

MACATAWA BANK CORP  
Form 10-Q  
July 25, 2013

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

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

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

Commission file number: 000-25927

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

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

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

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

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

Yes  No

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

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

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

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

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

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Forward-Looking Statements

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

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

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## Part I Financial Information

## Item 1.

## MACATAWA BANK CORPORATION

## CONSOLIDATED BALANCE SHEETS

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

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

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

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

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

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See accompanying notes to consolidated financial statements.

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

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

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

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See accompanying notes to consolidated financial statements.

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

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

See accompanying notes to consolidated financial statements.

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## MACATAWA BANK CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Six Month Periods Ended June 30, 2013 and 2012

(unaudited)

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

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See accompanying notes to consolidated financial statements.

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

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

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

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

Regulatory Developments:

Release of Memorandum of Understanding with Macatawa Bank and its Regulators

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

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

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

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

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Board Resolution

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

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

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

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

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

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

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

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

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

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

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

We recognize a tax position as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. We recognize interest and penalties related to income tax matters in income tax expense.

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

## NOTE 2 – SECURITIES

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

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

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

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## NOTE 2 – SECURITIES (Continued)

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

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

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

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

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

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

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

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

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## NOTE 2 – SECURITIES (Continued)

## Other-Than-Temporary-Impairment

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

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

## NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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## NOTE 3 – LOANS (Continued)

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

June 30, 2013:

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

December 31, 2012:

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

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## NOTE 3 – LOANS (Continued)

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

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



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

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## NOTE 3 – LOANS (Continued)

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

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

| Three Months<br>Ended | Three Months<br>Ended |
|-----------------------|-----------------------|
|-----------------------|-----------------------|

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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

Consumer

---      ---      1      70

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

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

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

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

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

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## NOTE 3 – LOANS (Continued)

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

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

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

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

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

|          | December |
|----------|----------|
| June 30, | 31,      |
| 2013     | 2012     |

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

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## NOTE 3 – LOANS (Continued)

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

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

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

## NOTE 4 – OTHER REAL ESTATE OWNED

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

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

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

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

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

## NOTE 5 – FAIR VALUE

ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

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

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

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

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

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

Impaired Loans: Loans identified as impaired are measured using one of three methods: the loan's observable market price, the fair value of collateral or the present value of expected future cash flows. For each period presented, no impaired loans were measured using the loan's observable market price. If an impaired loan has had a chargeoff or if the fair value of the collateral is less than the recorded investment in the loan, we establish a specific reserve and report the loan as nonrecurring Level 3. The fair value of collateral of impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers

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

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

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## NOTE 5 – FAIR VALUE (Continued)

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

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

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

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

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

December 31, 2012

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

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## NOTE 5 – FAIR VALUE (Continued)

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

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

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

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

## NOTE 6 – DEPOSITS

Deposits are summarized as follows (in thousands):



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

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

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## NOTE 7 - OTHER BORROWED FUNDS

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

Federal Home Loan Bank Advances

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

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

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

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

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

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

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

Federal Reserve Bank Borrowings

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

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## NOTE 8 - EARNINGS PER COMMON SHARE

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

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

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

## NOTE 9 - FEDERAL INCOME TAXES

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

|         | Three<br>Months<br>Ended<br>June 30,<br>2013 | Three<br>Months<br>Ended<br>June 30,<br>2012 | Six<br>Months<br>Ended<br>June 30,<br>2013 | Six<br>Months<br>Ended<br>June 30,<br>2012 |
|---------|--|--|--|--|
| Current | \$55   | \$ (176 )                                    | \$55                                       | \$ (163 )                                  |

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

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## NOTE 9 - FEDERAL INCOME TAXES (Continued)

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

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

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

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

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

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## NOTE 9 - FEDERAL INCOME TAXES (Continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 11 – CONTINGENCIES

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

NOTE 12 – SHAREHOLDERS' EQUITY

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

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

Regulatory Capital

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

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



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## NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

## RESULTS OF OPERATIONS

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

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

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

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

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

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

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

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

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

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

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

(1) Yield adjusted to fully tax equivalent.

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





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

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

(1) Yield adjusted to fully tax equivalent.

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

| Three<br>Months | Three<br>Months | Six<br>Months | Six<br>Months |
|-----------------|-----------------|---------------|---------------|
|-----------------|-----------------|---------------|---------------|

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

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

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

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

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

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

## FINANCIAL CONDITION

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

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

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

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



funds sold or other short-term investments.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

|  | June<br>30,<br>2013 | Mar<br>31,<br>2013 | Dec<br>31,<br>2012 | Sept<br>30,<br>2012 | June<br>30,<br>2012 | March<br>31,<br>2012 | Dec<br>31,<br>2011 |
|--|---------------------|--------------------|--------------------|---------------------|---------------------|----------------------|--------------------|
|--|---------------------|--------------------|--------------------|---------------------|---------------------|----------------------|--------------------|

|                                       |       |       |       |       |       |       |       |
|---------------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Total capital to risk weighted assets | 16.1% | 15.4% | 15.0% | 14.9% | 14.2% | 13.7% | 13.2% |
|---------------------------------------|-------|-------|-------|-------|-------|-------|-------|

|                                  |       |       |       |       |       |       |       |
|----------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Tier 1 capital to average assets | 10.9% | 10.5% | 10.4% | 9.5 % | 9.0 % | 8.8 % | 8.3 % |
|----------------------------------|-------|-------|-------|-------|-------|-------|-------|

All of the \$40.0 million of trust preferred securities outstanding at June 30, 2013 qualified as Tier 1 capital. The ratios have increased each quarter since March 31, 2010 due to declines in risk weighted assets, positive earnings for each quarter and the stock offering completed in the second quarter of 2011.

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

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

LIQUIDITY

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

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

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

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

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

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

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

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

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

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

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES:**

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

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

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

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

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

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

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

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

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



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

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

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

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

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

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

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

#### Item 4: CONTROLS AND PROCEDURES

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

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

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

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



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PART II – OTHER INFORMATION

Item 6. Exhibits.

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



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

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SIGNATURES

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

MACATAWA BANK CORPORATION

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

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

Dated: July 25, 2013

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