INDEPENDENT BANK CORP /MI/
Form 10-Q
August 09, 2011

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, 2011

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)

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

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

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

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

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 x NO o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, non-accelerated filer or smaller reporting company.
Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company x

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

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	8,403,875
Class	Outstanding at August 8, 2011

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

INDEX

Discussions and statements in this report that are not statements of historical fact, including, without limitation, statements that include terms such as “will,” “may,” “should,” “believe,” “expect,” “forecast,” “anticipate,” “estimate,” “proje “likely,” “optimistic” and “plan,” and statements about future or projected financial and operating results, plans, projections, objectives, expectations, and intentions and other statements that are not historical facts, 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; predictions as to our Bank’s ability to maintain certain regulatory capital standards; our expectation that we will have sufficient cash on hand to meet expected obligations during 2011; and descriptions of steps we may take to improve our capital position. These forward-looking statements express our current expectations, forecasts of future events, or long-term goals and, by their nature, are subject to assumptions, risks, and uncertainties. Although we believe that the expectations, forecasts, and goals reflected in these forward-looking statements are reasonable, actual results could differ materially for a variety of reasons, including, among others:

- our ability to successfully raise new equity capital through a public offering of our common stock, effect a conversion of our outstanding preferred stock held by the U.S. Treasury into our common stock, and otherwise implement our capital restoration plan;
- the failure of assumptions underlying the establishment of and provisions made to our allowance for loan losses;
- the timing and pace of an economic recovery in Michigan and the United States in general, including regional and local real estate markets;
- the ability of our Bank to remain well-capitalized;
- the failure of assumptions underlying our estimate of probable incurred losses from vehicle service contract payment plan counterparty contingencies, including our assumptions regarding future cancellations of vehicle service contracts, the value to us of collateral that may be available to recover funds due from our counterparties,

and our ability to enforce the contractual obligations of our counterparties to pay amounts owing to us;

1

Index

- further adverse developments in the vehicle service contract industry, whose recent turmoil has increased the credit risk and reputation risk for our subsidiary, Mepco Finance Corporation;
- potential limitations on our ability to access and rely on wholesale funding sources;
- the risk that sales of our common stock could trigger a reduction in the amount of net operating loss carryforwards that we may be able to utilize for income tax purposes;
- the continued services of our management team, particularly as we work through our asset quality issues and the implementation of our capital restoration plan;
- implementation of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act or other new legislation, which may have significant effects on us and the financial services industry, the exact nature and extent of which cannot be determined at this time; and
- the risk that our common stock may be delisted from the Nasdaq Global Select Market.

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 A of our Annual Report on Form 10-K for the year ended December 31, 2010, 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.

Index

Part I - Item 1. INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Financial Condition

Assets	June 30, 2011 (unaudited)	December 31, 2010
	(In thousands, except share amounts)	
Cash and due from banks	$58,673	$48,933
Interest bearing deposits	262,111	336,441
Cash and Cash Equivalents	320,784	385,374
Trading securities	156	32
Securities available for sale	78,192	67,864
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	21,005	23,630
Loans held for sale, carried at fair value	26,308	50,098
Loans		
Commercial	666,497	707,530
Mortgage	622,460	658,679
Installment	231,411	245,644
Payment plan receivables	155,385	201,263
Total Loans	1,675,753	1,813,116
Allowance for loan losses	(61,115)	(67,915)
Net Loans	1,614,638	1,745,201
Other real estate and repossessed assets	37,608	39,413
Property and equipment, net	65,596	68,359
Bank-owned life insurance	48,812	47,922
Other intangibles	8,294	8,980
Capitalized mortgage loan servicing rights	14,741	14,661
Prepaid FDIC deposit insurance assessment	14,155	15,899
Vehicle service contract counterparty receivables, net	40,827	37,270
Accrued income and other assets	26,492	30,545
Total Assets	$2,317,608	$2,535,248
Liabilities and Shareholders' Equity		
Deposits		
Non-interest bearing	$448,458	$451,856
Savings and NOW	1,003,537	995,662
Retail time	522,261	530,774
Brokered time	90,429	273,546
Total Deposits	2,064,685	2,251,838
Other borrowings	40,909	71,032
Subordinated debentures	50,175	50,175
Vehicle service contract counterparty payables	14,597	11,739
Accrued expenses and other liabilities	32,801	31,379
Total Liabilities	2,203,167	2,416,163
Shareholders' Equity		
Preferred stock, no par value–200,000 shares authorized; 74,426 shares issued and outstanding at June 30, 2011 and December 31, 2010; per share liquidation preference: $1,062 at June 30, 2011 and $1,036 at December 31, 2010	77,759	75,700

Common stock, no par value–500,000,000 shares authorized; issued and outstanding:		
8,345,651 shares at June 30, 2011 and 7,860,483 shares at December 31, 2010	248,198	246,407
Accumulated deficit	(199,326)	(189,902)
Accumulated other comprehensive loss	(12,190)	(13,120)
Total Shareholders' Equity	114,441	119,085
Total Liabilities and Shareholders' Equity	$2,317,608	$2,535,248

See notes to interim condensed consolidated financial statements (unaudited)

Index

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
	(unaudited) (In thousands)			
Interest Income				
Interest and fees on loans	$ 28,102	$36,675	$57,586	$75,702
Interest on securities				
Taxable	344	902	811	2,062
Tax-exempt	298	526	630	1,211
Other investments	383	389	818	761
Total Interest Income	29,127	38,492	59,845	79,736
Interest Expense				
Deposits	4,511	7,508	9,456	15,727
Other borrowings	1,232	2,413	2,555	5,407
Total Interest Expense	5,743	9,921	12,011	21,134
Net Interest Income	23,384	28,571	47,834	58,602
Provision for loan losses	4,378	12,680	15,454	29,694
Net Interest Income After Provision for Loan Losses	19,006	15,891	32,380	28,908
Non-interest Income				
Service charges on deposit accounts	4,784	5,833	9,066	11,108
Interchange income	2,308	2,086	4,476	4,022
Net gains (losses) on assets				
Mortgage loans	1,793	2,372	3,728	4,215
Securities	115	1,363	328	1,628
Other than temporary loss on securities available for sale				
Total impairment loss	327	-	(142)	(118)
Loss recognized in other comprehensive income	(327)	-	-	-
Net impairment loss recognized in earnings	-	-	(142)	(118)
Mortgage loan servicing	(126)	(2,043)	770	(1,611)
Title insurance fees	318	366	791	860
Decrease in fair value of U.S. Treasury warrant	642	-	996	-
Gain on extinguishment of debt	-	18,086	-	18,086
Other	2,622	1,682	5,154	3,936
Total Non-interest Income	12,456	29,745	25,167	42,126
Non-interest Expense				
Compensation and employee benefits	13,029	13,430	25,378	26,643
Loan and collection	3,580	2,785	7,447	7,571
Occupancy, net	2,663	2,595	5,764	5,504
Data processing	2,415	2,470	4,725	4,939
Vehicle service contract counterparty contingencies	1,311	4,861	3,657	8,279
Furniture, fixtures and equipment	1,502	1,648	2,920	3,367
Net losses on other real estate and repossessed assets	777	1,554	2,183	3,583
Credit card and bank service fees	1,013	1,500	2,060	3,175
FDIC deposit insurance	652	1,763	1,887	3,565
Communications	889	1,015	1,837	2,088

Legal and professional	801	894	1,579	2,030
Advertising	670	674	1,224	1,453
Costs related to unfunded lending commitments	89	280	184	336
Other	2,292	2,127	4,332	4,562
Total Non-interest Expense	31,683	37,596	65,177	77,095
Income (Loss) Before Income Tax	(221)	8,040	(7,630)	(6,061)
Income tax expense (benefit)	(258)	156	(266)	(108)
Net Income (Loss)	$ 37	$ 7,884	$ (7,364)	$ (5,953)
Preferred stock dividends and discount accretion	1,051	1,113	2,059	2,190
Net Income (Loss) Applicable to Common Stock	$ (1,014)	$ 6,771	$ (9,423)	$ (8,143)
Net Income (Loss) Per Common Share				
Basic	$ (.12)	$ 2.37	$ (1.16)	$ (3.10)
Diluted	(.12)	.44	(1.16)	(3.10)
Dividends Per Common Share				
Declared	$ .00	$ .00	$ .00	$ .00
Paid	.00	.00	.00	.00

See notes to interim condensed consolidated financial statements (unaudited)

Index

INDEPENDENT BANK CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows

	Six months ended June 30,	
	2011	2010
	(unaudited - In thousands)	
Net Loss	$(7,364)	$(5,953)
Adjustments to Reconcile Net Loss to Net Cash from Operating Activities		
Proceeds from sales of loans held for sale	187,558	178,593
Disbursements for loans held for sale	(160,040)	(172,930)
Provision for loan losses	15,454	29,694
Depreciation, amortization of intangible assets and premiums and accretion of discounts on securities and loans	(6,442)	(16,925)
Net gains on sales of mortgage loans	(3,728)	(4,215)
Net gains on securities	(328)	(1,628)
Securities impairment recognized in earnings	142	118
Net losses on other real estate and repossessed assets	2,183	3,583
Vehicle service contract counterparty contingencies	3,657	8,279
Gain on extinguishment of debt	-	(18,086)
Deferred loan fees	(214)	326
Share based compensation	455	292
Decrease in accrued income and other assets	4,346	4,542
Increase in accrued expenses and other liabilities	2,036	2,690
	45,079	14,333
Net Cash from Operating Activities	37,715	8,380
Cash Flow from Investing Activities		
Proceeds from the sale of securities available for sale	70,322	94,685
Proceeds from the maturity of securities available for sale	295	2,165
Principal payments received on securities available for sale	3,872	10,834
Purchases of securities available for sale	(83,906)	(53,355)
Redemption of Federal Home Loan Bank stock	2,397	-
Redemption of Federal Reserve Bank stock	228	1,411
Net decrease in portfolio loans (loans originated, net of principal payments)	108,369	190,798
Proceeds from the collection of vehicle service contract counterparty receivables	671	-
Proceeds from the sale of other real estate and repossessed assets	10,084	8,986
Capital expenditures	(1,554)	(2,017)
Net Cash from Investing Activities	110,778	253,507
Cash Flow used in Financing Activities		
Net decrease in total deposits	(187,153)	(188,617)
Net decrease in other borrowings	(8)	(1,674)
Proceeds from Federal Home Loan Bank advances	7,000	33,000
Payments of Federal Home Loan Bank advances	(37,115)	(29,106)
Net increase (decrease) in vehicle service contract counterparty payables	2,858	(7,310)
Extinguishment of debt, net	-	(985)
Proceeds from issuance of common stock	1,335	-
Net Cash used in Financing Activities	(213,083)	(194,692)
Net Increase (Decrease) in Cash and Cash Equivalents	(64,590)	67,195
Cash and Cash Equivalents at Beginning of Period	385,374	288,736

Cash and Cash Equivalents at End of Period	$320,784	$355,931
Cash paid during the period for		
Interest	$11,361	$21,873
Income taxes	26	204
Transfer of loans to other real estate and repossessed assets	10,462	22,820
Transfer of payment plan receivables to vehicle service contract counterparty receivables	8,010	38,599
Issuance of common stock in exchange for subordinated debentures	-	23,502
Subordinated debentures exchanged for common stock	-	42,713
Retirement of Series A Preferred Stock	-	69,364
Retirement of common stock warrants	-	3,579
Issuance of Series B Preferred Stock	-	72,888
Issuance of common stock warrants	-	1,704

See notes to interim condensed consolidated financial statements (unaudited)

5

Index

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

	Six months ended June 30, 2011	2010
	(unaudited) (In thousands)	
Balance at beginning of period	$119,085	$109,861
Net loss	(7,364)	(5,953)
Preferred dividends	-	(1,076)
Issuance of common stock	1,335	23,502
Share based compensation	455	292
Issuance of Series B preferred stock	-	69,550
Retirement of Series A preferred stock	-	(69,364)
Issuance of common stock warrants	-	5,041
Retirement of common stock warrants	-	(3,579)
Net change in accumulated other comprehensive loss, net of related tax effect	930	1,398
Balance at end of period	$114,441	$129,672

See notes to interim condensed consolidated financial statements (unaudited)

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. The interim 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 generally accepted accounting principles 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, 2010 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, 2011 and December 31, 2010, and the results of operations for the three and six-month periods ended June 30, 2011 and 2010. The results of operations for the three and six-month periods ended June 30, 2011, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the assessment for other than temporary impairment ("OTTI") on investment securities, the determination of the allowance for loan losses, the determination of vehicle service contract counterparty contingencies, the valuation of originated mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2010 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. In April 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2010-02, "A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring", an amendment to FASB ASC Topic 310 "Receivables". Given the recent economic downturn, the volume of debt restructured (modified) by creditors has increased. This ASU gives additional guidance and clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring ("TDR"). This ASU is effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The adoption of this ASU is not expected to have a material impact on our consolidated financial statements.

Index

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

3. Securities available for sale consist of the following:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
		(In thousands)		
June 30, 2011				
U.S. agency residential mortgage-backed	$33,559	$506	$70	$33,995
Private label residential mortgage-backed	14,325	-	3,286	11,039
Obligations of states and political subdivisions	29,141	515	307	29,349
Trust preferred	4,693	-	884	3,809
Total	$81,718	$1,021	$4,547	$78,192
December 31, 2010				
U.S. agency residential mortgage-backed	$13,103	$249	$21	$13,331
Private label residential mortgage-backed	18,203	31	4,050	14,184
Obligations of states and political subdivisions	31,534	375	650	31,259
Trust preferred	9,472	116	498	9,090
Total	$72,312	$771	$5,219	$67,864

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, 2011						
U.S. agency residential mortgage-backed	$14,895	$70	$-	$-	$14,895	$70
Private label residential mortgage-backed	273	42	10,763	3,244	11,036	3,286
Obligations of states and political political subdivisions	2,220	137	4,630	170	6,850	307
Trust preferred	1,395	412	2,414	472	3,809	884
Total	$18,783	$661	$17,807	$3,886	$36,590	$4,547
December 31, 2010						
U.S. agency residential mortgage-backed	$2,733	$21	$-	$-	$2,733	$21
Private label residential mortgage-backed	-	-	12,624	4,050	12,624	4,050
Obligations of states and political subdivisions	8,371	428	1,796	222	10,167	650
Trust preferred	-	-	2,384	498	2,384	498

Total	$11,104	$449	$16,804	$4,770	$27,908	$5,219

Index

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

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

U.S. Agency residential mortgage-backed securities — at June 30, 2011 we had three securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to modest spread widening on certain issues. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label residential mortgage-backed securities — at June 30, 2011 we had nine securities whose fair value is less than amortized cost. Two of the issues are rated by a major rating agency as investment grade while four are below investment grade and three are split rated. Eight of these bonds have impairment in excess of 10% and only one of these holdings has been impaired for less than 12 months.

The unrealized losses are largely attributable to credit spread widening on these securities. The underlying loans within these securities include Jumbo (66%) and Alt A (34%) at June 30, 2011.

	June 30, 2011		December 31, 2010	
	Fair Value	Net Unrealized Gain (Loss)	Fair Value	Net Unrealized Gain (Loss)
	(In thousands)			
Private label residential mortgage-backed				
Jumbo	$7,338	$(1,850)	$8,429	$(2,600)
Alt-A	3,701	(1,436)	5,755	(1,419)

Eight of the private label residential mortgage-backed transactions have geographic concentrations in California, ranging from 22% to 58% of the collateral pool. Typical exposure levels to California (median exposure is 43%) are consistent with overall market collateral characteristics. Three transactions have modest exposure to Florida, ranging from 5% to 7% and one transaction has modest exposure to Nevada (5%). The underlying collateral pools do not have meaningful exposure to Arizona, Michigan or Ohio. None of the issues involve subprime mortgage collateral. Thus the impact of this market segment is only indirect, in that it has impacted liquidity and pricing in general for private label residential mortgage-backed securities. The majority of transactions are backed by fully amortizing loans. However, six transactions have concentrations in interest only loans ranging from 31% to 94% (at origination date). The structure of the residential mortgage securities portfolio provides protection to credit losses. The portfolio primarily consists of senior securities as demonstrated by the following: super senior (17%), senior (41%), senior support (21%) and mezzanine (21%). The mezzanine classes are from seasoned transactions (82 to 109 months) with significant levels of subordination (9% to 27%). Except for the additional discussion below relating to other than temporary impairment, each private label residential mortgage-backed security has sufficient credit enhancement via subordination to reasonably assure full realization of book value. This assertion is based on a transaction level review of the portfolio.

Index

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

Individual security reviews include: external credit ratings, forecasted weighted average life, recent prepayment speeds, underwriting characteristics of the underlying collateral, the structure of the securitization and the credit performance of the underlying collateral. The review of underwriting characteristics considers: average loan size, type of loan (fixed or ARM), vintage, rate, FICO, loan-to-value, scheduled amortization, occupancy, purpose, geographic mix and loan documentation. The review of the securitization structure focuses on the priority of cash flows to the bond, the priority of the bond relative to the realization of credit losses and the level of subordination available to absorb credit losses. The review of credit performance includes: current period as well as cumulative realized losses; the level of severe payment problems, which includes other real estate (ORE), foreclosures, bankruptcy and 90 day delinquencies; and the level of less severe payment problems, which consists of 30 and 60 day delinquencies.

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

In addition to the review discussed above, certain private label residential mortgage-backed securities, including the four securities with a rating below investment grade were reviewed for OTTI utilizing a cash flow projection. The scope of review included securities that account for 81% of the $3.3 million in gross unrealized losses. The cash flow analysis forecasted cash flow from the underlying loans in each transaction and then applied these cash flows to the bonds in the securitization. The cash flows from the underlying loans considered contractual payment terms (scheduled amortization), prepayments, defaults and severity of loss given default. The analysis used dynamic assumptions for prepayments, defaults and loss severity. Near term prepayment assumptions were based on recently observed prepayment rates. More weight was given to longer term historic performance (12 months). Recent prepayment experience has increased somewhat due to an increase in nonconforming loans being refinanced into conventional transactions. In some cases, recently observed prepayment rates are lower than historic norms due to the absence of new jumbo loan issuances. This loan market is heavily dependent upon securitization for funding, and new securitization transactions have been minimal. Our model projections anticipate that prepayment rates gradually revert to historical levels. For seasoned ARM transactions, normalized prepayment rates are estimated at 15% to 25% CPR. For fixed rate collateral (two transactions), the prepayment speeds are projected to be flat.

Default assumptions are largely based on the volume of existing real-estate owned, pending foreclosures and severe delinquencies. Other considerations include the quality of loan underwriting, recent default experience, realized loss performance and the volume of less severe delinquencies. Default levels generally are projected to remain elevated or increase for a period of time sufficient to address the level of distressed loans in the transaction. Our projections expect defaults to then decline, generally beginning in year three. Current loss severity assumptions are based on recent observations when meaningful data is available. Loss severity is expected to remain elevated for the next three years as recent housing data remains weak. Severity is expected to decline beginning in year four as the back log of foreclosure and distressed sales clear the market. Except for two securities discussed in further detail below (both are currently below investment grade), our cash flow analysis forecasts complete recovery of our cost basis for each reviewed security.

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

At June 30, 2011 two below investment grade private label residential mortgage-backed securities with fair values of $4.5 million and $0.3 million, respectively and unrealized losses of $1.1 million and $0.04 million, respectively (amortized cost of $5.6 million and $0.3 million, respectively) had losses that were considered other than temporary.

The underlying loans in the first transaction are 30 year fixed rate jumbos with an average FICO of 744 and an average loan-to-value ratio of 72%. The loans backing this transaction were originated in 2007 and is our only security backed by 2007 vintage loans. We believe that this vintage is a key differentiating factor between this security and the others in our portfolio that do not have unrealized losses that are considered OTTI. The bond is a senior security that is receiving principal and interest payments similar to principal reductions in the underlying collateral. The cash flow analysis described above calculated $0.314 million of credit related OTTI as of June 30, 2011 and was recognized in our consolidated statements of operations ($0.052 million and $0.051 million during the first six months of 2011 and 2010, respectively and $0.197 million and $0.065 million during the years ended December 31, 2010 and 2009, respectively). The remaining unrealized loss was attributed to other factors and is reflected in other comprehensive income (loss) during those same periods.

The underlying loans in the second transaction are 30 year hybrid ARM jumbos with an average FICO of 738 and an average loan-to-value ratio of 57%. The loans backing this transaction were originated in 2005. The bond is a senior support security that is receiving principal and interest payments similar to principal reductions in the underlying collateral. The cash flow analysis described above calculated credit related OTTI of $0.288 million as of June 30, 2011 and was recognized in our consolidated statements of operations ($0.090 million during the first six months of 2011 and $0.198 million during the year ended December 31, 2010). The remaining unrealized loss was attributed to other factors and is reflected in other comprehensive income (loss) during those same periods.

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

Obligations of states and political subdivisions — at June 30, 2011 we had 16 municipal securities whose fair value is less than amortized cost. The unrealized losses are largely attributed to a widening of market spreads and continued illiquidity for certain issues. The majority of the securities are not rated by a major rating agency. Approximately 77% of the non rated securities originally had a AAA credit rating by virtue of bond insurance. However, the insurance provider no longer has an investment grade rating. The remaining non rated issues are small local issues that did not receive a credit rating due to the size of the transaction. The non rated securities have a periodic internal credit review according to established procedures. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at June 30, 2011 we had four securities whose fair value is less than amortized cost. All of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities over the past three to four years has suffered from significant credit spread widening fueled by uncertainty regarding potential losses of financial companies, the absence of a liquid functioning secondary market and potential supply concerns from financial companies issuing new debt to recapitalize themselves. During the first six months of 2011 pricing for rated issues increased modestly while prices for non rated issues declined due to credit spread widening.

Index

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

One of the four securities is rated by a major rating agency as investment grade, while one is split rated (this security is rated as investment grade by one major rating agency and below investment grade by another) and the other two are non-rated. The non-rated issues are relatively small banks and were never rated. The issuers of these non-rated trust preferred securities, which had a total amortized cost of $2.8 million and total fair value of $2.2 million as of June 30, 2011, continue to make interest payments and have satisfactory credit metrics.

An additional $0.250 million trust preferred security was written down to zero as of December 31, 2010, including a $0.067 million credit related OTTI charge in the first quarter of 2010.

The following table breaks out our trust preferred securities in further detail as of June 30, 2011 and December 31, 2010:

	June 30, 2011		December 31, 2010	
	Fair Value	Net Unrealized Gain (Loss)	Fair Value	Net Unrealized Gain (Loss)
	(In thousands)			
Trust preferred securities				
Rated issues	$1,643	$(243)	$6,290	$(375)
Unrated issues - no OTTI	2,166	(641)	2,800	(7)

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

During the six month periods ended June 30, 2011 and 2010 we recorded in earnings OTTI charges on securities available for sale of $0.1 million in each period. No such charges were recorded in earnings for the three month periods ended June 30, 2011 and 2010.

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

	2011	2010
	(In thousands)	
Balance at beginning of year	$710	$248
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	142	118
Total	$852	$366

Index

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

The amortized cost and fair value of securities available for sale at June 30, 2011, by contractual maturity, follow. 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.

	Amortized Cost	Fair Value
	(In thousands)	
Maturing within one year	$1,358	$1,373
Maturing after one year but within five years	8,214	8,481
Maturing after five years but within ten years	12,123	11,769
Maturing after ten years	12,139	11,535
	33,834	33,158
U.S. agency residential mortgage-backed	33,559	33,995
Private label residential mortgage-backed	14,325	11,039
Total	$81,718	$78,192

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(1)
		(In thousands)	
2011	$70,322	$279	$75
2010	94,685	1,876	221

(1) Losses in 2011 and 2010 exclude $0.142 million and $0.118 million, respectively of credit related OTTI recognized in earnings

During 2011 and 2010 our trading securities consisted of various preferred stocks. During the first six months of 2011 and 2010 we recognized gains (losses) on trading securities of $0.124 million and $(0.027) million, respectively, that are included in net gains (losses) on securities in the consolidated statements of operations. Both of these amounts, relate to gains (losses) recognized on trading securities still held at each respective period end.

Index

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

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

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

	Commercial	Mortgage	Installment	Payment Plan Receivables	Unallocated	Total
			(In thousands)			
2011						
Balance at beginning of period	$23,836	$22,642	$6,769	$ 389	$14,279	$67,915
Additions (deductions)						
Provision for loan losses	6,043	8,929	1,681	45	(1,244)	15,454
Recoveries credited to allowance	731	740	707	4	-	2,182
Loans charged against the allowance	(12,913)	(8,563)	(2,868)	(92)	-	(24,436)
Balance at end of period	$17,697	$23,748	$6,289	$ 346	$13,035	$61,115
2010						
Balance at beginning of period	$41,259	$18,434	$6,404	$ 754	$14,866	$81,717
Additions (deductions)						
Provision for loan losses	12,294	13,646	4,462	(217)	(491)	29,694
Recoveries credited to allowance	504	588	736	11	-	1,839
Loans charged against the allowance	(22,295)	(10,945)	(4,360)	(44)	-	(37,644)
Balance at end of period	$31,762	$21,723	$7,242	$ 504	$14,375	$75,606

14

Index

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

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

	Commercial	Mortgage	Installment	Payment Plan Receivables	Unallocated	Total
			(In thousands)			
June 30, 2011						
Allowance for loan losses:						
Individually evaluated for impairment	$7,139	$10,862	$1,801	$ -	$ -	$19,802
Collectively evaluated for impairment	10,558	12,886	4,488	346	13,035	41,313
Total ending allowance balance	$17,697	$23,748	$6,289	$ 346	$13,035	$61,115
Loans						
Individually evaluated for impairment	$38,388	$100,474	$7,907	$ -		$146,769
Collectively evaluated for impairment	630,065	525,039	224,397	155,385		1,534,886
Total loans recorded investment	668,453	625,513	232,304	155,385		1,681,655
Accrued interest included in recorded investment	1,956	3,053	893	-		5,902
Total Loans	$666,497	$622,460	$231,411	$ 155,385		$1,675,753
December 31, 2010						
Allowance for loan losses:						
Individually evaluated for impairment	$11,522	$11,567	$1,836	$ -	$ -	$24,925
Collectively evaluated for impairment	12,314	11,075	4,933	389	14,279	42,990
Total ending allowance balance	$23,836	$22,642	$6,769	$ 389	$14,279	$67,915
Loans						
Individually evaluated for impairment	$53,415	$107,026	$6,904	$ -		$167,345
Collectively evaluated for impairment	656,681	554,534	239,835	201,263		1,652,313
Total loans recorded investment	710,096	661,560	246,739	201,263		1,819,658
Accrued interest included in recorded investment	2,566	2,881	1,095	-		6,542
Total Loans	$707,530	$658,679	$245,644	$ 201,263		$1,813,116

15

Index

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, 2011			
Commercial			
Income producing - real estate	$342	$11,110	$11,452
Land, land development and construction - real estate	-	5,228	5,228
Commercial and industrial	101	8,419	8,520
Mortgage			
1-4 family	8	15,003	15,011
Resort lending	-	7,162	7,162
Home equity line of credit - 1st lien	-	584	584
Home equity line of credit - 2nd lien	-	1,145	1,145
Installment			
Home equity installment - 1st lien	-	1,448	1,448
Home equity installment - 2nd lien	-	919	919
Loans not secured by real estate	-	647	647
Other	-	1	1
Payment plan receivables			
Full refund	-	1,182	1,182
Partial refund	-	358	358
Other	-	67	67
Total recorded investment	$451	$53,273	$53,724
Accrued interest included in recorded investment	$8	$-	$8
December 31, 2010			
Commercial			
Income producing - real estate	$276	$11,925	$12,201
Land, land development and construction - real estate	-	9,672	9,672
Commercial and industrial	675	7,016	7,691
Mortgage			
1-4 family	-	19,428	19,428
Resort lending	-	9,206	9,206
Home equity line of credit - 1st lien	-	1,080	1,080
Home equity line of credit - 2nd lien	-	1,153	1,153
Installment			
Home equity installment - 1st lien	-	1,916	1,916
Home equity installment - 2nd lien	-	1,373	1,373
Loans not secured by real estate	-	923	923
Other	-	34	34
Payment plan receivables			
Full refund	-	2,470	2,470
Partial refund	-	329	329

Other	-	127	127
Total recorded investment	$951	$66,652	$67,603
Accrued interest included in recorded investment	$23	$-	$23

Index

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

An aging analysis of loans by class follows:

	Loans Past Due					
	30-59 days	60-89 days	90+ days	Total	Loans not Past Due	Total Loans
				(In thousands)		
June 30, 2011						
Commercial						
Income producing - real estate	$ 1,820	$ 2,233	$ 5,357	$ 9,410	$ 279,305	$ 288,715
Land, land development and construction - real estate	873	769	3,341	4,983	52,650	57,633
Commercial and industrial	3,179	1,120	6,047	10,346	311,759	322,105
Mortgage						
1-4 family	3,193	1,458	15,011	19,662	309,632	329,294
Resort lending	1,600	1,338	7,162	10,100	201,757	211,857
Home equity line of credit - 1st lien	1,005	16	584	1,605	24,214	25,819
Home equity line of credit - 2nd lien	744	398	1,145	2,287	56,256	58,543
Installment						
Home equity installment - 1st lien	778	209	1,448	2,435	45,761	48,196
Home equity installment - 2nd lien	820	365	919	2,104	56,372	58,476
Loans not secured by real estate	1,185	263	647	2,095	120,360	122,455
Other	35	28	1	64	3,113	3,177
Payment plan receivables						
Full refund	3,988	2,517	1,182	7,687	130,360	138,047
Partial refund	550	420	358	1,328	13,540	14,868
Other	119	127	67	313	2,157	2,470
Total recorded investment	$ 19,889	$ 11,261	$ 43,269	$ 74,419	$ 1,607,236	$ 1,681,655
Accrued interest included in recorded investment	$ 202	$ 108	$ 8	$ 318	$ 5,584	$ 5,902
December 31, 2010						
Commercial						
Income producing - real estate	$ 3,269	$ 914	$ 8,978	$ 13,161	$ 295,948	$ 309,109

Land, land development and construction - real estate	1,923	147	4,919	6,989	55,693	62,682
Commercial and industrial	1,636	2,204	4,665	8,505	329,800	338,305
Mortgage						
1-4 family	4,074	2,349	19,428	25,851	319,361	345,212
Resort lending	2,667	1,003	9,206	12,876	215,398	228,274
Home equity line of credit - 1st lien	576	-	1,080	1,656	25,951	27,607
Home equity line of credit - 2nd lien	723	464	1,153	2,340	58,127	60,467
Installment						
Home equity installment - 1st lien	472	228	1,916	2,616	50,150	52,766
Home equity installment - 2nd lien	746	529	1,373	2,648	63,345	65,993
Loans not secured by real estate	1,302	348	923	2,573	122,066	124,639
Other	51	16	34	101	3,240	3,341
Payment plan receivables						
Full refund	6,475	3,957	2,470	12,902	148,751	161,653
Partial refund	1,134	642	329	2,105	24,170	26,275
Other	583	166	127	876	12,459	13,335
Total recorded investment	$ 25,631	$ 12,967	$ 56,601	$ 95,199	$ 1,724,459	$ 1,819,658
Accrued interest included in recorded investment	$ 225	$ 133	$ 23	$ 381	$ 6,161	$ 6,542

Index

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

Impaired loans are as follows :

	June 30,2011	December 31,2010
	(In thousands)	
Impaired loans with no allocated allowance		
TDR	$26,017	$25,754
Non - TDR	1,108	4,495
Impaired loans with an allocated allowance		
TDR - allowance based on collateral	9,845	19,418
TDR - allowance based on present value cash flow	89,200	93,070
Non - TDR - allowance based on collateral	20,130	21,623
Non - TDR - allowance based on present value cash flow	-	2,351
Total impaired loans	$146,300	$166,711
Amount of allowance for loan losses allocated		
TDR - allowance based on collateral	$2,479	$5,462
TDR - allowance based on present value cash flow	11,807	12,086
Non - TDR - allowance based on collateral	5,516	6,644
Non - TDR - allowance based on present value cash flow	-	733
Total amount of allowance for loan losses allocated	$19,802	$24,925

Index

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

Impaired loans by class at June 30, 2011 are as follows (1):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:			(In thousands)		
Commercial					
Income producing - real estate	$1,590	$1,588	$-	$2,796	$30
Land, land development & construction-real estate	156	278	-	876	27
Commercial and industrial	2,075	2,114	-	3,143	17
Mortgage					
1-4 family	9,515	11,837	-	9,095	214
Resort lending	8,906	8,894	-	7,584	223
Home equity line of credit - 1st lien	-	-	-	-	-
Home equity line of credit - 2nd lien	114	188	-	108	2
Installment					
Home equity installment - 1st lien	2,039	2,058	-	1,870	48
Home equity installment - 2nd lien	2,070	2,082	-	1,963	49
Loans not secured by real estate	741	784	-	540	16
Other	27	27	-	9	1
	27,233	29,850	-	27,984	627
With an allowance recorded:					
Commercial					
Income producing - real estate	18,152	24,480	3,139	16,618	122
Land, land development & construction-real estate	6,931	10,810	1,694	9,667	69
Commercial and industrial	9,484	11,397	2,306	10,335	141
Mortgage					
1-4 family	62,170	63,544	8,116	63,714	1,351
Resort lending	19,703	21,536	2,714	24,417	396
Home equity line of credit - 1st lien	47	47	31	16	1
Home equity line of credit - 2nd lien	19	23	1	15	-
Consumer					
Home equity installment - 1st lien	1,433	1,469	645	1,467	28
Home equity installment - 2nd lien	1,466	1,481	1,110	1,511	30
Loans not secured by real estate	131	132	46	185	1
Other	-	-	-	-	-
	119,536	134,919	19,802	127,945	2,139
Total					
Commercial					
Income producing - real estate	19,742	26,068	3,139	19,414	152
Land, land development & construction-real estate	7,087	11,088	1,694	10,543	96
Commercial and industrial	11,559	13,511	2,306	13,478	158
Mortgage					

1-4 family	71,685	75,381	8,116	72,809	1,565
Resort lending	28,609	30,430	2,714	32,001	619
Home equity line of credit - 1st lien	47	47	31	16	1
Home equity line of credit - 2nd lien	133	211	1	123	2
Consumer					
Home equity installment - 1st lien	3,472	3,527	645	3,337	76
Home equity installment - 2nd lien	3,536	3,563	1,110	3,474	79
Loans not secured by real estate	872	916	46	725	17
Other	27	27	-	9	1
Total	$146,769	$164,769	$19,802	$155,929	$ 2,766
Accrued interest included in recorded investment	$469				

(1) There were no impaired payment plan receivables at June 30, 2011.

Index

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

Impaired loans by class at December 31, 2010 are as follows (1):

	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:		(In thousands)	
Commercial			
Income producing - real estate	$4,545	$4,763	$-
Land, land development & construction-real estate	1,600	2,810	-
Commercial and industrial	5,830	5,873	-
Mortgage			
1-4 family	8,770	10,551	-
Resort lending	5,666	5,670	-
Home equity line of credit - 1st lien	-	-	-
Home equity line of credit - 2nd lien	93	93	-
Installment			
Home equity installment - 1st lien	1,772	1,805	-
Home equity installment - 2nd lien	1,891	1,904	-
Loans not secured by real estate	211	220	-
Other	-	-	-
	30,378	33,689	-
With an allowance recorded:			
Commercial			
Income producing - real estate	16,206	22,748	4,279
Land, land development & construction-real estate	12,735	21,017	3,922
Commercial and industrial	12,499	13,844	3,321
Mortgage			
1-4 family	64,157	66,379	8,223
Resort lending	28,315	28,874	3,319
Home equity line of credit - 1st lien	-	-	-
Home equity line of credit - 2nd lien	25	97	25
Consumer			
Home equity installment - 1st lien	1,361	1,374	620
Home equity installment - 2nd lien	1,413	1,429	1,110
Loans not secured by real estate	256	258	106
Other	-	-	-
	136,967	156,020	