 4.00% | NA | NA |
| Independent Bank | 311,043 | 9.44 | 131,778 | 4.00 | \$ 164,723 | 5.00% |

(1) These ratios do not reflect a capital conservation buffer of 2.50% and 1.875% at June 30, 2019 and December 31, 2018, respectively.

NA - Not applicable

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

The components of our regulatory capital are as follows:

| | Consolidated | | Independent Bank | |
|---|-------------------|----------------------|-------------------|----------------------|
| | June 30, 2019 | December 31, 2018 | June 30, 2019 | December 31, 2018 |
| | (In thousands) | | | |
| Total shareholders' equity | \$ 330,846 | \$ 338,994 | \$ 354,165 | \$ 341,496 |
| Add (deduct) | | | | |
| Accumulated other comprehensive (income) loss for regulatory purposes | (1,366) | 4,311 | (1,366) | 4,311 |
| Goodwill and other intangibles | (34,170) | (34,715) | (34,170) | (34,715) |
| Disallowed deferred tax assets | - | (1,335) | - | (49) |
| Common equity tier 1 capital | 295,310 | 307,255 | 318,629 | 311,043 |
| Qualifying trust preferred securities | 38,198 | 38,164 | - | - |
| Tier 1 capital | 333,508 | 345,419 | 318,629 | 311,043 |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 27,386 | 26,184 | 27,386 | 26,184 |
| Total risk-based capital | <u>\$ 360,894</u> | <u>\$ 371,603</u> | <u>\$ 346,015</u> | <u>\$ 337,227</u> |

11. Fair Value Disclosures

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

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

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

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

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

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

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

Securities: Where quoted market prices are available in an active market, securities (equity securities at fair value or available for sale) are classified as Level 1 of the valuation hierarchy. Level 1 securities include certain preferred stocks included in our equity securities at fair value for which there are quoted prices in active markets (at December 31, 2018). If quoted market prices are not available for the specific security, then fair values are estimated by (1) using quoted market prices of securities with similar characteristics, (2) matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted prices, or (3) a discounted cash flow analysis whose significant fair value inputs can generally be verified and do not typically involve judgment by management. These securities are classified as Level 2 of the valuation hierarchy and primarily include agency securities, private label mortgage-backed securities, other asset backed securities, obligations of states and political subdivisions, trust preferred securities, corporate securities and foreign government securities.

Loans held for sale: The fair value of mortgage loans held for sale, carried at fair value is based on agency cash window loan pricing for comparable assets (recurring Level 2) and the fair value of mortgage loans held for sale, carried at the lower of cost or fair value (at December 31, 2018) is based on a quoted sales price (non-recurring Level 1).

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. Those impaired loans not requiring an allowance for loan losses represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2019 and December 31, 2018, all of our impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

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

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

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

Capitalized mortgage loan servicing rights: The fair value of capitalized mortgage loan servicing rights is based on a valuation model used by an independent third party that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Certain model assumptions are generally unobservable and are based upon the best information available including data relating to our own servicing portfolio, reviews of mortgage servicing assumption and valuation surveys and input from various mortgage servicers and, therefore, are recorded as Level 3. Management evaluates the third party valuation for reasonableness each quarter as part of our financial reporting control processes.

Derivatives: The fair value of rate-lock mortgage loan commitments is based on agency cash window loan pricing for comparable assets and the fair value of mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets (recurring Level 2). The fair value of interest rate swap and interest rate cap agreements are derived from proprietary models which utilize current market data. The significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management (recurring Level 2). The fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management (recurring Level 2).

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

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

| | Fair Value Measurements | Fair Value Measurements Using | | |
|---|-------------------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | (In thousands) | | |
| June 30, 2019: | | | | |
| Measured at Fair Value on a Recurring Basis | | | | |
| Assets | | | | |
| Securities available for sale | | | | |
| U.S. agency | \$ 17,183 | \$ - | \$ 17,183 | \$ - |
| U.S. agency residential mortgage-backed | 137,017 | - | 137,017 | - |
| U.S. agency commercial mortgage-backed | 12,238 | - | 12,238 | - |
| Private label mortgage-backed | 30,129 | - | 30,129 | - |
| Other asset backed | 91,151 | - | 91,151 | - |
| Obligations of states and political subdivisions | 104,827 | - | 104,827 | - |
| Corporate | 33,882 | - | 33,882 | - |
| Trust preferred | 1,851 | - | 1,851 | - |
| Foreign government | 2,027 | - | 2,027 | - |
| Loans held for sale, carried at fair value | 62,883 | - | 62,883 | - |
| Capitalized mortgage loan servicing rights | 17,894 | - | - | 17,894 |
| Derivatives (1) | 6,233 | - | 6,233 | - |
| Liabilities | | | | |
| Derivatives (2) | 4,217 | - | 4,217 | - |
| Measured at Fair Value on a Non-recurring Basis: | | | | |
| Assets | | | | |
| Impaired loans (3) | | | | |
| Commercial | | | | |
| Income producing - real estate | 116 | - | - | 116 |
| Land, land development & construction-real estate | 1,198 | - | - | 1,198 |
| Commercial and industrial | 106 | - | - | 106 |
| Mortgage | | | | |
| 1-4 family | 839 | - | - | 839 |
| Resort lending | 360 | - | - | 360 |
| Home equity - 1st lien | 41 | - | - | 41 |
| Home equity - 2nd lien | 182 | - | - | 182 |
| Installment | | | | |
| Home equity - 1st lien | 2 | - | - | 2 |
| Home equity - 2nd lien | 31 | - | - | 31 |
| Boat lending | 21 | - | - | 21 |
| Recreational vehicle lending | 1 | - | - | 1 |
| Other | 97 | - | - | 97 |
| Other real estate (4) | | | | |
| Mortgage | | | | |
| 1-4 family | 8 | - | - | 8 |
| Home equity - 2nd lien | 59 | - | - | 59 |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

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

| | Fair Value Measure- ments | Fair Value Measurements Using | | |
|---|---------------------------------|---|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Un- observable Inputs (Level 3) |
| (In thousands) | | | | |
| December 31, 2018: | | | | |
| Measured at Fair Value on a Recurring Basis | | | | |
| Assets | | | | |
| Equity securities at fair value | \$ 393 | \$ 393 | \$ - | \$ - |
| Securities available for sale | | | | |
| U.S. agency | 20,014 | - | 20,014 | - |
| U.S. agency residential mortgage-backed | 123,751 | - | 123,751 | - |
| U.S. agency commercial mortgage-backed | 5,726 | - | 5,726 | - |
| Private label mortgage-backed | 29,419 | - | 29,419 | - |
| Other asset backed | 83,319 | - | 83,319 | - |
| Obligations of states and political subdivisions | 127,555 | - | 127,555 | - |
| Corporate | 34,309 | - | 34,309 | - |
| Trust preferred | 1,819 | - | 1,819 | - |
| Foreign government | 2,014 | - | 2,014 | - |
| Loans held for sale, carried at fair value | 44,753 | - | 44,753 | - |
| Capitalized mortgage loan servicing rights | 21,400 | - | - | 21,400 |
| Derivatives (1) | 5,155 | - | 5,155 | - |
| Liabilities | | | | |
| Derivatives (2) | 2,326 | - | 2,326 | - |
| Measured at Fair Value on a Non-recurring Basis: | | | | |
| Assets | | | | |
| Loans held for sale, carried at the lower of cost or fair value | 41,471 | 41,471 | - | - |
| Impaired loans (3) | | | | |
| Commercial | | | | |
| Income producing - real estate | 217 | - | - | 217 |
| Land, land development & construction-real estate | 106 | - | - | 106 |
| Commercial and industrial | 2,243 | - | - | 2,243 |
| Mortgage | | | | |
| 1-4 family | 333 | - | - | 333 |
| Resort lending | 572 | - | - | 572 |
| Other real estate (4) | | | | |
| Mortgage | | | | |
| 1-4 family | 95 | - | - | 95 |
| Home equity - 2nd lien | 59 | - | - | 59 |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2019 and 2018.

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

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

| | Changes in Fair Values for the Six-Month Periods Ended June 30 for Items Measured at Fair Value Pursuant to Election of the Fair Value Option | | | |
|--|---|-------------------|------------------------------------|--|
| | Net Gains (Losses) on Assets | | Mortgage Loan Servicing, net | Total Change in Fair Values Included in Current Period Earnings |
| | Securities | Mortgage Loans | | |
| | (In thousands) | | | |
| 2019 | | | | |
| Equity securities at fair value | \$ 167 | \$ - | \$ - | \$ 167 |
| Loans held for sale | - | 577 | - | 577 |
| Capitalized mortgage loan servicing rights | - | - | (6,113) | (6,113) |
| 2018 | | | | |
| Equity securities at fair value | \$ (119) | \$ - | \$ - | \$ (119) |
| Loans held for sale | - | 367 | - | 367 |
| Capitalized mortgage loan servicing rights | - | - | 892 | 892 |

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

The following represent impairment charges recognized during the three and six month periods ended June 30, 2019 and 2018 relating to assets measured at fair value on a non-recurring basis:

- Loans which are measured for impairment using the fair value of collateral for collateral dependent loans had a carrying amount of \$3.0 million, which is net of a valuation allowance of \$1.2 million at June 30, 2019, and had a carrying amount of \$3.5 million, which is net of a valuation allowance of \$1.5 million at December 31, 2018. The provision for loan losses included in our results of operations relating to impaired loans was a net expense of \$0.3 million and \$0.5 million for the three month periods ending June 30, 2019 and 2018, respectively, and a net expense of \$0.4 million and \$0.5 million for the six month periods ending June 30, 2019 and 2018, respectively.
- Other real estate, which is measured using the fair value of the property, had a carrying amount of \$0.1 million which is net of a valuation allowance of \$0.1 million at June 30, 2019, and a carrying amount of \$0.2 million, which is net of a valuation allowance of \$0.1 million, at December 31, 2018. Charges included in our results of operations relating to other real estate measured at fair value were zero and \$0.01 million during each of the three and six month periods ended June 30, 2019, and were zero during each of the three and six month periods ended June 30, 2018.

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

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

| | Capitalized Mortgage Loan Servicing Rights | | | |
|---|--|------------------|-------------------|------------------|
| | Three Months Ended | | Six Months Ended | |
| | June 30, | | June 30, | |
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands) | | (In thousands) | |
| Beginning balance | \$ 19,909 | \$ 17,783 | \$ 21,400 | \$ 15,699 |
| Total gains (losses) realized and unrealized: | | | | |
| Included in results of operations | (3,422) | (137) | (6,113) | 892 |
| Included in other comprehensive income (loss) | - | - | - | - |
| Purchases, issuances, settlements, maturities and calls | 1,407 | 4,202 | 2,607 | 5,257 |
| Transfers in and/or out of Level 3 | - | - | - | - |
| Ending balance | <u>\$ 17,894</u> | <u>\$ 21,848</u> | <u>\$ 17,894</u> | <u>\$ 21,848</u> |
| Amount of total gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at June 30 | <u>\$ (3,422)</u> | <u>\$ (137)</u> | <u>\$ (6,113)</u> | <u>\$ 892</u> |

The fair value of our capitalized mortgage loan servicing rights has been determined based on a valuation model used by an independent third party as discussed above. The significant unobservable inputs used in the fair value measurement of the capitalized mortgage loan servicing rights are discount rate, cost to service, ancillary income and float rate. Significant changes in all four of these assumptions in isolation would result in significant changes to the value of our capitalized mortgage loan servicing rights. Quantitative information about our Level 3 fair value measurements measured on a recurring basis follows:

| | Asset Fair Value | Valuation Technique | Unobservable Inputs | Range | Weighted Average |
|--|------------------------|--|------------------------|------------------|---------------------|
| | (In thousands) | | | | |
| June 30, 2019 | | | | | |
| Capitalized mortgage loan servicing rights | \$ 17,894 | Present value of net servicing revenue | Discount rate | 10.00% to 13.00% | 10.14% |
| | | | Cost to service | \$ 66 to \$216 | \$ 80 |
| | | | Ancillary income | 20 to 36 | 22 |
| | | | Float rate | 1.77% | 1.77% |
| December 31, 2018 | | | | | |
| Capitalized mortgage loan servicing rights | \$ 21,400 | Present value of net servicing revenue | Discount rate | 10.00% to 13.00% | 10.15% |
| | | | Cost to service | \$ 68 to \$216 | \$ 81 |
| | | | Ancillary income | 20 to 36 | 23 |
| | | | Float rate | 2.57% | 2.57% |

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

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

| | Asset Fair Value | Valuation Technique | Unobservable Inputs | Range | Weighted Average |
|-----------------------------|------------------------|---------------------------|---|------------------|---------------------|
| | (In thousands) | | | | |
| June 30, 2019 | | | | | |
| Impaired loans | | | | | |
| Commercial(1) | \$ 1,420 | Sales comparison approach | Adjustment for differences between comparable sales | (48.0)% to 40.0% | (6.0)% |
| Mortgage and Installment(2) | 1,574 | Sales comparison approach | Adjustment for differences between comparable sales | (40.1) to 56.7 | (2.6) |
| Other real estate Mortgage | 67 | Sales comparison approach | Adjustment for differences between comparable sales | (0.0) to 10.2 | 4.1 |
| December 31, 2018 | | | | | |
| Impaired loans | | | | | |
| Commercial(1) | \$ 2,566 | Sales comparison approach | Adjustment for differences between comparable sales | (32.5)% to 60.0% | (1.9)% |
| Mortgage | 905 | Sales comparison approach | Adjustment for differences between comparable sales | (40.1) to 25.6 | 0.7 |
| Other real estate Mortgage | 154 | Sales comparison approach | Adjustment for differences between comparable sales | 0.0 to 34.1 | 11.2 |

(1) In addition to the valuation techniques and unobservable inputs discussed above, at June 30, 2019 and December 31, 2018, we had an impaired collateral dependent commercial relationship that totaled \$0.5 million and \$0.7 million, respectively that was secured by collateral other than real estate. Collateral securing this relationship primarily included accounts receivable, inventory and cash at June 30, 2019 and December 31, 2018. Valuation techniques at June 30, 2019 and December 31, 2018, included discounting financial statement values for each particular asset type. Discount rates used ranged from 5% to 97% of stated values at June 30, 2019 and 20% to 80% of stated values at December 31, 2018.

(2) In addition to the valuation techniques and unobservable inputs discussed above, at June 30, 2019 certain impaired collateral dependent installment loans totaling approximately \$0.1 million are secured by collateral other than real estate. For the majority of these loans, we apply internal discount rates to industry valuation guides.

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

| | Aggregate Fair Value | Difference (In thousands) | Contractual Principal |
|---------------------|-------------------------|------------------------------|--------------------------|
| Loans held for sale | | | |
| June 30, 2019 | \$ 62,883 | \$ 1,834 | \$ 61,049 |
| December 31, 2018 | 44,753 | 1,257 | 43,496 |

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

12. Fair Values of Financial Instruments

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

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

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

The estimated recorded book balances and fair values follow:

| | Recorded Book Balance | Fair Value | Fair Value Using | | |
|---|-----------------------------|--------------|---|---|---|
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Un- observable Inputs (Level 3) |
| (In thousands) | | | | | |
| June 30, 2019 | | | | | |
| Assets | | | | | |
| Cash and due from banks | \$ 34,461 | \$ 34,461 | \$ 34,461 | \$ - | \$ - |
| Interest bearing deposits | 20,676 | 20,676 | 20,676 | - | - |
| Interest bearing deposits - time | 498 | 498 | - | 498 | - |
| Securities available for sale | 430,305 | 430,305 | - | 430,305 | - |
| Federal Home Loan Bank and Federal Reserve Bank | | | | | |
| Stock | 18,359 | NA | NA | NA | NA |
| Net loans and loans held for sale | 2,743,506 | 2,747,828 | - | 62,883 | 2,684,945 |
| Accrued interest receivable | 10,816 | 10,816 | 1 | 1,634 | 9,181 |
| Derivative financial instruments | 6,233 | 6,233 | - | 6,233 | - |
| Liabilities | | | | | |
| Deposits with no stated maturity (1) | \$ 2,294,255 | \$ 2,294,255 | \$ 2,294,255 | \$ - | \$ - |
| Deposits with stated maturity (1) | 684,630 | 683,547 | - | 683,547 | - |
| Other borrowings | 41,144 | 41,271 | - | 41,271 | - |
| Subordinated debentures | 39,422 | 33,214 | - | 33,214 | - |
| Accrued interest payable | 1,668 | 1,668 | 128 | 1,540 | - |
| Derivative financial instruments | 4,217 | 4,217 | - | 4,217 | - |
| December 31, 2018 | | | | | |
| Assets | | | | | |
| Cash and due from banks | \$ 23,350 | \$ 23,350 | \$ 23,350 | \$ - | \$ - |
| Interest bearing deposits | 46,894 | 46,894 | 46,894 | - | - |
| Interest bearing deposits - time | 595 | 594 | - | 594 | - |
| Equity securities at fair value | 393 | 393 | 393 | - | - |
| Securities available for sale | 427,926 | 427,926 | - | 427,926 | - |
| Federal Home Loan Bank and Federal Reserve Bank | | | | | |
| Stock | 18,359 | NA | NA | NA | NA |
| Net loans and loans held for sale | 2,643,856 | 2,606,256 | 41,471 | 44,753 | 2,520,032 |
| Accrued interest receivable | 10,164 | 10,164 | 22 | 1,789 | 8,353 |
| Derivative financial instruments | 5,155 | 5,155 | - | 5,155 | - |
| Liabilities | | | | | |
| Deposits with no stated maturity (1) | \$ 2,197,494 | \$ 2,197,494 | \$ 2,197,494 | \$ - | \$ - |
| Deposits with stated maturity (1) | 715,934 | 711,312 | - | 711,312 | - |
| Other borrowings | 25,700 | 25,706 | - | 25,706 | - |
| Subordinated debentures | 39,388 | 35,021 | - | 35,021 | - |
| Accrued interest payable | 1,646 | 1,646 | 114 | 1,532 | - |
| Derivative financial instruments | 2,326 | 2,326 | - | 2,326 | - |

(1) Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$270.864 million and \$123.080 million at June 30, 2019 and December 31, 2018, respectively. Deposits with a stated maturity include reciprocal deposits with a recorded book balance of \$55.462 million and \$58.992 million at June 30, 2019 and December 31, 2018, respectively.

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

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

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

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

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

13. Contingencies

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

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

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

The provision for loss reimbursement on sold loans represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank of Indianapolis). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The provision for loss reimbursement on sold loans was an expense of \$0.03 million and \$0.02 million for the three month periods ended June 30, 2019 and 2018 and an expense of \$0.15 million and \$0.03 million for the six month periods ended June 30, 2019 and 2018, respectively. The reserve for loss reimbursements on sold mortgage loans totaled \$0.83 million and \$0.78 million at June 30, 2019 and December 31, 2018, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

We own 12,566 shares of VISA Class B common stock. At the present time, these shares can only be sold to other Class B shareholders. As a result, there has generally been limited transfer activity in private transactions between buyers and sellers. Given the limited activity that we have become aware of and the continuing uncertainty regarding the likelihood, ultimate timing and eventual exchange rate for Class B shares into Class A shares, we have elected to value these shares at zero. However, given the current conversion ratio of 1.6298 to Class A shares and the closing price of VISA Class A shares on July 30, 2019 of \$181.53 per share, our 12,566 Class B shares would have a current “value” of approximately \$3.7 million. We continue to monitor Class B trading activity and the status of the resolution of certain litigation matters at VISA that would trigger the conversion of Class B common shares into Class A common shares that would have no trading restrictions.

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

14. Accumulated Other Comprehensive Loss (“AOCL”)

A summary of changes in AOCL follows:

| | Unrealized Gains (Losses) on Securities Available for Sale | Dispropor- tionate Tax Effects from Securities Available for Sale | Unrealized Gains (Losses) on Cash Flow Hedges | Total |
|--|---|---|---|-------------------|
| | (In thousands) | | | |
| For the three months ended June 30, | | | | |
| 2019 | | | | |
| Balances at beginning of period | \$ (57) | \$ (5,798) | \$ (962) | \$ (6,817) |
| Other comprehensive income (loss) before reclassifications | 3,097 | - | (599) | 2,498 |
| Amounts reclassified from AOCL | - | - | (112) | (112) |
| Net current period other comprehensive income (loss) | 3,097 | - | (711) | 2,386 |
| Balances at end of period | <u>\$ 3,040</u> | <u>\$ (5,798)</u> | <u>\$ (1,673)</u> | <u>\$ (4,431)</u> |
| 2018 | | | | |
| Balances at beginning of period | \$ (3,509) | \$ (5,798) | \$ 805 | \$ (8,502) |
| Other comprehensive income (loss) before reclassifications | (949) | - | 258 | (691) |
| Amounts reclassified from AOCL | 21 | - | (42) | (21) |
| Net current period other comprehensive income (loss) | (928) | - | 216 | (712) |
| Balances at end of period | <u>\$ (4,437)</u> | <u>\$ (5,798)</u> | <u>\$ 1,021</u> | <u>\$ (9,214)</u> |
| For the six months ended June 30, | | | | |
| 2019 | | | | |
| Balances at beginning of period | \$ (4,185) | \$ (5,798) | \$ (125) | \$ (10,108) |
| Other comprehensive income (loss) before reclassifications | 7,333 | - | (1,318) | 6,015 |
| Amounts reclassified from AOCL | (108) | - | (230) | (338) |
| Net current period other comprehensive income (loss) | 7,225 | - | (1,548) | 5,677 |
| Balances at end of period | <u>\$ 3,040</u> | <u>\$ (5,798)</u> | <u>\$ (1,673)</u> | <u>\$ (4,431)</u> |
| 2018 | | | | |
| Balances at beginning of period | \$ (470) | \$ (5,798) | \$ 269 | \$ (5,999) |
| Other comprehensive income (loss) before reclassifications | (4,003) | - | 799 | (3,204) |
| Amounts reclassified from AOCL | 36 | - | (47) | (11) |
| Net current period other comprehensive income (loss) | (3,967) | - | 752 | (3,215) |
| Balances at end of period | <u>\$ (4,437)</u> | <u>\$ (5,798)</u> | <u>\$ 1,021</u> | <u>\$ (9,214)</u> |

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

The disproportionate tax effects from securities available for sale arose due to tax effects of other comprehensive income (“OCI”) in the presence of a valuation allowance against our deferred tax assets and a pretax loss from operations. Generally, the amount of income tax expense or benefit allocated to operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided when, in the presence of a valuation allowance against deferred tax assets, there is a pretax loss from operations and pretax income from other categories in the current period. In such instances, income from other categories must offset the current loss from operations, the tax benefit of such offset being reflected in operations. Release of material disproportionate tax effects from other comprehensive income to earnings is done by the portfolio method whereby the effects will remain in AOCL as long as we carry a more than inconsequential portfolio of securities available for sale.

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

| AOCL Component | Amount Reclassified From AOCL (In thousands) | Affected Line Item in Condensed Consolidated Statements of Operations |
|--|--|--|
| 2019 | | |
| Unrealized gains (losses) on securities available for sale | \$ | - Net gains (losses) on securities |
| | | - Net impairment loss recognized in earnings |
| | | - Total reclassifications before tax |
| | | - Income tax expense |
| | <u>\$</u> | - Reclassifications, net of tax |
| Unrealized gains (losses) on cash flow hedges | \$ | (142) Interest expense |
| | | (30) Income tax expense |
| | <u>\$</u> | (112) Reclassification, net of tax |
| | <u>\$</u> | 112 Total reclassifications for the period, net of tax |
| 2018 | | |
| Unrealized gains (losses) on securities available for sale | \$ | (26) Net gains (losses) on securities |
| | | - Net impairment loss recognized in earnings |
| | | (26) Total reclassifications before tax |
| | | (5) Income tax expense |
| | <u>\$</u> | (21) Reclassifications, net of tax |
| Unrealized gains (losses) on cash flow hedges | \$ | (53) Interest expense |
| | | (11) Income tax expense |
| | <u>\$</u> | (42) Reclassification, net of tax |
| | <u>\$</u> | 21 Total reclassifications for the period, net of tax |

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

A summary of reclassifications out of each component of AOCL for the six months ended June 30 follows:

| AOCL Component | Amount Reclassified From AOCL (In thousands) | Affected Line Item in Condensed Consolidated Statements of Operations |
|--|--|--|
| 2019 | | |
| Unrealized gains (losses) on securities available for sale | \$ 137 | Net gains (losses) on securities |
| | - | Net impairment loss recognized in earnings |
| | <u>137</u> | Total reclassifications before tax |
| | 29 | Income tax expense |
| | <u>\$ 108</u> | Reclassifications, net of tax |
| Unrealized gains (losses) on cash flow hedges | \$ (291) | Interest expense |
| | (61) | Income tax expense |
| | <u>\$ (230)</u> | Reclassification, net of tax |
| | <u>\$ 338</u> | Total reclassifications for the period, net of tax |
| 2018 | | |
| Unrealized gains (losses) on securities available for sale | \$ (45) | Net gains (losses) on securities |
| | - | Net impairment loss recognized in earnings |
| | <u>(45)</u> | Total reclassifications before tax |
| | (9) | Income tax expense |
| | <u>\$ (36)</u> | Reclassifications, net of tax |
| Unrealized gains (losses) on cash flow hedges | \$ (59) | Interest expense |
| | (12) | Income tax expense |
| | <u>\$ (47)</u> | Reclassification, net of tax |
| | <u>\$ 11</u> | Total reclassifications for the period, net of tax |

15. Revenue from Contracts with Customers

We account for revenue in accordance with ASC Topic 606, Revenue from Contracts with Customers. We derive the majority of our revenue from financial instruments and their related contractual rights and obligations which for the most part are excluded from the scope of this topic. These sources of revenue that are excluded from the scope of this topic include interest income, net gains on mortgage loans, net gains (losses) on securities, mortgage loan servicing, net and bank owned life insurance and were approximately 84.6% and 82.8% of total revenues at June 30, 2019 and 2018, respectively.

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

Material sources of revenue that are included in the scope of this topic include service charges on deposit accounts, other deposit related income, interchange income and investment and insurance commissions and are discussed in the following paragraphs. Generally these sources of revenue are earned at the time the service is delivered or over the course of a monthly period and do not result in any contract asset or liability balance at any given period end. As a result, there were no contract assets or liabilities recorded as of June 30, 2019 and December 31, 2018.

Service charges on deposit accounts and other deposit related income: Revenues are earned on depository accounts for commercial and retail customers and include fees for transaction-based, account maintenance and overdraft services. Transaction-based fees, which includes services such as ATM use fees, stop payment charges and ACH fees are recognized at the time the transaction is executed as that is the time we fulfill our customer's request. Account maintenance fees, which includes monthly maintenance services are earned over the course of a month representing the period over which the performance obligation is satisfied. Our obligation for overdraft services is satisfied at the time of the overdraft.

Interchange income: Interchange income primarily includes debit card interchange and network revenues. Debit card interchange and network revenues are earned on debit card transactions conducted through payment networks such as MasterCard and NYCE. Interchange income is recognized concurrently with the delivery of services on a daily basis. Interchange and network revenues are presented gross of interchange expenses, which are presented separately as a component of non-interest expense.

Investment and insurance commissions: Investment and insurance commissions include fees and commissions from asset management, custody, recordkeeping, investment advisory and other services provided to our customers. Revenue is recognized on an accrual basis at the time the services are performed and are generally based on either the market value of the assets managed or the services provided. We have an agent relationship with a third party provider of these services and net certain direct costs charged by the third party provider associated with providing these services to our customers.

Net (gains) losses on other real estate and repossessed assets: We record a gain or loss from the sale of other real estate when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. If we were to finance the sale of other real estate to the buyer, we would assess whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction is probable. Once these criteria are met, the other real estate asset would be derecognized and the gain or loss on sale would be recorded upon the transfer of control of the property to the buyer. There were no other real estate properties sold during the three and six month periods ending June 30, 2019 and 2018 that were financed by us.

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

Disaggregation of our revenue sources by attribute follows:

Three months ending June 30, 2019

| | Service Charges on Deposit Accounts | Other Deposit Related Income | Interchange Income | Investment and Insurance Commissions | Total |
|---------------------------|--|---------------------------------------|-----------------------|---|-----------------|
| | (In thousands) | | | | |
| Retail | | | | | |
| Overdraft fees | \$ 1,882 | - | - | - | \$ 1,882 |
| Account service charges | 541 | - | - | - | 541 |
| ATM fees | - | \$ 346 | - | - | 346 |
| Other | - | 212 | - | - | 212 |
| Business | | | | | |
| Overdraft fees | 377 | - | - | - | 377 |
| Account service charges | - | - | - | - | - |
| ATM fees | - | 9 | - | - | 9 |
| Other | - | 89 | - | - | 89 |
| Interchange income | - | - | \$ 2,604 | - | 2,604 |
| Asset management revenue | - | - | - | \$ 277 | 277 |
| Transaction based revenue | - | - | - | 173 | 173 |
| Total | <u>\$ 2,800</u> | <u>\$ 656</u> | <u>\$ 2,604</u> | <u>\$ 450</u> | <u>\$ 6,510</u> |

Reconciliation to Condensed Consolidated Statement of Operations:

| | |
|--------------------------------------|-----------------|
| Non-interest income - other: | |
| Other deposit related income | \$ 656 |
| Investment and insurance commissions | 450 |
| Bank owned life insurance | 270 |
| Other | 730 |
| Total | <u>\$ 2,106</u> |

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

Three months ending June 30, 2018

| | Service Charges on Deposit Accounts | Other Deposit Related Income | Interchange Income | Investment and Insurance Commissions | Total |
|---------------------------|--|---------------------------------------|-----------------------|---|-----------------|
| | (In thousands) | | | | |
| Retail | | | | | |
| Overdraft fees | \$ 2,044 | - | - | - | \$ 2,044 |
| Account service charges | 588 | - | - | - | 588 |
| ATM fees | - | \$ 358 | - | - | 358 |
| Other | - | 230 | - | - | 230 |
| Business | | | | | |
| Overdraft fees | 380 | - | - | - | 380 |
| Account service charges | 83 | - | - | - | 83 |
| ATM fees | - | 8 | - | - | 8 |
| Other | - | 146 | - | - | 146 |
| Interchange income | - | - | \$ 2,504 | - | 2,504 |
| Asset management revenue | - | - | - | \$ 281 | 281 |
| Transaction based revenue | - | - | - | 202 | 202 |
| Total | <u>\$ 3,095</u> | <u>\$ 742</u> | <u>\$ 2,504</u> | <u>\$ 483</u> | <u>\$ 6,824</u> |

Reconciliation to Condensed Consolidated Statement of Operations:

| | | | | | |
|--------------------------------------|--|--|--|-----------|--------------|
| Non-interest income - other: | | | | | |
| Other deposit related income | | | | \$ | 742 |
| Investment and insurance commissions | | | | | 483 |
| Bank owned life insurance | | | | | 220 |
| Other | | | | | 772 |
| Total | | | | <u>\$</u> | <u>2,217</u> |

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

Six months ending June 30, 2019

| | Service Charges on Deposit Accounts | Other Deposit Related Income | Interchange Income (In thousands) | Investment and Insurance Commissions | Total |
|---------------------------|--|---------------------------------------|---|---|------------------|
| Retail | | | | | |
| Overdraft fees | \$ 3,612 | - | - | - | \$ 3,612 |
| Account service charges | 1,057 | - | - | - | 1,057 |
| ATM fees | - | \$ 668 | - | - | 668 |
| Other | - | 463 | - | - | 463 |
| Business | | | | | |
| Overdraft fees | 762 | - | - | - | 762 |
| Account service charges | 9 | - | - | - | 9 |
| ATM fees | - | 17 | - | - | 17 |
| Other | - | 218 | - | - | 218 |
| Interchange income | - | - | \$ 4,959 | - | 4,959 |
| Asset management revenue | - | - | - | \$ 531 | 531 |
| Transaction based revenue | - | - | - | 216 | 216 |
| Total | <u>\$ 5,440</u> | <u>\$ 1,366</u> | <u>\$ 4,959</u> | <u>\$ 747</u> | <u>\$ 12,512</u> |

Reconciliation to Condensed Consolidated Statement of Operations:

| | | | | | |
|--------------------------------------|--|--|--|-----------|--------------|
| Non-interest income - other: | | | | | |
| Other deposit related income | | | | \$ | 1,366 |
| Investment and insurance commissions | | | | | 747 |
| Bank owned life insurance | | | | | 512 |
| Other | | | | | 1,745 |
| Total | | | | <u>\$</u> | <u>4,370</u> |

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

Six months ending June 30, 2018

| | Service Charges on Deposit Accounts | Other Deposit Related Income | Interchange Income | Investment and Insurance Commissions | Total |
|---------------------------|--|---------------------------------------|-----------------------|---|------------------|
| | (In thousands) | | | | |
| Retail | | | | | |
| Overdraft fees | \$ 4,016 | - | - | - | \$ 4,016 |
| Account service charges | 1,088 | - | - | - | 1,088 |
| ATM fees | - | \$ 703 | - | - | 703 |
| Other | - | 437 | - | - | 437 |
| Business | | | | | |
| Overdraft fees | 745 | - | - | - | 745 |
| Account service charges | 151 | - | - | - | 151 |
| ATM fees | - | 16 | - | - | 16 |
| Other | - | 275 | - | - | 275 |
| Interchange income | - | - | \$ 4,750 | - | 4,750 |
| Asset management revenue | - | - | - | \$ 552 | 552 |
| Transaction based revenue | - | - | - | 369 | 369 |
| Total | <u>\$ 6,000</u> | <u>\$ 1,431</u> | <u>\$ 4,750</u> | <u>\$ 921</u> | <u>\$ 13,102</u> |

Reconciliation to Condensed Consolidated Statement of Operations:

| | | | | | |
|--------------------------------------|--|--|--|-----------|--------------|
| Non-interest income - other: | | | | | |
| Other deposit related income | | | | \$ | 1,431 |
| Investment and insurance commissions | | | | | 921 |
| Bank owned life insurance | | | | | 476 |
| Other | | | | | 1,332 |
| Total | | | | <u>\$</u> | <u>4,160</u> |

16. Leases

We have operating leases, primarily relating to certain office facilities, some of which include renewal options and escalation clauses. Certain leases also include both lease components (fixed payments including rent, taxes and insurance costs) and non-lease components (common area or other maintenance costs) which are accounted for as a single lease component as we have elected the practical expedient to group lease and non-lease components for all leases. Most of our leases include one or more options to renew. The exercise of lease renewal options is typically at our sole discretion and are included in our ROU assets and lease liabilities if they are reasonably certain of exercise. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at the lease commencement date in determining the present value of the lease payments.

The cost components of our operating leases follows:

| | Three Months Ended | Six Months Ended |
|-----------------------|-----------------------|---------------------|
| | June 30, 2019 | |
| | (In thousands) | |
| Operating lease cost | \$ 563 | \$ 1,127 |
| Variable lease cost | 49 | 72 |
| Short-term lease cost | 5 | 10 |
| Total | <u>\$ 617</u> | <u>\$ 1,209</u> |

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

Variable lease costs consist primarily of taxes, insurance, and common area or other maintenance costs for our leased facilities.

Supplemental balance sheet information related to our operating leases follows:

| | June 30, 2019 |
|---|----------------|
| | (In thousands) |
| Lease right of use asset (1) | \$ 6,692 |
| Lease liabilities (2) | \$ 6,700 |
| Weighted average remaining lease term (years) | 5.58 |
| Weighted average discount rate | 3.2% |

(1) Included in Accrued income and other assets in our Condensed Consolidated Statements of Financial Condition.

(2) Included in Accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition.

Maturity analysis of our lease liabilities at June 30, 2019 based on required contractual payments follows:

| | (In thousands) |
|-------------------------------------|----------------|
| Six months ending December 31, 2019 | \$ 1,098 |
| 2020 | 1,711 |
| 2021 | 1,248 |
| 2022 | 963 |
| 2023 | 925 |
| 2024 and thereafter | 1,428 |
| Total lease payments | 7,373 |
| Less imputed interest | (673) |
| Total | \$ 6,700 |

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

17. Recent Acquisition

Effective April 1, 2018, we completed the acquisition of all of the issued and outstanding shares of common stock of TCSB through a merger of TCSB into Independent Bank Corporation (“IBCP”), with IBCP as the surviving corporation (the “Merger”). On that same date we also consolidated Traverse City State Bank, TCSB’s wholly-owned subsidiary bank, into Independent Bank (with Independent Bank as the surviving institution). Under the terms of the merger agreement each holder of TCSB common stock received 1.1166 shares of IBCP common stock plus cash in lieu of fractional shares totaling \$0.005 million. TCSB option holders had their options converted into IBCP stock options. As a result we issued 2.71 million shares of common stock and 0.19 million stock options with a fair value of approximately \$64.5 million to the shareholders and option holders of TCSB. The fair value of common stock and stock options issued as the consideration paid for TCSB was determined using the closing price of our common stock on the acquisition date. This acquisition was accounted for under the acquisition method of accounting. Accordingly, we recognized amounts for identifiable assets acquired and liabilities assumed at their estimated acquisition date fair values. TCSB results of operations are included in our results beginning April 1, 2018.

The following table reflects our final valuation of the assets acquired and liabilities assumed:

| | (In thousands) |
|--|----------------|
| Cash and cash equivalents | \$ 23,521 |
| Interest bearing deposits - time | 4,054 |
| Securities available for sale | 6,066 |
| Federal Home Loan Bank stock | 778 |
| Loans, net | 295,799 |
| Property and equipment, net | 1,067 |
| Capitalized mortgage loan servicing rights | 3,047 |
| Accrued income and other assets | 3,362 |
| Other intangibles (1) | 5,798 |
| Total assets acquired | 343,492 |
| Deposits | 287,710 |
| Other borrowings | 14,345 |
| Subordinated debentures | 3,768 |
| Accrued expenses and other liabilities | 1,429 |
| Total liabilities assumed | 307,252 |
| Net assets acquired | 36,240 |
| Goodwill | 28,300 |
| Purchase price (fair value of consideration) | \$ 64,540 |

(1) Relates to core deposit intangibles (see note #7).

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

Management views the disclosed fair values presented above to be final as the one-year measurement period for finalizing acquisition-date fair values has expired. During this measurement period we had one adjustment to our acquisition date fair values. During the third quarter of 2018, goodwill was reduced by \$0.7 million (to \$28.3 million) related to the collection of a TCSB acquired loan that had been charged off in full prior to the Merger. Because of the status of the collection activities related to this loan at the time of the Merger, we determined that this transaction was a measurement period adjustment and reduced goodwill accordingly.

Goodwill related to this acquisition will not be deductible for tax purposes and consists largely of synergies and cost savings resulting from the combining of the operations of TCSB into ours as well as expansion into a new market.

The estimated fair value of the core deposit intangible was \$5.8 million and is being amortized over an estimated useful life of 10 years.

The fair value of net assets acquired includes fair value adjustments to certain receivables that were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows. However, we believe that all contractual cash flows related to these financial instruments will be collected. As such, these receivables were not considered impaired at the acquisition date and were not subject to the guidance relating to purchased credit impaired loans which have shown evidence of credit deterioration since origination. Receivables acquired that are not subject to these requirements included non-impaired customer receivables with a fair value and gross contractual amounts receivable of \$292.9 million and \$298.6 million on the date of acquisition.

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

Introduction. The following section presents additional information to assess the financial condition and results of operations of Independent Bank Corporation ("IBCP"), its wholly-owned bank, Independent Bank (the "Bank"), and their subsidiaries. This section should be read in conjunction with the Condensed Consolidated Financial Statements. We also encourage you to read our 2018 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC"). That report includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

Overview. We provide banking services to customers located primarily in Michigan's Lower Peninsula. We also have two loan production offices in Ohio (Columbus and Fairlawn). As a result, our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula.

Recent Developments. On December 4, 2017, we entered into an Agreement and Plan of Merger with TCSB Bancorp, Inc. ("TCSB") (the "Merger Agreement") providing for a business combination of IBCP and TCSB. On April 1, 2018, TCSB was merged with and into IBCP, with IBCP as the surviving corporation (the "Merger"). In connection with the Merger, on April 1, 2018, IBCP consolidated Traverse City State Bank, TCSB's wholly-owned subsidiary bank, with and into Independent Bank (with Independent Bank as the surviving institution). See note #17.

It is against this backdrop that we discuss our results of operations and financial condition in the second quarter and first six months of 2019 as compared to 2018.

RESULTS OF OPERATIONS

Summary. We recorded net income of \$10.7 million and \$8.8 million during the three months ended June 30, 2019 and 2018, respectively. The increase in 2019 second quarter results as compared to 2018 primarily reflects an increase in net interest income and a decrease in non-interest expense that were partially offset by a decline in non-interest income and an increase in income tax expense.

We recorded net income of \$20.1 million and \$18.0 million during the six months ended June 30, 2019 and 2018, respectively. The increase in 2019 year-to-date results as compared to 2018 is primarily due to an increase in net interest income that was partially offset by a decline in non-interest income as well as increases in the provision for loan losses, non-interest expense and income tax expense.

Key performance ratios

| | Three months ended June 30, | | Six months ended June 30, | |
|-------------------------------------|--------------------------------|---------|------------------------------|---------|
| | 2019 | 2018 | 2019 | 2018 |
| Net income (annualized) to | | | | |
| Average assets | 1.27% | 1.12% | 1.20% | 1.22% |
| Average common shareholders' equity | 12.72 | 10.57 | 11.93 | 12.09 |
| Net income per common share | | | | |
| Basic | \$ 0.47 | \$ 0.37 | \$ 0.86 | \$ 0.79 |
| Diluted | 0.46 | 0.36 | 0.85 | 0.78 |

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

Our net interest income totaled \$30.8 million during the second quarter of 2019, an increase of \$1.8 million, or 6.1% from the year-ago period. This increase primarily reflects a \$227.3 million increase in average interest-earning assets that was partially offset by a six basis point decrease in our tax equivalent net interest income as a percent of average interest-earning assets (the “net interest margin”).

For the first six months of 2019, net interest income totaled \$61.0 million, an increase of \$8.1 million, or 15.3% from 2018. This increase primarily reflects a \$382.9 million increase in average interest-earning assets as well as a five basis point increase in our net interest margin.

Interest and fees on loans include \$0.4 million and \$0.8 million for the second quarter and first six months of 2019, respectively, and include \$0.6 million for both the second quarter and first six months of 2018, of accretion of the discount recorded on loans acquired in the Merger.

The increase in average interest-earning assets primarily reflects loan growth utilizing funds from increases in deposits and borrowed funds as well as the impact of the Merger (for the year-to-date comparative periods). The quarterly comparative decrease in the net interest margin reflects the impact of the flattening yield curve during 2019 and rising funding costs. The year-to-date comparative increase in the net interest margin reflects a change in the mix of average-interest earning assets (higher percentage of loans), increases in short-term market interest rates during 2018 and the impact of the Merger.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the second quarter and first six months of 2019, non-accrual loans averaged \$8.4 million and \$8.8 million, respectively. In the second quarter and first six months of 2018, non-accrual loans averaged \$7.5 million in each period. In addition, in the second quarter and first six months of 2019, we had net recoveries of \$0.20 million and \$0.43 million, respectively, of unpaid interest on loans placed on or taken off non-accrual during each period or on loans previously charged-off compared to net recoveries of \$0.18 million and \$0.35 million, respectively, during the same periods in 2018.

Average Balances and Tax Equivalent Rates

| | 2019 | | | 2018 | | |
|---|---------------------|------------------|--------------|---------------------|------------------|--------------|
| | Average Balance | Interest | Rate (2) | Average Balance | Interest | Rate (2) |
| (Dollars in thousands) | | | | | | |
| Assets | | | | | | |
| Taxable loans | \$ 2,692,168 | \$ 33,762 | 5.02% | \$ 2,442,159 | \$ 29,606 | 4.86% |
| Tax-exempt loans (1) | 7,480 | 94 | 5.04 | 6,897 | 85 | 4.94 |
| Taxable securities | 392,075 | 3,034 | 3.10 | 401,102 | 2,720 | 2.71 |
| Tax-exempt securities (1) | 49,448 | 406 | 3.28 | 69,325 | 559 | 3.23 |
| Interest bearing cash | 31,734 | 115 | 1.45 | 28,187 | 66 | 0.94 |
| Other investments | 18,359 | 264 | 5.77 | 16,312 | 199 | 4.89 |
| Interest Earning Assets | <u>3,191,264</u> | <u>37,675</u> | 4.73 | <u>2,963,982</u> | <u>33,235</u> | 4.49 |
| Cash and due from banks | 33,252 | | | 31,564 | | |
| Other assets, net | 163,882 | | | 172,650 | | |
| Total Assets | <u>\$ 3,388,398</u> | | | <u>\$ 3,168,196</u> | | |
| Liabilities | | | | | | |
| Savings and interest-bearing checking | \$ 1,413,073 | 2,647 | 0.75 | \$ 1,241,700 | 1,011 | 0.33 |
| Time deposits | 664,909 | 3,374 | 2.04 | 603,833 | 2,198 | 1.46 |
| Other borrowings | 77,678 | 796 | 4.11 | 100,754 | 914 | 3.64 |
| Interest Bearing Liabilities | <u>2,155,660</u> | <u>6,817</u> | 1.27 | <u>1,946,287</u> | <u>4,123</u> | 0.85 |
| Non-interest bearing deposits | 851,903 | | | 855,829 | | |
| Other liabilities | 42,581 | | | 31,454 | | |
| Shareholders' equity | 338,254 | | | 334,626 | | |
| Total liabilities and shareholders' equity | <u>\$ 3,388,398</u> | | | <u>\$ 3,168,196</u> | | |
| Net Interest Income | | <u>\$ 30,858</u> | | | <u>\$ 29,112</u> | |
| Net Interest Income as a Percent of Average Interest Earning Assets | | | <u>3.87%</u> | | | <u>3.93%</u> |

(1) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 21%.

(2) Annualized

Average Balances and Tax Equivalent Rates

| | 2019 | | | 2018 | | |
|--|---------------------|------------------|--------------|---------------------|------------------|--------------|
| | Average Balance | Interest | Rate (2) | Average Balance | Interest | Rate (2) |
| (Dollars in thousands) | | | | | | |
| Assets | | | | | | |
| Taxable loans | \$ 2,652,893 | \$ 66,362 | 5.03% | \$ 2,252,492 | \$ 52,945 | 4.72% |
| Tax-exempt loans (1) | 8,081 | 197 | 4.92 | 4,526 | 104 | 4.63 |
| Taxable securities | 390,966 | 6,040 | 3.09 | 411,619 | 5,355 | 2.60 |
| Tax-exempt securities (1) | 53,148 | 875 | 3.29 | 73,810 | 1,162 | 3.15 |
| Interest bearing cash | 48,381 | 426 | 1.78 | 30,531 | 148 | 0.98 |
| Other investments | 18,359 | 528 | 5.80 | 15,930 | 447 | 5.66 |
| Interest Earning Assets | 3,171,828 | 74,428 | 4.72 | 2,788,908 | 60,161 | 4.33 |
| Cash and due from banks | 33,744 | | | 31,848 | | |
| Other assets, net | 167,270 | | | 152,912 | | |
| Total Assets | \$ 3,372,842 | | | \$ 2,973,668 | | |
| Liabilities | | | | | | |
| Savings and interest-bearing checking | \$ 1,387,208 | 4,969 | 0.72 | \$ 1,168,747 | 1,562 | 0.27 |
| Time deposits | 676,606 | 6,733 | 2.01 | 584,167 | 3,934 | 1.36 |
| Other borrowings | 71,901 | 1,508 | 4.23 | 82,920 | 1,488 | 3.62 |
| Interest Bearing Liabilities | 2,135,715 | 13,210 | 1.25 | 1,835,834 | 6,984 | 0.77 |
| Non-interest bearing deposits | 855,732 | | | 807,504 | | |
| Other liabilities | 41,481 | | | 30,531 | | |
| Shareholders' equity | 339,914 | | | 299,799 | | |
| Total liabilities and shareholders' equity | \$ 3,372,842 | | | \$ 2,973,668 | | |
| Net Interest Income | | \$ 61,218 | | | \$ 53,177 | |
| Net Interest Income as a Percent of Average Interest Earning Assets | | | 3.88% | | | 3.83% |

(1) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 21%.

(2) Annualized

Reconciliation of Non-GAAP Financial Measures

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------------|------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (Dollars in thousands) | | | |
| Net Interest Margin, Fully Taxable Equivalent (“FTE”) | | | | |
| Net interest income | \$ 30,756 | \$ 28,980 | \$ 60,999 | \$ 52,916 |
| Add: taxable equivalent adjustment | 102 | 132 | 219 | 261 |
| Net interest income - taxable equivalent | <u>\$ 30,858</u> | <u>\$ 29,112</u> | <u>\$ 61,218</u> | <u>\$ 53,177</u> |
| Net interest margin (GAAP) ⁽¹⁾ | <u>3.86%</u> | <u>3.92%</u> | <u>3.86%</u> | <u>3.81%</u> |
| Net interest margin (FTE) ⁽¹⁾ | <u>3.87%</u> | <u>3.93%</u> | <u>3.88%</u> | <u>3.83%</u> |

(1) Annualized.

Provision for loan losses. The provision for loan losses was an expense of \$0.7 million during both the three months ended June 30, 2019 and 2018. During the six-month periods ended June 30, 2019 and 2018, the provision was an expense of \$1.3 million and \$1.0 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan growth, loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See “Portfolio Loans and asset quality” for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the second quarter and first half of 2019.

Non-interest income. Non-interest income is a significant element in assessing our results of operations. Non-interest income totaled \$9.9 million during the second quarter of 2019 compared to \$12.3 million in the second quarter of 2018. For the first six months of 2019, non-interest income totaled \$19.9 million compared to \$24.0 million for the first six months of 2018.

The components of non-interest income are as follows:

Non-Interest Income

| | Three months ended June 30, | | Six months ended June 30, | |
|--------------------------------------|--------------------------------|------------------|------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands) | | | |
| Service charges on deposit accounts | \$ 2,800 | \$ 3,095 | \$ 5,440 | \$ 6,000 |
| Interchange income | 2,604 | 2,504 | 4,959 | 4,750 |
| Net gains (losses) on assets: | | | | |
| Mortgage loans | 4,302 | 3,255 | 7,913 | 5,826 |
| Securities | -- | 9 | 304 | (164) |
| Mortgage loan servicing, net | (1,907) | 1,235 | (3,122) | 3,456 |
| Investment and insurance commissions | 450 | 483 | 747 | 921 |
| Bank owned life insurance | 270 | 220 | 512 | 476 |
| Other | 1,386 | 1,514 | 3,111 | 2,763 |
| Total non-interest income | <u>\$ 9,905</u> | <u>\$ 12,315</u> | <u>\$ 19,864</u> | <u>\$ 24,028</u> |

Service charges on deposit accounts decreased on both a comparative quarterly and year-to-date basis in 2019 as compared to 2018. These decreases were principally due to lower service charges on commercial accounts and a decrease in non-sufficient funds occurrences.

Interchange income increased on both a comparative quarterly and year-to-date basis in 2019 as compared to 2018 due primarily to an increase in debit card transaction volume.

Net gains on mortgage loans increased from 2018 on both a quarterly and a year to date basis. Mortgage loan activity is summarized as follows:

Mortgage Loan Activity

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|------------|------------------------------|------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (Dollars in thousands) | | | |
| Mortgage loans originated | \$ 241,402 | \$ 226,264 | \$ 379,160 | \$ 385,231 |
| Mortgage loans sold | 131,636 | 115,299 | 286,161 | 221,642 |
| Net gains on mortgage loans | 4,302 | 3,255 | 7,913 | 5,826 |
| Net gains as a percent of mortgage loans sold ("Loan Sales Margin") | 3.27% | 2.82% | 2.77% | 2.63% |
| Fair value adjustments included in the Loan Sales Margin | 0.74 | 0.57 | 0.66 | 0.35 |

The quarterly comparative increase in mortgage loans originated is due primarily to lower interest rates in the second quarter of 2019 which have begun to increase refinance volumes. On a year-to-date comparative basis, mortgage loans originated were relatively unchanged. Mortgage loans sold increased due to a higher mix of salable loans in our origination volumes and some portfolio mortgage loan sales that were completed during the first quarter of 2019. Net gains on mortgage loans also increased in 2019 as compared to 2018 due to fair value adjustments as discussed below.

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

Our Loan Sales Margin is impacted by several factors including competition and the manner in which the loan is sold. Net gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding these fair value accounting adjustments, the Loan Sales Margin would have been 2.53% and 2.25% in the second quarters of 2019 and 2018, respectively and 2.11% and 2.28% for the comparative 2019 and 2018 year-to-date periods, respectively. The increase in the Loan Sales Margin (excluding fair value adjustments) in the second quarter of 2019 was generally due to a widening of primary-to-secondary market pricing spreads as market interest rates fell during this period. The lower Loan Sales Margin (excluding fair value adjustments) for the first six months of 2019, primarily reflects the impact of some portfolio mortgage loan sales in the first quarter of 2019 that were executed at lower pricing spreads. The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale.

Net gains (losses) on securities were relatively nominal for the comparative quarterly periods. We recorded a net gain of \$0.3 million and a net loss of \$0.2 million on securities for the first six months of 2019 and 2018, respectively. We recorded no net impairment losses in either 2019 or 2018 for other than temporary impairment of securities available for sale. See “Securities” below and note #3 to the Condensed Consolidated Financial Statements.

Mortgage loan servicing, net, generated a loss of \$1.9 million and income of \$1.2 million in the second quarters of 2019 and 2018, respectively. For the first six months of 2019, mortgage loan servicing, net, generated a loss of \$3.1 million as compared to income of \$3.5 million for the comparable period in 2018. The significant variances in mortgage loan servicing, net are primarily due to changes in the fair value of capitalized mortgage loan servicing rights associated with changes in mortgage loan interest rates (a decline in 2019 as compared to an increase in 2018) and expected future prepayment levels. Mortgage loan servicing, net activity is summarized in the following table:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------------------|--------------------------------|----------|------------------------------|----------|
| | 2019 | 2018 | 2019 | 2018 |
| Mortgage loan servicing, net: | (In thousands) | | | |
| Revenue, net | \$ 1,515 | \$ 1,372 | \$ 2,991 | \$ 2,564 |
| Fair value change due to price | (2,670) | 518 | (4,873) | 1,976 |
| Fair value change due to pay-downs | (752) | (655) | (1,240) | (1,084) |
| Total | \$ (1,907) | \$ 1,235 | \$ (3,122) | \$ 3,456 |

Activity related to capitalized mortgage loan servicing rights is as follows:

Capitalized Mortgage Loan Servicing Rights

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands) | | | |
| Balance at beginning of period | \$ 19,909 | \$ 17,783 | \$ 21,400 | \$ 15,699 |
| Servicing rights acquired | - | \$ 3,047 | - | \$ 3,047 |
| Originated servicing rights capitalized | 1,407 | 1,155 | 2,607 | 2,210 |
| Change in fair value | (3,422) | (137) | (6,113) | 892 |
| Balance at end of period | <u>\$ 17,894</u> | <u>\$ 21,848</u> | <u>\$ 17,894</u> | <u>\$ 21,848</u> |

At June 30, 2019 we were servicing approximately \$2.41 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.27% and a weighted average service fee of approximately 25.8 basis points. Capitalized mortgage loan servicing rights at June 30, 2019 totaled \$17.9 million, representing approximately 74.1 basis points on the related amount of mortgage loans serviced for others.

Investment and insurance commissions represent revenues generated on the sale or management of investments and insurance for our customers. These revenues were relatively comparable on a quarterly basis, but declined on a year-to-date basis in 2019 as compared to 2018. The year-to-date decline in 2019 was primarily due to slower sales in the first quarter of 2019, principally reflecting market volatility and uncertainty.

Income from bank owned life insurance (“BOLI”) increased on both a comparative quarterly and year-to-date basis in 2019 compared to 2018 reflecting a higher crediting rate on our cash surrender value. Our BOLI separate account is primarily invested in agency mortgage-backed securities. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our BOLI was \$55.6 million and \$55.1 million at June 30, 2019 and December 31, 2018, respectively.

Other non-interest income decreased slightly on a comparative quarterly basis, but increased on a year-to-date basis in 2019 compared to 2018. The year-to-date increase in 2019 compared to 2018 is primarily due to \$0.38 million of recoveries recorded in the first quarter of 2019 on TCSB loans that had been charged-off prior to the Merger.

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

Non-interest expense decreased by \$3.2 million to \$26.6 million and increased by \$0.7 million to \$54.6 million during the three- and six-month periods ended June 30, 2019, respectively, compared to the same periods in 2018. On a year-to-date basis, several of our components of non-interest expense increased in 2019 due to the Merger.

The components of non-interest expense are as follows:

Non-Interest Expense

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|------------------|------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | (In thousands) | | | |
| Compensation | \$ 10,185 | \$ 9,574 | \$ 20,666 | \$ 18,504 |
| Performance-based compensation | 2,296 | 3,150 | 4,516 | 5,933 |
| Payroll taxes and employee benefits | 3,450 | 3,145 | 7,100 | 5,900 |
| Compensation and employee benefits | 15,931 | 15,869 | 32,282 | 30,337 |
| Occupancy, net | 2,131 | 2,170 | 4,636 | 4,434 |
| Data processing | 2,171 | 2,251 | 4,315 | 4,129 |
| Furniture, fixtures and equipment | 1,006 | 1,019 | 2,035 | 1,986 |
| Communications | 717 | 704 | 1,486 | 1,384 |
| Interchange expense | 753 | 661 | 1,441 | 1,259 |
| Advertising | 627 | 543 | 1,299 | 984 |
| Loan and collection | 628 | 692 | 1,262 | 1,369 |
| Legal and professional | 371 | 456 | 740 | 834 |
| FDIC deposit insurance | 342 | 250 | 710 | 480 |
| Amortization of intangible assets | 273 | 295 | 545 | 381 |
| Supplies | 153 | 178 | 311 | 343 |
| Credit card and bank service fees | 97 | 106 | 200 | 202 |
| Costs (recoveries) related to unfunded lending commitments | 27 | 37 | 187 | (77) |
| Provision for loss reimbursement on sold loans | 35 | 20 | 146 | 31 |
| Net gains on other real estate and repossessed assets | (198) | (4) | (79) | (294) |
| Merger related expenses | -- | 3,082 | -- | 3,256 |
| Other | 1,528 | 1,432 | 3,066 | 2,858 |
| Total non-interest expense | <u>\$ 26,592</u> | <u>\$ 29,761</u> | <u>\$ 54,582</u> | <u>\$ 53,896</u> |

Compensation and employee benefits expenses, in total, increased \$0.1 million on a quarterly comparative basis and increased \$1.9 million for the first six months of 2019 compared to the same periods in 2018.

Compensation expense increased by \$0.6 million and \$2.2 million in the second quarter and first six months of 2019, respectively, compared to the same periods in 2018. The quarterly comparative increase in 2019 is primarily due to salary increases that were predominantly effective on January 1, 2019. The higher year-to-date comparative increase in 2019 also reflects the impact of the Merger.

Performance-based compensation decreased by \$0.9 million and \$1.4 million in the second quarter and first six months of 2019, respectively, versus the same periods in 2018, due primarily to relative comparative changes in the accrual for anticipated incentive compensation based on our estimated full-year performance as compared to goals.

Payroll taxes and employee benefits increased by \$0.3 million and \$1.2 million in the second quarter and first six months of 2019, respectively, compared to the same periods in 2018, due primarily to increases in health care costs (due to increased claims in 2019) and workers' compensation insurance costs and for the year-to-date comparative periods, the impact of the Merger.

Occupancy, net, data processing, furniture, fixtures and equipment, communications, supplies, and credit card and bank service fees expenses were all relatively unchanged on a comparative quarterly basis in 2019 as compared to 2018.

Interchange expense primarily represents our third-party cost to process debit card transactions. This cost increased in 2019 on both a comparative quarterly and year-to-date basis as compared to 2018 due principally to an increase in transaction volume.

Total advertising expenses increased in 2019 on both a comparative quarterly and year-to-date basis as compared to 2018 due primarily to an increase in outdoor (billboard) advertising.

Loan and collection expenses reflect costs related to new lending activity as well as the management and collection of non-performing loans and other problem credits. These costs did not vary significantly in 2019 as compared to 2018.

Legal and professional fees declined in 2019 on both a comparative quarterly and year-to-date basis as compared to 2018 due primarily to a decrease in consulting fees related to certain deposit account acquisition and branch evaluation projects.

FDIC deposit insurance expense increased in 2019 on both a comparative quarterly and year-to-date basis as compared to 2018 due to a combination of an increase in our assessment rate and growth in our total assets.

The amortization of intangible assets relates to the Merger and prior branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$5.9 million and \$6.4 million at June 30, 2019 and December 31, 2018, respectively. See note #7 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets.

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

The provision for loss reimbursement on sold loans was an expense of \$0.04 million and \$0.15 million in the second quarter and first six months of 2019, respectively, compared to an expense of \$0.02 million and \$0.03 million in the second quarter and first six months of 2018, respectively. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank of Indianapolis). The small expense provisions in 2019 and 2018 are primarily due to growth in the balance of loans serviced for investors. Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The reserve for loss reimbursements on sold mortgage loans totaled \$0.83 million and \$0.78 million at June 30, 2019 and December 31, 2018, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition.

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

Merger related expenses totaled \$3.1 million and \$3.3 million for the second quarter and first six months of 2018, respectively. These expenses included our investment banking fees, certain accounting and legal costs, various contract termination fees, data processing conversion costs, payments made on officer change-in-control contracts, and employee severance costs.

Other non-interest expenses increased in 2019 on both a comparative quarterly and year-to-date basis as compared to 2018 due primarily to an increase in deposit account/debit card fraud costs.

Income tax expense. We recorded an income tax expense of \$2.7 million and \$4.9 million in the second quarter and the first six months of 2019, respectively. This compares to an income tax expense of \$2.1 million and \$4.1 million in the second quarter and the first six months of 2018, respectively.

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

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at June 30, 2019 and 2018 and at December 31, 2018, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

FINANCIAL CONDITION

Summary. Our total assets increased by \$85.0 million during the first six months of 2019. Loans, excluding loans held for sale (“Portfolio Loans”), totaled \$2.71 billion at June 30, 2019, an increase of \$124.0 million, or 4.8%, from December 31, 2018. (See “Portfolio Loans and asset quality.”)

Deposits totaled \$2.98 billion at June 30, 2019, compared to \$2.91 billion at December 31, 2018. The \$65.5 million increase in total deposits during the period is due to growth in reciprocal deposits.

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

Securities

| | <u>Amortized Cost</u> | <u>Gains</u> | <u>Unrealized</u> (In thousands) | <u>Losses</u> | <u>Fair Value</u> |
|-------------------------------|---------------------------|--------------|-------------------------------------|---------------|-----------------------|
| Securities available for sale | | | | | |
| June 30, 2019 | \$ 426,458 | \$ 4,922 | | \$ 1,075 | \$ 430,305 |
| December 31, 2018 | 433,224 | 1,520 | | 6,818 | 427,926 |

Securities available for sale increased \$2.4 million during the first six months of 2019. Our portfolio of securities available for sale is reviewed quarterly for impairment in value. In performing this review, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet these recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income (loss). We recorded no impairment losses related to other than temporary impairment on securities available for sale in either of the first six months of 2019 or 2018.

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

| | Six months ended June 30, | |
|------------------------|------------------------------|-------------|
| | <u>2019</u> | <u>2018</u> |
| | (In thousands) | |
| Proceeds | \$ 42,236 | \$ 31,445 |
| Gross gains | \$ 169 | \$ 81 |
| Gross losses | (32) | (126) |
| Net impairment charges | -- | - |
| Fair value adjustments | 167 | (119) |
| Net gains (losses) | \$ 304 | \$ (164) |

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

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

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

A summary of our Portfolio Loans follows:

| | June 30, 2019 | December 31, 2018 |
|--|---------------------|----------------------|
| | (In thousands) | |
| Real estate(1) | | |
| Residential first mortgages | \$ 844,151 | \$ 811,719 |
| Residential home equity and other junior mortgages | 175,330 | 177,574 |
| Construction and land development | 202,997 | 180,286 |
| Other(2) | 713,008 | 707,347 |
| Consumer | 431,227 | 379,607 |
| Commercial | 333,522 | 319,058 |
| Agricultural | 6,291 | 6,929 |
| Total loans | <u>\$ 2,706,526</u> | <u>\$ 2,582,520</u> |

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

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

Non-performing assets⁽¹⁾

| | June 30, 2019 | December 31, 2018 |
|--|------------------|----------------------|
| (Dollars in thousands) | | |
| Non-accrual loans | \$ 7,798 | \$ 9,029 |
| Loans 90 days or more past due and still accruing interest | -- | 5 |
| Less - government guaranteed loans | (436) | (460) |
| Total non-performing loans | 7,362 | 8,574 |
| Other real estate and repossessed assets | 1,990 | 1,299 |
| Total non-performing assets | \$ 9,352 | \$ 9,873 |
| As a percent of Portfolio Loans | | |
| Non-performing loans | 0.27 % | 0.33% |
| Allowance for loan losses | 0.96 | 0.96 |
| Non-performing assets to total assets | 0.27 | 0.29 |
| Allowance for loan losses as a percent of non-performing loans | 351.85 | 290.27 |

(1) Excludes loans classified as “troubled debt restructured” that are not past due.

Troubled debt restructurings (“TDR”)

| | June 30, 2019 | | |
|-------------------------------------|-------------------|-----------------------|-----------|
| | Commercial | Retail ⁽¹⁾ | Total |
| (In thousands) | | | |
| Performing TDR’s | \$ 7,166 | \$ 42,136 | \$ 49,302 |
| Non-performing TDR’s ⁽²⁾ | 54 | 2,783 ⁽³⁾ | 2,837 |
| Total | \$ 7,220 | \$ 44,919 | \$ 52,139 |
| | December 31, 2018 | | |
| | Commercial | Retail ⁽¹⁾ | Total |
| (In thousands) | | | |
| Performing TDR’s | \$ 6,460 | \$ 46,627 | \$ 53,087 |
| Non-performing TDR’s ⁽²⁾ | 74 | 2,884 ⁽³⁾ | 2,958 |
| Total | \$ 6,534 | \$ 49,511 | \$ 56,045 |

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

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

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

Non-performing loans decreased by \$1.2 million during the first six months of 2019 due principally to a decline in non-performing commercial loans. This decline primarily reflects reduced levels of new loan defaults as well as loan charge-offs, pay-offs, negotiated transactions, and the migration of loans into other real estate. In general, stable economic conditions in our market areas, as well as our collection and resolution efforts, have resulted in a downward trend in non-performing loans. However, we are still experiencing some loan defaults, particularly related to commercial loans secured by income-producing property and mortgage loans secured by resort/vacation property.

Non-performing loans exclude performing loans that are classified as troubled debt restructurings (“TDRs”). Performing TDRs totaled \$49.3 million, or 1.8% of total Portfolio Loans, and \$53.1 million, or 2.1% of total Portfolio Loans, at June 30, 2019 and December 31, 2018, respectively. The decrease in the amount of performing TDRs in the first six months of 2019 primarily reflects pay downs and payoffs.

Other real estate and repossessed assets totaled \$2.0 million and \$1.3 million at June 30, 2019 and December 31, 2018, respectively. This increase is primarily due to the addition of a \$0.6 million commercial office building located in Grand Rapids, Michigan during the second quarter of 2019.

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

The ratio of loan net charge-offs to average Portfolio Loans was 0.02% and 0.00% (on an annualized basis) in the first six months of 2019 and 2018, respectively. This year-over-year change was primarily due to a decline in recoveries on previously charged-off commercial loans that was partially offset by a decline in mortgage loan charge-offs.

Allowance for loan losses

| | Six months ended June 30, | | | |
|--|------------------------------|-------------------------|------------------|-------------------------|
| | 2019 | | 2018 | |
| | Loans | Unfunded Commitments | Loans | Unfunded Commitments |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | \$ 24,888 | \$ 1,296 | \$ 22,587 | \$ 1,125 |
| Additions (deductions) | | | | |
| Provision for loan losses | 1,316 | - | 965 | - |
| Recoveries credited to allowance | 1,457 | - | 1,860 | - |
| Loans charged against the allowance | (1,758) | - | (1,908) | - |
| Additions included in non-interest expense | - | 187 | - | (77) |
| Balance at end of period | <u>\$ 25,903</u> | <u>\$ 1,483</u> | <u>\$ 23,504</u> | <u>\$ 1,048</u> |
| Net loans charged against the allowance to average Portfolio Loans | 0.02% | | 0.00% | |

Allocation of the Allowance for Loan Losses

| | June 30, 2019 | December 31, 2018 |
|--|------------------|----------------------|
| | (In thousands) | |
| Specific allocations | \$ 6,027 | \$ 6,310 |
| Other adversely rated commercial loans | 2,908 | 1,861 |
| Historical loss allocations | 8,541 | 7,792 |
| Additional allocations based on subjective factors | 8,427 | 8,925 |
| Total | \$ 25,903 | \$ 24,888 |

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

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

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

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

The AFLL increased \$1.0 million to \$25.9 million at June 30, 2019 from \$24.9 million at December 31, 2018 and was equal to 0.96% of total Portfolio Loans at both June 30, 2019 and December 31, 2018, respectively.

During the first quarter of 2019, we deployed a third-party software solution (we previously used spreadsheet software) to assist in the determination of our AFLL. This new third-party software will also assist us in moving to the expected loss framework that is required to be implemented on January 1, 2020. Although the use of this new third-party software did not have any material impact on our overall AFLL, it did result in some classification shifts from the AFLL related to subjective factors into the AFLL related to historical losses as the new software model allowed us to capture longer historical look-back periods (previously this was being captured in the subjective portion of the AFLL).

Two of the four components of the AFLL outlined above increased during the first six months of 2019. The AFLL related to specific loans decreased \$0.3 million during the first six months of 2019 due primarily to a \$3.0 million decline in the amount of such loans. The AFLL related to other adversely rated commercial loans increased \$1.0 million during the first six months of 2019, primarily due to an increase in the balance of such loans included in this component to \$59.0 million at June 30, 2019 from \$44.7 million at December 31, 2018. The increase in other adversely rated commercial loans was primarily in early watch credit categories and these loans are largely performing. We do not believe that we will experience any significant loan losses as a result of this rise in other adversely rated commercial loans. The AFLL related to historical losses increased \$0.7 million during the first six months of 2019, and the AFLL related to subjective factors decreased \$0.5 million during the first six months of 2019, due primarily to the classification shifts discussed above.

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

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

Deposits totaled \$2.98 billion and \$2.91 billion at June 30, 2019 and December 31, 2018, respectively. The \$65.5 million increase in deposits during the first six months of 2019 is primarily due to growth in reciprocal deposits. Reciprocal deposits totaled \$326.3 million and \$182.1 million at June 30, 2019 and December 31, 2018, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network's Insured Cash Sweep[®] service and Certificate of Deposit Account Registry Service[®]. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum. The significant increase in reciprocal deposits is due in part to an automated sweep product that we introduced in mid-2018 as well as the marketing and sales efforts of our treasury management team.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At June 30, 2019, we had approximately \$491.9 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

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

Other borrowings, comprised primarily of advances from the FHLB, totaled \$41.1 million and \$25.7 million at June 30, 2019 and December 31, 2018, respectively.

As described above, we utilize wholesale funding, including FHLB borrowings and Brokered CDs to augment our core deposits and fund a portion of our assets. At June 30, 2019, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$612.2 million, or 20.3% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all. Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. During the first six months of 2019 and 2018, we entered into \$17.6 million and \$10.4 million (aggregate notional amounts), respectively, of interest rate swaps with commercial loan customers, which were offset with interest rate swaps that the Bank entered into with a broker-dealer. We recorded \$0.25 million and \$0.33 million of fee income related to these transactions during the first six months of 2019 and 2018, respectively. See note #6 to the Condensed Consolidated Financial Statements included within this report for more information on our derivative financial instruments.

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

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

At June 30, 2019, we had \$556.2 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$2.29 billion of our deposits at June 30, 2019, were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

We also believe that the available cash on hand at the parent company (including time deposits) of approximately \$13.3 million as of June 30, 2019 provides sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures, and to pay projected cash dividends on our common stock.

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

Capitalization

| | June 30, 2019 | December 31, 2018 |
|---|------------------|----------------------|
| | (In thousands) | |
| Subordinated debentures | \$ 39,422 | \$ 39,388 |
| Amount not qualifying as regulatory capital | (1,224) | (1,224) |
| Amount qualifying as regulatory capital | 38,198 | 38,164 |
| Shareholders' equity | | |
| Common stock | 351,894 | 377,372 |
| Accumulated deficit | (16,617) | (28,270) |
| Accumulated other comprehensive loss | (4,431) | (10,108) |
| Total shareholders' equity | 330,846 | 338,994 |
| Total capitalization | \$ 369,044 | \$ 377,158 |

We currently have four special purpose entities with \$39.4 million of outstanding cumulative trust preferred securities as of June 30, 2019. These special purpose entities issued common securities and provided cash to our parent company that in turn issued subordinated debentures to these special purpose entities equal to the trust preferred securities and common securities. The subordinated debentures represent the sole asset of the special purpose entities. The common securities and subordinated debentures are included in our Condensed Consolidated Statements of Financial Condition.

The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at June 30, 2019 and December 31, 2018.

Common shareholders' equity decreased to \$330.8 million at June 30, 2019, from \$339.0 million at December 31, 2018, due primarily to our share repurchases and cash dividend payments that were partially offset by our net income and a decrease in our accumulated other comprehensive loss. Our tangible common equity ("TCE") totaled \$296.7 million and \$304.3 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 8.72% and 9.17% at June 30, 2019, and December 31, 2018, respectively. TCE and the ratio of TCE to tangible assets are non-GAAP measures. TCE represents total common equity less goodwill and other intangible assets.

In December 2018, our Board of Directors authorized a 2019 share repurchase plan. Under the terms of the original 2019 share repurchase plan, we were authorized to buy back up to 5% of our outstanding common stock. During the first six months of 2019, we completed the repurchase of 5% of our outstanding common shares (1,179,688 shares at a weighted average purchase price of \$21.85 per share). In June 2019, our Board of Directors supplemented the 2019 share repurchase plan and authorized the repurchase of up to 300,000 additional common shares. The 2019 share repurchase plan is authorized to last through December 31, 2019.

We pay a quarterly cash dividend on our common stock. These dividends totaled \$0.18 per share in the first and second quarters of 2019 and \$0.15 per share in the first and second quarters 2018. We generally favor a dividend payout ratio between 30% and 50% of net income.

As of June 30, 2019 and December 31, 2018, our Bank (and holding company) continued to meet the requirements to be considered “well-capitalized” under federal regulatory standards (also see note #10 to the Condensed Consolidated Financial Statements included within this report).

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

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

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

CHANGES IN MARKET VALUE OF PORTFOLIO EQUITY AND NET INTEREST INCOME

| Change in Interest Rates | Market Value of Portfolio Equity(1) | Percent Change | Net Interest Income(2) | Percent Change |
|--------------------------|-------------------------------------|----------------|------------------------|----------------|
| (Dollars in thousands) | | | | |
| June 30, 2019 | | | | |
| 200 basis point rise | \$ 407,000 | (5.66)% | \$ 124,500 | 1.55% |
| 100 basis point rise | 427,000 | (1.02) | 123,900 | 1.06 |
| Base-rate scenario | 431,400 | - | 122,600 | - |
| 100 basis point decline | 407,200 | (5.61) | 120,500 | (1.71) |
| December 31, 2018 | | | | |
| 200 basis point rise | \$ 481,100 | (3.37)% | \$ 126,200 | 3.27% |
| 100 basis point rise | 495,400 | (0.50) | 124,800 | 2.13 |
| Base-rate scenario | 497,900 | - | 122,200 | - |
| 100 basis point decline | 482,800 | (3.03) | 119,600 | (2.13) |

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

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

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

We utilize fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. FASB ASC topic 820 differentiates between those assets and liabilities required to be carried at fair value at every reporting period (“recurring”) and those assets and liabilities that are only required to be adjusted to fair value under certain circumstances (“nonrecurring”). Certain equity securities (at December 31, 2018), securities available for sale, loans held for sale, derivatives and capitalized mortgage loan servicing rights are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a nonrecurring basis, such as loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. See note #11 to the Condensed Consolidated Financial Statements included within this report for a complete discussion on our use of fair valuation of financial instruments and the related measurement techniques.

LITIGATION MATTERS

The aggregate amount we have accrued for losses we consider probable as a result of litigation matters is immaterial. However, because of the inherent uncertainty of outcomes from any litigation matter, we believe it is reasonably possible we may incur losses in addition to the amounts we have accrued. At this time, we estimate the maximum amount of additional losses that are reasonably possible is insignificant. However, because of a number of factors, including the fact that certain of these litigation matters are still in their early stages, this maximum amount may change in the future.

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

CRITICAL ACCOUNTING POLICIES

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for the AFL and capitalized mortgage loan servicing rights are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2018.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Item 4.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

With the participation of management, our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) for the period ended June 30, 2019, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended June 30, 2019, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1A. Risk Factors

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

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

The Company maintains a Deferred Compensation and Stock Purchase Plan for Non-Employee Directors (the “Plan”) pursuant to which non-employee directors can elect to receive shares of the Company’s common stock in lieu of fees otherwise payable to the director for his or her service as a director. A director can elect to receive shares on a current basis or to defer receipt of the shares, in which case the shares are issued to a trust to be held for the account of the director and then generally distributed to the director after his or her retirement from the Board. Pursuant to this Plan, during the second quarter of 2019, the Company issued 731 shares of common stock to non-employee directors on a current basis and 2,093 shares of common stock to the trust for distribution to directors on a deferred basis. These shares were issued on April 1, 2019 representing aggregate fees of \$0.06 million. The shares on a current basis were issued at a price of \$21.50 per share and the shares on a deferred basis were issued at a price of \$19.35 per share, representing 90% of the fair value of the shares on the credit date. The price per share was the consolidated closing bid price per share of the Company’s common stock as of the date of issuance, as determined in accordance with NASDAQ Marketplace Rules. The Company issued the shares pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933 due to the fact that the issuance of the shares was made on a private basis pursuant to the Plan.

The following table shows certain information relating to repurchases of common stock for the three-months ended June 30, 2019:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan | Remaining Number of Shares Authorized for Purchase Under the Plan |
|------------|----------------------------------|------------------------------|---|---|
| April 2019 | 65,196 | \$ 21.28 | 65,196 | 998,003 |
| May 2019 | 998,705 | 21.89 | 998,705 | (702) ⁽¹⁾ |
| June 2019 | -- | -- | -- | 299,298 |
| Total | 1,063,901 | \$ 21.86 | 1,063,901 | 299,298 |

- (1) In May 2019, the Company repurchased a large number of shares in a private transaction. The number of shares repurchased included an immaterial number of shares (702 shares) in excess of the remaining shares under the publicly-announced plan. As previously disclosed, the Company’s Board of Directors expanded the repurchase plan in June 2019.

Item 6. Exhibits

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

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

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

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

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

101.INS Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

Date August 2, 2019

By /s/ Robert N. Shuster
Robert N. Shuster, Principal Financial Officer

Date August 2, 2019

By /s/ James J. Twarozynski
James J. Twarozynski, Principal Accounting Officer

CERTIFICATION

I, William B. Kessel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Independent Bank Corporation;
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 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 we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our 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 our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - 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 quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
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 the registrant's board of directors (or persons performing the equivalent functions):
 - 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 controls over financial reporting.

INDEPENDENT BANK CORPORATION

Date: August 2, 2019

/s/ William B. Kessel
William B. Kessel
President and Chief Executive Officer

CERTIFICATION

I, Robert N. Shuster, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Independent Bank Corporation;
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 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 we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our 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 our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - 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 quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
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 the registrant's board of directors (or persons performing the equivalent functions):
 - 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 controls over financial reporting.

INDEPENDENT BANK CORPORATION

Date: August 2, 2019

/s/ Robert N. Shuster
Robert N. Shuster
Chief Financial Officer

CERTIFICATE OF THE
CHIEF EXECUTIVE OFFICER OF
INDEPENDENT BANK CORPORATION

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350):

I, William B. Kessel, President and Chief Executive Officer of Independent Bank Corporation, certify, to the best of my knowledge and belief, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350) that:

(1) The quarterly report on Form 10-Q for the quarterly period ended June 30, 2019, which this statement accompanies, fully complies with requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and;

(2) The information contained in this quarterly report on Form 10-Q for the quarterly period ended June 30, 2019, fairly presents, in all material respects, the financial condition and results of operations of Independent Bank Corporation.

INDEPENDENT BANK CORPORATION

Date: August 2, 2019

/s/ William B. Kessel
William B. Kessel
President and Chief Executive Officer

The signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Independent Bank Corporation and will be retained by Independent Bank Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATE OF THE
CHIEF FINANCIAL OFFICER OF
INDEPENDENT BANK CORPORATION

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350):

I, Robert N. Shuster, Chief Financial Officer of Independent Bank Corporation, certify, to the best of my knowledge and belief, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350) that:

(1) The quarterly report on Form 10-Q for the quarterly period ended June 30, 2019, which this statement accompanies, fully complies with requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and;

(2) The information contained in this quarterly report on Form 10-Q for the quarterly period ended June 30, 2019, fairly presents, in all material respects, the financial condition and results of operations of Independent Bank Corporation.

INDEPENDENT BANK CORPORATION

Date: August 2, 2019

/s/ Robert N. Shuster
Robert N. Shuster
Chief Financial Officer

The signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Independent Bank Corporation and will be retained by Independent Bank Corporation and furnished to the Securities and Exchange Commission or its staff upon request.
