ISABELLA BANK CORP
Form 10-K
March 12, 2012
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the fiscal year ended December 31, 2011

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the transition period from to

Commission File Number: 0-18415

Isabella Bank Corporation

(Exact name of registrant as specified in its charter)

Michigan	**38-2830092**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer identification No.)**

401 North Main Street, Mount Pleasant, Michigan 48858

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code (989) 772-9471

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

Title of each class	Name of each exchange on which registered

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

Common Stock - No Par Value

(Title of Class)

Indicated by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicated by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 definition of accelerated filer , large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	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 x

The aggregate market value of the voting stock held by non-affiliates of the registrant was $132,423,000 as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s Common Stock (no par value) was 7,584,909 as of February 16, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

(Such documents are incorporated herein only to the extent specifically set forth in response to an item herein.)

Documents	**Part of Form 10-K Incorporated into**
Isabella Bank Corporation Proxy Statement for its Annual Meeting of Shareholders to be held May 1, 2012	Part III

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ISABELLA BANK CORPORATION

ANNUAL REPORT ON FORM 10-K

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Part I

Item 1. Business (All dollars in thousands)

General

Isabella Bank Corporation (the Corporation) is a registered financial services holding company incorporated in September 1988 under Michigan law. The Corporation has three subsidiaries: Isabella Bank (the Bank), IB&T Employee Leasing, LLC, and Financial Group Information Services. Isabella Bank has 25 banking offices located throughout Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties. The area includes significant agricultural production, light manufacturing, retail, gaming and tourism, and five colleges and universities. IB&T Employee Leasing, LLC is an employee leasing company. Financial Group Information Services renders computer services to the Corporation and its subsidiaries. All employees of the Corporation are employed by IB&T Employee Leasing, LLC which leases employees to the Corporation and each of its subsidiaries. The principal city in which the Corporation operates is Mount Pleasant, Michigan which has a population of approximately 26,000.

The Corporation s reportable segments are based on legal entities that account for at least 10% of net operating results. Retail banking operations for 2011, 2010, and 2009 represent approximately 90% or greater of the Corporation s total assets and operating results. As such, the Corporation has only one reportable segment.

Competition

The Corporation competes with other commercial banks, many of which are subsidiaries of other bank holding companies, savings and loan associations, mortgage brokers, finance companies, credit unions, and retail brokerage firms. The Bank is a community bank with a focus on providing high quality, personalized service at a fair price. The Bank offers a broad array of banking services to businesses, institutions, and individuals. Deposit services offered include checking accounts, savings accounts, certificates of deposit, direct deposits, cash management services, mobile and internet banking, electronic bill pay services, and automated teller machines. Lending activities include loans made pursuant to commercial and agricultural operating and real estate purposes, residential real estate loans, and consumer loans. The Bank also offers full service trust and brokerage services.

Lending

The Corporation limits lending activities primarily to local markets and has not purchased any loans from the secondary market. The Corporation does not make loans to fund leveraged buyouts, has no foreign corporate or government loans, and has limited holdings of corporate debt securities. The general lending philosophy is to limit concentrations to individuals and business segments. The following table sets forth the composition of the Corporation s loan portfolio as of December 31, 2011:

	Amount	%
Commercial		
Commercial real estate	$ 258,095	34.40%
Commercial other	107,619	14.34%
Total commercial	365,714	48.74%
Agricultural		
Agricultural real estate	44,683	5.96%
Agricultural other	29,962	3.99%
Total agricultural	74,645	9.95%
Residential mortgage		
Senior liens	217,601	29.00%
Junior liens	21,246	2.83%
Home equity lines of credit	39,513	5.27%

Total residential mortgage	278,360	37.10%
Consumer		
Secured	26,174	3.49%
Unsecured	5,398	0.72%
Total consumer	31,572	4.21%
Total	$ 750,291	100.00%

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

Loans that management has the intent and ability to hold in its portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the allowance for loans losses, and any deferred fees or costs. Interest income on loans is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

The accrual of interest on mortgage and commercial loans is typically discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Consumer loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the allowance for loan losses. The interest on these loans is accounted for on the cash basis, until qualifying for return to accrual status. Loans are returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and state and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business; thus, these loans generally involve greater risk than other types of lending. The Corporation minimizes its risk by limiting the amount of loans to any one borrower to $12,500. Borrowers with credit needs of more than $12,500 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan to value limits of less than 80%. Depending upon the type of loan, past credit history, and current operating results, the Corporation may require the borrower to pledge accounts receivable, inventory, and fixed assets. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, the Corporation requires annual financial statements, prepares cash flow analyses, and reviews credit reports as deemed necessary.

The Corporation offers adjustable rate mortgages, fixed rate balloon mortgages, construction loans, and fixed rate mortgage loans which typically have amortization periods up to a maximum of 30 years. Fixed rate loans with an amortization of greater than 15 years are generally sold upon origination to the Federal Home Loan Mortgage Corporation. Fixed rate residential mortgage loans with an amortization of 15 years or less may be held in the Corporation s portfolio, held for future sale, or sold upon origination. Factors used in determining when to sell these mortgages include management s judgment about the direction of interest rates, the Corporation s need for fixed rate assets in the management of its interest rate sensitivity, and overall loan demand.

Lending policies generally limit the maximum loan to value ratio on residential mortgages to 95% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan to value ratios in excess of 80%. Substantially all loans upon origination have a loan to value ratio of less than 80%. Underwriting criteria for residential real estate loans include: evaluation of the borrower s ability to make monthly payments, the value of the property securing the loan, ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower s gross income, all debt

servicing does not exceed 36% of income, acceptable credit reports, verification of employment, income, and financial information. Appraisals are performed by independent appraisers and reviewed internally. All mortgage loan requests are reviewed by a mortgage loan committee or through a secondary market automated underwriting system; loans in excess of $400 require the approval of the Bank s Internal Loan Committee, Board of Directors, or the Board of Director s Loan Committee.

Consumer loans include automobile loans, secured and unsecured personal loans, and overdraft protection related loans. Loans are amortized generally for a period of up to 6 years. The underwriting emphasis is on a borrower s ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

Supervision and Regulation

The Corporation is subject to supervision and regulation by the Securities and Exchange Commission (SEC) under the Securities Act of 1933 and the Securities Exchange Act of 1934 and by the Board of Governors of the Federal Reserve Bank System (the FRB) under the Bank Holding Company Act of 1956 as amended (BHC Act), the Financial Services Holding Company Act of 2000, and the Dodd-Frank Act of 2011 (the Dodd-Frank Act). A bank holding company and its subsidiaries are able to conduct only the business of commercial banking and activities closely related or incidental to commercial banking (see Regulation below).

Isabella Bank is chartered by the State of Michigan and is a member of the FRB. The Bank s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law. The Bank is a member of the Federal Home Loan Bank of Indianapolis. The Bank is supervised and regulated by the Michigan Office of Financial and Insurance Regulation (OFIR), the FRB, and the Consumer Financial Protection Bureau (CFPB). For further discussion, see Regulation below.

Personnel

As of December 31, 2011, the Corporation and its subsidiaries had 352 full-time equivalent employees. The Corporation provides group life, health, accident, disability, and other insurance programs for employees as well as a number of other employee benefit programs. The Corporation believes its relationship with its employees to be good. None of the Corporation s workforce is subject to collective bargaining agreements.

Legal Proceedings

There are various claims and lawsuits in which the Corporation and its subsidiaries are periodically involved, such as claims to enforce liens, condemnation proceedings on making and servicing of real property loans, and other issues incidental to the Corporation s business. However, the Corporation and its subsidiaries are not involved in any material pending litigation.

AVAILABLE INFORMATION

The Corporation s SEC filings (including the Corporation s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Definitive Proxy Statements, Current Reports on Form 8-K and amendments to those reports) are available through the Bank s website (www.isabellabank.com). The Corporation will provide paper copies of its SEC reports free of charge upon request of a shareholder.

The SEC maintains an internet site (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding the Corporation (CIK #0000842517) and other issuers.

REGULATION

The earnings and growth of the banking industry and, therefore, the earnings of the Corporation and of the Bank are affected by the credit policies of monetary authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to combat recessions and curb inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Treasury and U.S. Government Agency securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements against member bank deposits. These methods are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks and related financial service providers in the past and are expected to continue to do so in the future. The effect of such policies upon the future business and earnings of the Corporation cannot be predicted.

The Corporation

The Corporation, as a financial services holding company, is regulated under the BHC Act, and is subject to the supervision of the FRB. The Corporation is registered as a financial services holding company with the FRB and is required to file with the FRB an annual report and such additional information as the FRB requires. The FRB makes inspections and examinations of the Corporation and its subsidiaries.

Prior to March 13, 2000, a bank holding company generally was prohibited under the BHC Act from acquiring the beneficial ownership or control of more than 5% of the voting shares or substantially all the assets of any company, including a bank, without the FRB s prior approval. Also, prior to March 13, 2000, a bank holding company generally was limited to engaging in banking and such other activities as determined by the FRB to be closely related to banking.

Under the Gramm-Leach-Bliley Act of 1999 (GLB Act), beginning March 13, 2000, an eligible bank holding company was able to elect to become a financial holding company and thereafter affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. The GLB Act defines financial in nature to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; activities that the FRB has determined to be closely related to banking; and other activities that the FRB, after consultation with the Secretary of the Treasury, determines by regulation or order to be financial in nature or incidental to a financial activity. No FRB approval is required for a financial holding company to acquire a company, other than a bank holding company, bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as defined in the GLB Act or as determined by the FRB.

A bank holding company is eligible to become a financial holding company if each of its subsidiary banks and savings associations is well capitalized under the prompt corrective action provisions of the Federal Deposit Insurance Act (FDI Act), is well managed and has a rating under the Community Reinvestment Act (CRA) of satisfactory or better. If any bank or savings association subsidiary of a financial holding company ceases to be well capitalized or well managed, the FRB may require the financial holding company to divest the subsidiary. Alternatively, the financial holding company may elect to conform its activities to those permissible for bank holding companies that do not elect to become financial holding companies. If any bank or savings association subsidiary of a financial holding company receives a CRA rating of less than satisfactory, the financial holding company will be prohibited from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations.

The Corporation became a financial holding company effective March 13, 2000. It continues to maintain its status as a bank holding company for purposes of other FRB regulations.

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Under FRB policy, the Corporation is expected to act as a source of financial strength to its subsidiary Bank and to commit resources to support its subsidiaries. This support may be required at times when, in the absence of such FRB policy, the Corporation would not otherwise be required to provide it.

Under Michigan law, if the capital of a Michigan state chartered bank (such as the Bank) has become impaired by losses or otherwise, the Commissioner of the OFIR may require that the deficiency in capital be met by assessment upon the bank s shareholders pro rata on the amount of capital stock held by each, and if any such assessment is not paid by any shareholder within 30 days of the date of mailing of notice thereof to such shareholder, cause the sale of the stock of such shareholder to pay such assessment and the costs of sale of such stock.

Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to a priority of payment. This priority would apply to guarantees of capital plans under the Federal Deposit Insurance Corporation Improvement Act of 1991.

The Sarbanes-Oxley Act of 2002 (SOX) contains important requirements for public companies in the area of financial disclosure and corporate governance. In accordance with Section 302(a) of SOX, written certifications by the Corporation s principal executive, financial, and accounting officers are required. These certifications attest that the Corporation s quarterly and annual reports filed with the SEC do not contain any untrue statement of a material fact. See the Certifications filed as Exhibits 31 (a) and (b) to this Form 10-K for such certification of the financial statements and other information for this 2011 Form 10-K. The Corporation has also implemented a program designed to comply with Section 404 of SOX, which included the identification of significant processes and accounts, documentation of the design of control effectiveness over process and entity level controls, and testing of the operating effectiveness of key controls. See Item 9A, Controls and Procedures for the Corporation s evaluation of its disclosure controls and procedures.

Certain additional information concerning regulatory guidelines for capital adequacy and other regulatory matters is presented herein under the caption Capital on page 35 and in the notes to the consolidated financial statements Note 15 Commitments and Other Matters and Note 16 Minimum Regulatory Capital Requirements .

Isabella Bank

The Bank is subject to regulation and examination primarily by OFIR and is also subject to regulation and examination by the FRB.

The agencies and federal and state laws extensively regulate various aspects of the banking business including, among other things, permissible types and amounts of loans, investments and other activities, capital adequacy, branching, interest rates on loans and on deposits and the safety and soundness of banking practices.

The deposits of the Corporation are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that assesses insurance premiums based upon a risk matrix that takes into account a bank s capital level and supervisory ratings.

Banking laws and regulations also restrict transactions by insured banks owned by a bank holding company, including loans to and certain purchases from the parent holding company, non bank and bank subsidiaries of the parent holding company, principal shareholders, officers, directors and their affiliates, and investments by the subsidiary bank in the shares or securities of the parent holding company (or any of the other non bank or bank affiliates), or acceptance of such shares or securities as collateral security for loans to any borrower.

The Bank is also subject to legal limitations on the frequency and amount of dividends that can be paid to the Corporation. For example, a Michigan state chartered bank may not declare a cash dividend or a dividend in kind except out of net profits then on hand after deducting all losses and bad debts, and then only if it will have a

surplus amounting to not less than 20% of its capital after the payment of the dividend. Moreover, a Michigan state chartered bank may not declare or pay any cash dividend or dividend in kind until the cumulative dividends on its preferred stock, if any, have been paid in full. Further, if the surplus of a Michigan state chartered bank is at any time less than the amount of its capital, before the declaration of a cash dividend or dividend in kind, it must transfer to surplus not less than 10% of its net profits for the preceding half year (in the case of quarterly or semiannual dividends) or the preceding two consecutive half year periods (in the case of annual dividends).

The payment of dividends by the Corporation and the Bank is also affected by various regulatory requirements and policies, such as the requirement to maintain adequate capital above regulatory guidelines. Federal laws impose further restrictions on the payment of dividends by insured banks that fail to meet specified capital levels. The FDIC may prevent an insured bank from paying dividends if the bank is in default of payment of any assessment due to the FDIC. In addition, payment of dividends by a bank may be prevented by the applicable federal regulatory authority if such payment is determined, by reason of the financial condition of such bank, to be an unsafe and unsound banking practice. The FRB and the FDIC have issued policy statements providing that bank holding companies and insured banks should generally pay dividends only out of current operating earnings. Additionally beginning in 2009, the FRB Board of Governors required the Corporation to notify the FRB prior to increasing its cash dividend by more than 10% over the prior year.

In 2010, the President signed into law the Dodd-Frank Act. The Dodd-Frank Act made sweeping changes in the regulation of financial institutions aimed at strengthening the sound operation of the financial services sector. Many of the provisions in the Dodd-Frank Act will not become effective until future years. The Dodd-Frank Act included the following provisions, among other things:

- Directed the Federal Reserve to issue rules which to limit debit-card interchange fees for financial institutions with assets in excess of $10,000,000;
- Created the CFPB, which has rulemaking and enforcement authority for a wide range of consumer protection laws affecting financial institutions;
- Increased leverage and risk-based capital requirements, FDIC premiums and examination fees;
- Provided for new disclosure, say-on-pay, and other rules relating to executive compensation and corporate governance for public companies, including public financial institutions;
- Permanently increased the federal deposit insurance coverage limit to $250;
- Provided for mortgage reform addressing a customer s ability to repay, restricted variable-rate lending, and made more loans subject to disclosure requirements and other restrictions; and
- Created a financial stability oversight council that will recommend to the FRB increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity.

Uncertainty remains as to the ultimate impact of the Dodd-Frank Act on the financial services industry as a whole and on the Corporation. In particular, many provisions of the Dodd-Frank Act are subject to rulemaking, which make it difficult to predict the impact of the Dodd-Frank Act on the Corporation, its customers and the financial services industry as a whole. While the overall effects of the Dodd-Frank Act remains unclear, management anticipates that it will be substantial. During 2011, the Corporation began to experience increased compensation costs as a result of staff additions necessary to comply with the new regulations.

The aforementioned regulations and restrictions may limit the Corporation s ability to obtain funds from the Bank for its cash needs, including payment of dividends and operating expenses.

The activities and operations of the Bank are also subject to other federal and state laws and regulations, including usury and consumer credit laws, the Federal Truth-in-Lending Act, Truth-in-Saving and Regulation Z of the FRB, the Federal Bank Merger Act, and the Bank Secrecy Act.

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Item 1A. Risk Factors

In the normal course of business the Corporation is exposed to various risks. These risks, if not managed correctly, could have a significant impact on the Corporation s earnings, capital, share price, and ability to pay dividends. In order to effectively monitor and control the following risks, management utilizes an enterprise risk model. Management balances the Corporation s strategic goals, including revenue and profitability objectives, with associated risks through the use of policies, systems, and procedures which have been adopted to identify, assess, control, monitor, and manage each risk area. Senior management continually reviews the adequacy and effectiveness of these policies, systems, and procedures.

In order to effectively monitor and control the following risks, management utilizes an enterprise risk process which covers each of the following areas.

Increases to loan losses and the Corporation s required allowance for loan losses

To manage the credit risk arising from lending activities, the Corporation s most significant source of credit risk, management maintains what it believes are sound underwriting policies and procedures. Management continuously monitors asset quality in order to manage the Corporation s credit risk to determine the appropriateness of valuation allowances. These valuation allowances take into consideration various factors including, but not limited to, local, regional, and national economic conditions.

The Corporation maintains an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management s best estimate of losses that may be incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management s continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires the Corporation to make significant estimates of current credit risks and economic trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Corporation s control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review the Corporation s allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge offs, based on judgments different than those of management.

Changes in economic conditions

An economic downturn within the Corporation s local markets, as well as downturns in the state or national markets, could negatively impact household and corporate incomes. This could lead to decreased demand for both loan and deposit products and lead to an increase of customers who fail to pay interest or principal on their loans. Management continually monitors key economic indicators in an effort to anticipate the possible effects of downturns in the local, regional, and national economies.

The Corporation s success depends primarily on the general economic conditions of the State of Michigan and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers located primarily in the Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The local economic conditions in these areas have a significant impact on the demand for the Corporation s products and services, as well as the ability of the Corporation s customers to repay loans, the value of the collateral securing loans and the stability of the Corporation s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or

other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Corporation s financial condition and results of operations.

Changes in interest rates

Interest rate risk is the timing differences in the maturity or repricing frequency of a financial institution s interest earning assets and its interest bearing liabilities. Management monitors the potential effects of changes in interest rates through rate shock and gap analyses. To help mitigate the effects of changes in interest rates, management makes significant efforts to stagger projected cash flows and maturities of interest sensitive assets and liabilities.

Liquidity risk

Liquidity risk is the risk to earnings or capital arising from the Corporation s inability to meet its obligations when they come due without incurring unacceptable costs. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources, or failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value. The Corporation has significant borrowing capacity through correspondent banks and the ability to sell certain investments to fund potential cash shortages, which management may use to help mitigate this risk.

The value of investment securities may be negatively impacted by fluctuations in the market

A volatile, illiquid market could require the Corporation to recognize an other-than-temporary impairment loss related to the investment securities held in the Corporation s portfolio. Management considers many factors in determining whether other-than-temporary impairment exists including the length of time and extent to which fair value has been less than cost, the investment credit rating, and the probability the issuer will be unable to pay the amount when due. The presence of these factors could lead to impairment charges. These risks are mitigated by the fact that the Corporation asserts that it does not intend to sell the security in an unrealized loss position and it is more likely than not it will not have to sell the securities before recovery of its cost basis.

Inadequate or failed internal processes, people, and systems, or external events

The Corporation is exposed to operational risk. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or external events and includes reputation risk and transaction risk. Reputation risk is developing and retaining marketplace confidence in handling customers financial transactions in an appropriate manner and protecting the safety and soundness of the Corporation. Transaction risk includes losses from fraud, error, the inability to deliver products or services, and loss or theft of information. Transaction risk also encompasses product development and delivery, transaction processing, information technology systems, and the internal control environment.

To help minimize the potential losses due to operational risks, management has established a robust system of internal controls as well as an internal audit department and has retained the services of a certified public accounting firm to assist in performing such internal audit work. The focus of these internal audit procedures is to verify the validity and appropriateness of various transactions, processes, and controls. The results of these procedures are reported to the Corporation s Audit Committee.

The adoption of, violations of, or nonconformance with laws, rules, regulations, or prescribed practices

The financial services industry and public companies are extensively regulated and must meet regulatory standards set by the FDIC, OFIR, the FRB, Financial Accounting Standards Board (FASB), SEC, Public Company Accounting Oversight Board (PCAOB), the CPFB, and other regulatory bodies. Federal and state

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laws and regulations are designed primarily to protect the deposit insurance funds and consumers, and not necessarily to benefit the Corporation s shareholders. The nature, extent, and timing of the adoption of significant new laws, changes in existing laws, or repeal of existing laws may have a material impact on the Corporation s business, results of operations, and financial condition, the effect of which is impossible to predict at this time.

The Corporation s compliance department annually assesses the adequacy and effectiveness of the Corporation s processes for controlling and managing its principal compliance risks.

The Corporation may not adjust to changes in the financial services industry

The Corporation s financial performance depends in part on its ability to maintain and grow its core deposit customer base and expand its financial services to its existing and new customers. In addition to other banks, competitors include savings associations, credit unions, securities dealers, brokers, mortgage bankers, investment advisors and finance and insurance companies. The increasingly competitive environment is, in part, a result of changes in technology and product delivery systems and the accelerating pace of consolidation among financial service providers. New competitors may emerge to increase the degree of competition for the Corporation s products and services. Financial services and products are also constantly changing. The Corporation s financial performance is also dependent upon customer demand for the Corporation s products and services and the Corporation s ability to develop and offer competitive financial products and services.

The Corporation may be required to recognize an impairment of goodwill

Goodwill represents the excess of the amounts paid to acquire subsidiaries over the fair value of their net assets at the date of acquisition. The majority of the recorded goodwill is related to acquisitions of other banks, which were subsequently merged into Isabella Bank. If it is determined that the goodwill has been impaired, the Corporation must write-down the goodwill by the amount of the impairment.

The Corporation may face increasing pressure from purchasers of its residential mortgage loans to repurchase loans sold or reimburse purchasers for losses related to such loans

The Corporation generally sells the fixed rate long term residential mortgage loans it originates in the secondary market. In response to the financial crisis, the purchasers of residential mortgage loans, such as government sponsored entities, have increased their efforts to require sellers of residential mortgage loans to either repurchase loans previously sold, or reimburse the purchasers for losses incurred on foreclosed loans due to actual or alleged failure to strictly conform to the purchaser s purchase criteria.

Consumers may decide not to use banks to complete their financial transactions.

Technology and other changes are allowing customers to complete financial transactions without the involvement of banks. For example, consumers can now pay bills and transfer funds directly without banks. The process of eliminating banks as intermediaries in financial transactions could result in the loss of fee income, as well as the loss of customer deposits and income generated from those deposits.

Changes to the financial services industry as a result of regulatory changes or actions, or significant litigation

The financial services industry is extensively regulated. The Corporation is subject to extensive state and federal regulation, supervision and legislation that govern almost all aspects of its operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors, and the deposit insurance funds. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact the Corporation or its ability to increase the value of its business. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of

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restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution s allowance for loan losses. Future regulatory changes or accounting pronouncements may increase the Corporation s regulatory capital requirements or adversely affect its regulatory capital levels. Additionally, actions by regulatory agencies or significant litigation against the Corporation could require the dedication of significant time and resources to defending its business and may lead to penalties.

Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of computer systems or otherwise

As part of the Corporation s business, the Corporation collects and retains sensitive and confidential client and customer information on behalf of the Corporation and other third parties. Despite the security measures the Corporation has in place for its facilities and systems, and the security measures of its third party service providers, the Corporation may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, human errors or other similar events. Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether by the Corporation or by its vendors, could severely damage the Corporation s reputation, expose it to the risks of litigation and liability, disrupt the Corporation s operations and have a material adverse effect on the Corporation s business.

Management s estimates and assumptions may be incorrect

The Corporation s consolidated financial statements conform with generally accepted accounting principles, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. These estimates are based on information available to management at the time the estimates are made. Actual results could differ from those estimates. For further discussion regarding significant accounting estimates, see Note 1- Nature of Operations and Summary of Significant Accounting Policies in the Notes to the Consolidated Financial Statements.

Disruption of infrastructure

The Corporation s operations depend upon its technological and physical infrastructure, including its equipment and facilities. Extended disruption of its vital infrastructure by fire, power loss, natural disaster, telecommunications failure, computer hacking and viruses, or other events outside of the Corporation s control, could affect the financial outcome of the Corporation or the financial services industry as a whole. The Corporation has developed disaster recovery plans, which provide detailed instructions covering all significant aspects of the Corporation s operations.

Increases in FDIC insurance premiums

The Corporation is unable to control the amount of premiums that it is required to pay for FDIC insurance. If there are additional bank or financial institution failures, the Corporation may be required to pay higher FDIC premiums. These announced increases have, and any future increases in FDIC insurance premiums will, materially adversely affect the Corporation s results of operations, financial condition and ability to continue to pay dividends on its common shares at the current rate.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Corporation s executive offices are located at 401 North Main Street, Mount Pleasant, Michigan 48858. Isabella Bank owns 25 branches and an operations center. The Corporation s facilities current, planned, and best use is for conducting its current activities, with the exception of approximately 75% of the Corporation s

previous main office location, approximately 25% of the building that houses the Lake Isabella office, and approximately 25% of the building that houses the Corporation s mortgage processing operations which are leased to non-related parties. Management continually monitors and assesses the need for expansion and/or improvement for all facilities. In management s opinion, each facility has sufficient capacity and is in good condition.

Item 3. Legal Proceedings

The Corporation and its subsidiaries are not involved in any material pending legal proceedings. The Corporation, because of the nature of its business, is at times subject to numerous pending and threatened legal actions that arise out of the normal course of operating its business.

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Part II

Item 5. Market for Registrant s Common Equity, Related Shareholders Matters and Issuer Purchases of Equity Securities

Common Stock and Dividend Information

The Corporation s common stock is traded in the over the counter market. The common stock is quoted on the OTCQB tier of the OTC Markets Group, Inc. s electronic quotation system (www.otcmarkets.com) under the symbol ISBA . Other trades in the common stock occur in privately negotiated transactions from time to time of which the Corporation may have little or no information.

Management has reviewed the information available as to the range of reported high and low bid quotations, including high and low bid information as reported by OTC Markets and as reported by the parties to privately negotiated transactions. The following table sets forth management s compilation of that information for the periods indicated. Price information obtained from OTC Markets reflects inter dealer prices, without retail mark up, mark down or commissions and may not necessarily represent actual transactions. Price information obtained from parties to privately negotiated transactions reflects actual closing prices that were disclosed to the Corporation, which management has not independently verified. The following compiled data is provided for information purposes only and should not be viewed as indicative of the actual or market value of the Corporation s common stock.

	Number of	Sale Price	
	Shares	Low	High
2011			
First Quarter	48,909	$ 17.00	$ 19.75
Second Quarter	65,090	17.00	18.50
Third Quarter	92,953	17.41	18.95
Fourth Quarter	106,210	17.74	24.45
	313,162		
2010			
First Quarter	45,695	$ 16.75	$ 19.00
Second Quarter	64,290	17.00	18.50
Third Quarter	53,897	16.05	17.99
Fourth Quarter	56,534	16.57	18.30
	220,416		

The following table sets forth the cash dividends paid for the following quarters:

	Per Share	
	2011	2010
First Quarter	$ 0.19	$ 0.18
Second Quarter	0.19	0.18
Third Quarter	0.19	0.18
Fourth Quarter	0.19	0.18
Total	**$ 0.76**	**$ 0.72**

Isabella Bank Corporation s authorized common stock consists of 15,000,000 shares, of which 7,589,226 shares are issued and outstanding as of December 31, 2011. As of that date, there were 3,043 shareholders of record.

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The Board of Directors has authorized a common stock repurchase plan. On April 27, 2011, the Board of Directors amended the plan to allow for the repurchase of an additional 100,000 shares of the Corporation s common stock. These authorizations do not have expiration dates. As shares are repurchased under this plan, they revert back to the status of authorized, but unissued shares.

The following table provides information for the three month period ended December 31, 2011, with respect to this plan:

	Shares Repurchased		Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
	Number	Average Price Per Share		
Balance, September 30, 2011				62,729
October 1 - 31, 2011	7,934	$ 18.78	7,934	54,795
November 1 - 30, 2011	1,481	19.58	1,481	53,314
December 1 - 31, 2011	34,318	18.50	34,318	18,996
Balance, December 31, 2011	**43,733**	**$ 18.59**	**43,733**	**18,996**

Information concerning Securities Authorized for Issuance Under Equity Compensation Plans appears under Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters included elsewhere in this annual report on Form 10-K.

Stock Performance

The following graph compares the cumulative total shareholder return on Corporation common stock for the last five years with the cumulative total return on (1) the NASDAQ Stock Market Index (NASDAQ), which is comprised of all United States common shares traded on the NASDAQ and (2) the NASDAQ Bank Stock Index (NASDAQ Banks), which is comprised of bank and bank holding company common shares traded on the NASDAQ over the same period. The graph assumes the value of an investment in the Corporation and each index was $100 at December 31, 2006 and all dividends are reinvested.

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The dollar values for total shareholder return plotted in the graph above are shown in the table below:

Comparison of Five Year Cumulative

Among Isabella Bank Corporation, NASDAQ Stock Market,

and NASDAQ Bank Stock

Year	Isabella Bank Corporation	NASDAQ	NASDAQ Banks
12/31/2006	100.0	100.0	100.0
12/31/2007	101.6	110.6	80.4
12/31/2008	66.1	66.6	63.3
12/31/2009	51.0	96.6	52.9
12/31/2010	48.5	114.0	60.4
12/31/2011	69.1	113.1	54.0

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Item 6. Selected Financial Data

RESULTS OF OPERATIONS

SUMMARY OF SELECTED FINANCIAL DATA

(Dollars in thousands except per share data)

	2011	2010	2009	2008	2007
INCOME STATEMENT DATA					
Total interest income	$ 57,905	$ 57,217	$ 58,105	$ 61,385	$ 53,972
Net interest income	41,702	40,013	38,266	35,779	28,013
Provision for loan losses	3,826	4,857	6,093	9,500	1,211
Net income	10,210	9,045	7,800	4,101	7,930
BALANCE SHEET DATA					
End of year assets	$ 1,337,925	$ 1,225,810	$ 1,143,944	$ 1,139,263	$ 957,282
Daily average assets	1,287,195	1,182,930	1,127,634	1,113,102	925,631
Daily average deposits	927,186	840,392	786,714	817,041	727,762
Daily average loans/net	730,919	712,272	712,965	708,434	596,739
Daily average equity	145,725	139,855	139,810	143,626	119,246
PER SHARE DATA					
Earnings per share					
Basic	$ 1.35	$ 1.20	$ 1.04	$ 0.55	$ 1.14
Diluted	1.31	1.17	1.01	0.53	1.11
Cash dividends	0.76	0.72	0.70	0.65	0.62
Book value (at year end)	20.40	19.23	18.69	17.89	17.58
FINANCIAL RATIOS					
Shareholders equity to assets (at year end)	11.57%	11.84%	12.31%	11.80%	12.86%
Return on average equity	7.01	6.47	5.58	2.86	6.65
Return on average tangible equity	10.30	9.55	8.53	4.41	8.54
Cash dividend payout to net income	56.51	59.93	67.40	118.82	54.27
Return on average assets	0.79	0.76	0.69	0.37	0.86

	2011				2010			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
Quarterly Operating Results:								
Total interest income	$ 14,466	$ 14,532	$ 14,669	$ 14,238	$ 14,540	$ 14,306	$ 14,272	$ 14,099
Interest expense	3,979	4,070	4,101	4,053	4,217	4,296	4,291	4,400
Net interest income	10,487	10,462	10,568	10,185	10,323	10,010	9,981	9,699
Provision for loan losses	1,443	963	603	817	1,626	968	1,056	1,207
Noninterest income	2,433	1,859	1,978	1,948	2,629	2,634	1,870	2,167
Noninterest expenses	8,651	8,513	8,779	8,587	8,558	8,620	8,275	8,354
Net income	2,711	2,511	2,672	2,316	2,318	2,553	2,151	2,023
Per Share of Common Stock:								
Earnings per share								
Basic	$ 0.36	$ 0.33	$ 0.35	$ 0.31	$ 0.30	$ 0.34	$ 0.29	$ 0.27
Diluted	0.35	0.32	0.34	0.30	0.30	0.33	0.28	0.26
Cash dividends	0.19	0.19	0.19	0.19	0.18	0.18	0.18	0.18
Book value (at quarter end)	20.40	20.53	20.00	19.52	19.23	19.59	19.39	18.89

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(All dollars in thousands)

The following is management s discussion and analysis of the financial condition and results of operations for Isabella Bank Corporation. This discussion and analysis is intended to provide a better understanding of the consolidated financial statements and statistical data included elsewhere in the Annual Report.

Executive Summary

Isabella Bank Corporation, as well as all other financial institutions in Michigan and across the entire country, continues to experience the negative impacts on its operations from the persistent weak economy. The current economic environment has led to historically high levels of loans charged off and foreclosed asset and collection expenses.

In spite of the economic downturn that has occurred over the past few years, the Corporation continues to be profitable, with net income of $10,210 for the year ended December 31, 2011. Not only has the Corporation remained profitable, its loan quality also compares well to its peers as its ratio of nonperforming loans to total loans was 0.95% as of December 31, 2011 compared to 3.26% for all bank holding companies in the Corporation s peer group as of September 30, 2011 (December 31, 2011 peer group ratios are not yet available). The Corporation s interest margins also continue to be strong, as the net yield on interest earning assets (on a fully taxable equivalent basis) was 3.87% for the year ended December 31, 2011.

Recent Legislation

The Health Care and Education Act of 2010 and the Patient Protection and Affordable Care Act could have a significant impact on the Corporation s operating results in future periods. Aside from the potential increases in the Corporation s health care costs, the implementation of the new rules and requirements is likely to require a substantial commitment from the Corporation s management.

The Dodd-Frank Act is very broad and complex legislation that puts in place a sweeping new financial services framework that is likely to have significant regulatory and legal consequences and will likely impact the Corporation s future operating results. Implementation of the Act will require compliance with numerous new regulations, which will increase compliance and documentation costs. For more information, see the summary of the Dodd-Frank Act under the heading Supervision and Regulation in Item 1, on page 5.

Other

The Corporation has not received any notices of regulatory actions as of February 16, 2012.

CRITICAL ACCOUNTING POLICIES:

The Corporation s significant accounting policies are set forth in Note 1 of the Consolidated Financial Statements. Of these significant accounting policies, the Corporation considers its policies regarding the allowance for loan losses, acquisition intangibles, and the determination of the fair value and assessment of other-than-temporary impairment of investment securities to be its most critical accounting policies.

The allowance for loan losses requires management s most subjective and complex judgment. Changes in economic conditions can have a significant impact on the allowance for loan losses and, therefore, the provision for loan losses and results of operations. The Corporation has developed appropriate policies and procedures for assessing the appropriateness of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation s assessments may be impacted in

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future periods by changes in economic conditions, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation s allowance for loan losses and related matters, see the detailed discussion to follow under the heading Allowance for Loan Losses .

United States generally accepted accounting principles require that the Corporation determine the fair value of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. The Corporation employs a variety of measures in the determination of the fair value, including the use of discounted cash flow analysis, market appraisals, and projected future revenue streams. For certain items that management believes it has the appropriate expertise to determine the fair value, management may choose to use its own calculations of the value. In other cases, where the value is not easily determined, the Corporation consults with outside parties to determine the fair value of the identified asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired entity and the value of its balance sheet, including identifiable intangibles, is recorded as goodwill. This goodwill is not amortized, but is evaluated for impairment on at least an annual basis.

The Corporation currently has both available-for-sale and trading investment securities that are carried at fair value. Changes in the fair value of available-for-sale investment securities are included as a component of other comprehensive income, while declines in the fair value of these securities below their cost that are other-than-temporary are reflected as realized losses in the consolidated statements of income. The change in value of trading investment securities is included in current earnings. Management evaluates available-for-sale securities for indications of losses that are considered other-than-temporary, if any, on a regular basis. The market values for available-for-sale and trading investment securities are typically obtained from outside sources and applied to individual securities within the portfolio.

Due to the limited trading of certain auction rate money market preferred securities and preferred stocks during 2010, the Corporation utilized a discounted cash flow analysis to determine fair values on December 31, 2010. This analysis considered the creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institution debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources and ranged from 3.90% to 6.90% as of December 31, 2010. During 2011, the markets for these securities have normalized and established regular trading patterns. As such, the Corporation determined the fair value for these securities based on quoted prices for identical securities, or based on quoted prices for similar securities as of December 31, 2011.

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DISTRIBUTION OF ASSETS, LIABILITIES, AND SHAREHOLDERS EQUITY

INTEREST RATE AND INTEREST DIFFERENTIAL

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities for the last three years. These schedules also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a fully taxable equivalent (FTE) basis using a 34% federal income tax rate. Nonaccruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. Federal Reserve and Federal Home Loan Bank stock holdings which are restricted are included in accrued income and other assets.

	Year Ended December 31								
	2011			2010			2009		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
INTEREST EARNING ASSETS									
Loans	$ 743,441	$ 45,463	6.12%	$ 725,534	$ 46,794	6.45%	$ 725,299	$ 47,706	6.58%
Taxable investment securities	235,437	6,941	2.95%	160,514	5,271	3.28%	119,063	4,712	3.96%
Nontaxable investment securities	136,356	7,847	5.75%	120,999	7,095	5.86%	121,676	7,217	5.93%
Trading account securities	5,087	286	5.62%	8,097	436	5.38%	17,279	856	4.95%
Federal funds sold							842	1	0.12%
Other	37,539	506	1.35%	45,509	479	1.05%	27,433	376	1.37%
Total earning assets	1,157,860	61,043	5.27%	1,060,653	60,075	5.66%	1,011,592	60,868	6.02%
NONEARNING ASSETS									
Allowance for loan losses	(12,522)			(13,262)			(12,334)		
Cash and demand deposits due from banks	20,195			18,070			18,190		
Premises and equipment	24,397			24,624			23,810		
Accrued income and other assets	97,265			92,845			86,376		
Total assets	$ 1,287,195			$ 1,182,930			$ 1,127,634		
INTEREST BEARING LIABILITIES									
Interest bearing demand deposits	$ 152,530	189	0.12%	$ 137,109	151	0.11%	$ 116,412	146	0.13%
Savings deposits	192,999	488	0.25%	169,579	391	0.23%	177,538	399	0.22%
Time deposits	467,931	10,258	2.19%	430,892	10,988	2.55%	398,356	13,043	3.27%
Borrowed funds	198,828	5,268	2.65%	188,512	5,674	3.01%	193,922	6,251	3.22%
Total interest bearing liabilities	1,012,288	16,203	1.60%	926,092	17,204	1.86%	886,228	19,839	2.24%
NONINTEREST BEARING LIABILITIES									
Demand deposits	113,726			102,812			94,408		
Other	15,456			14,171			7,188		
Shareholders equity	145,725			139,855			139,810		
Total liabilities and shareholders equity	$ 1,287,195			$ 1,182,930			$ 1,127,634		

Net interest income (FTE)	$ 44,840	$ 42,871	$ 41,029
Net yield on interest earning assets (FTE)	3.87%	4.04%	4.06%

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Net Interest Income

The Corporation derives the majority of its gross income from interest earned on loans and investments, while its most significant expense is the interest cost incurred for funds used. Net interest income is the amount by which interest income on earning assets exceeds the interest cost of deposits and borrowings. Net interest income is influenced by changes in the balance and mix of assets and liabilities and market interest rates. Management exerts some control over these factors; however, Federal Reserve monetary policy and competition have a significant impact. Interest income includes loan fees of $2,385 in 2011, $2,196 in 2010, and $1,963 in 2009. For analytical purposes, net interest income is adjusted to a taxable equivalent basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

VOLUME AND RATE VARIANCE ANALYSIS

The following table details the dollar amount of changes in FTE net interest income for each major category of interest earning assets and interest bearing liabilities and the amount of change attributable to changes in average balances (volume) or average rates. The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	2011 Compared to 2010 Increase (Decrease) Due to			2010 Compared to 2009 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
CHANGES IN INTEREST INCOME:						
Loans	$ 1,136	$ (2,467)	$ (1,331)	$ 15	$ (927)	$ (912)
Taxable investment securities	2,254	(584)	1,670	1,453	(894)	559
Nontaxable investment securities	886	(134)	752	(40)	(82)	(122)
Trading account securities	(168)	18	(150)	(489)	69	(420)
Federal funds sold				(1)		(1)
Other	(93)	120	27	205	(102)	103
Total changes in interest income	4,015	(3,047)	968	1,143	(1,936)	(793)
CHANGES IN INTEREST EXPENSE:						
Interest bearing demand deposits	18	20	38	24	(19)	5
Savings deposits	57	40	97	(18)	10	(8)
Time deposits	894	(1,624)	(730)	1,002	(3,057)	(2,055)
Borrowed funds	299	(705)	(406)	(171)	(406)	(577)
Total changes in interest expense	1,268	(2,269)	(1,001)	837	(3,472)	(2,635)
Net change in interest margin (FTE)	$ 2,747	$ (778)	$ 1,969	$ 306	$ 1,536	$ 1,842

During 2011, average interest earning assets increased by $97,207. This increase resulted in $4,015 of additional interest income which exceeded the $3,047 decrease in interest income caused by declines in interest rates. Interest bearing liabilities increased $86,196 at a cost of $1,268 while the decline in rates, mostly those on time deposits and borrowed funds, decreased interest expense by $2,269. The diminished interest income earned on assets resulted in a 0.17% decline in the net interest yield. Management anticipates that net interest margin yield will decline slightly during 2012 due to the following factors:

Based on the current economic conditions, management does not anticipate any changes in the target Fed funds rate in the foreseeable future. As such, changes in market rates may be unlikely. However, it is likely that the Corporation may see declines in the rates earned on interest earning assets as the interest rates on many types of loans including home equity lines of credit, residential balloon mortgages, variable rate commercial lines of credit, and investment securities with acceptable credit and interest rate risk are currently priced at or below the Corporation s current net yield on interest earning assets. Most of the potential declines would arise out of the Corporation s investment portfolio as the majority of securities that are called or mature in 2012 will be

reinvested at significantly lower rates.

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Interest rates on residential mortgage loans remain at or near historical lows. This rate environment has led to strong consumer demand for fixed rate mortgage products which are generally sold to the secondary market. As a result, there has been a significant decline in balloon mortgages, which are held on the Corporation s consolidated balance sheet. As these balloon mortgages have paid off, the proceeds from these loans have been reinvested (typically in the form of available-for-sale investment securities) at lower interest rates which has adversely impacted interest income.

While the Corporation s liability sensitive balance sheet has allowed it to benefit from decreases in interest rates, it also makes the Corporation sensitive to increases in deposit and borrowing rates. As part of the Corporation s goal to minimize the potential negative impacts of possible increases in future interest rates, management has been, and continues to be, actively working to lengthen the terms of its interest bearing liabilities. This lengthening has increased the Corporation s cost of funding, reducing net interest income in the short term.

Allowance for Loan Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans outstanding represent the Corporation s single largest concentration of risk. The allowance for loan losses is management s estimation of probable losses inherent in the existing loan portfolio. Factors used to evaluate the loan portfolio, and thus to determine the current charge to expense, include recent loan loss history, financial condition of borrowers, amount of nonperforming and impaired loans, overall economic conditions and other factors. The following schedule summarizes the Corporation s chargeoff and recovery activity for the years ended December 31:

	2011	2010	2009	2008	2007
Allowance for loan losses - January 1	$ 12,373	$ 12,979	$ 11,982	$ 7,301	$ 7,605
Allowance of acquired bank				822	
Loans charged off					
Commercial and agricultural	1,984	3,731	3,081	2,137	905
Real estate mortgage	2,240	2,524	2,627	3,334	659
Consumer	552	596	934	854	582
Total loans charged off	**4,776**	**6,851**	**6,642**	**6,325**	**2,146**
Recoveries					
Commercial and agricultural	461	453	623	160	297
Real estate mortgage	177	638	546	240	49
Consumer	314	297	377	284	285
Total recoveries	**952**	**1,388**	**1,546**	**684**	**631**
Net loans charged off	3,824	5,463	5,096	5,641	1,515
Provision charged to income	3,826	4,857	6,093	9,500	1,211
Allowance for loan losses - December 31	**$ 12,375**	**$ 12,373**	**$ 12,979**	**$ 11,982**	**$ 7,301**
Year to date average loans	**$ 743,441**	**$ 725,534**	**$ 725,299**	**$ 717,040**	**$ 604,342**
Net loans charged off to average loans outstanding	**0.51%**	**0.75%**	**0.70%**	**0.79%**	**0.25%**
Total amount of loans outstanding	**$ 750,291**	**$ 735,304**	**$ 723,316**	**$ 735,385**	**$ 612,687**
Allowance for loan losses as a % of loans	**1.65%**	**1.68%**	**1.79%**	**1.63%**	**1.19%**

The Corporation originates and sells fixed rate residential real estate mortgages to the Federal Home Loan Mortgage Corporation (Freddie Mac). The Corporation has not originated loans for either trading or its own portfolio that would be classified as subprime, nor has it originated adjustable rate mortgages or financed loans for more than 80% of market value unless insured by private third party insurance.

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As shown in the preceding table, when comparing 2011 to 2010, net loans charged off decreased by $1,639. This improvement allowed the Corporation to reduce its provision for loan losses. While there have been marked improvements in the level of net loans charged off, which has contributed to the Corporation s ability to reduce its provision for loan losses, the overall local, regional and national economies have yet to show consistent improvement.

The Corporation allocates the allowance throughout its loan portfolio based on management s assessment of the underlying risks associated with each loan segment. Management s assessments include allocations based on specific impairment allocations, historical losses, internally assigned credit ratings, and past due and nonaccrual balances. A portion of the allowance for loan losses is not allocated to any one loan segment, but is instead a reflection of other qualitative risks within the Corporation s loan portfolio.

For further discussion on the allocation of the allowance for loan losses, see Note 6 Loans and Allowance for Loan Losses to the Corporation s consolidated financial statements.

Loans Past Due and Loans in Nonaccrual Status

Increases in past due and nonaccrual loans can have a significant impact on the allowance for loan losses. To determine the potential impact, and corresponding estimated losses, management analyzes its historical loss trends on loans past due 30-89 days, 90 days or more, and nonaccrual loans.

The following tables summarize the Corporation s past due and nonaccrual loans as of December 31:

	Total Past Due and Nonaccrual				
	2011	2010	2009	2008	2007
Commercial and agricultural	$ 7,420	$ 9,606	$ 8,839	$ 13,958	$ 8,746
Residential mortgage	5,297	8,119	10,296	12,418	8,357
Consumer installment	186	309	460	956	617
	$ 12,903	$ 18,034	$ 19,595	$ 27,332	$ 17,720

	2011			
	Accruing Loans Past Due			
	30-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual
Commercial and agricultural	$ 2,149	$ 466	$ 4,805	$ 7,420
Residential mortgage	3,424	289	1,584	5,297
Consumer installment	181	5		186
	$ 5,754	$ 760	$ 6,389	$ 12,903

	2010			
	Accruing Loans Past Due			
	30-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual
Commercial and agricultural	$ 5,291	$ 175	$ 4,140	$ 9,606
Residential mortgage	6,339	310	1,470	8,119
Consumer installment	308	1		309

$ 11,938	$ 486	$ 5,610	$ 18,034

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Troubled Debt Restructurings

The following table summarizes the Corporation s troubled debt restructurings as of December 31:

		2011			2010			2009			2008		2007
	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest
Current	$ 16,125	$ 514	$ 16,639	$ 4,798	$ 499	$ 5,297	$ 2,754	$ 786	$ 3,540	$ 2,297	$ 1,355	$ 3,652	$ 517
Past due 30-89 days	1,614	429	2,043	277	26	303	107	904	1,011	268		268	115
Past due 90 days or more		74	74		163	163		426	426		630	630	53
Total	**$ 17,739**	**$ 1,017**	**$ 18,756**	**$ 5,075**	**$ 688**	**$ 5,763**	**$ 2,861**	**$ 2,116**	**$ 4,977**	**$ 2,565**	**$ 1,985**	**$ 4,550**	**$ 685**

The Corporation had no troubled debt restructurings in nonaccrual status as of December 31, 2007.

As a result of adopting the amendments in ASU No. 2011-02, the Corporation reassessed all loan restructurings that occurred on or after January 1, 2011 for identification as troubled debt restructurings (TDR s). The Corporation identified as TDR s certain loans for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology. Upon identifying those loans as TDR s, the Corporation identified them as impaired. The amendments in ASU No. 2011-02 require prospective application of the impairment measurement guidance for those loans newly identified as impaired. The Corporation s recorded investment in loans for which the allowance for credit losses was previously measured under a general allowance for credit losses methodology and are now impaired was $5,136, with a specific valuation allowance of $1,022 as of December 31, 2011.

The Corporation has taken aggressive actions to avoid foreclosures on borrowers who are willing to work with the Corporation in modifying their loans, thus making them more affordable. These loan modifications have allowed borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure. Troubled debt restructurings that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance.

Loan modifications are considered to be TDR s when the modification results in terms outside of normal lending practices to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

1. Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.

2. Extending the amortization period beyond typical lending guidelines for debt with similar risk characteristics.

3. Forbearance of principal.

4. Forbearance of accrued interest.

To determine if a borrower is experiencing financial difficulties, the Corporation considers if:

1. The borrower is currently in default on any of their debt.

2. It is likely that the borrower would default on any of their debt if the concession was not granted.

3. The borrower s cash flow was sufficient to service all of their debt if the concession was not granted.

4. The borrower has declared, or is in the process of declaring, bankruptcy.

5. The borrower is unlikely to continue as a going concern (if the entity is a business).

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The following tables summarize concessions granted by the Corporation to borrowers experiencing financial difficulties in the year ended December 31:

	2011			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial				
Commercial real estate	1	$ 408		$
Commercial other	38	9,932	4	2,643
Total commercial	39	10,340	4	2,643
Agricultural other	8	1,321		
Residential mortgage				
Senior liens	19	2,161	17	1,754
Consumer				
Secured	6	65	1	4
Unsecured			2	20
Total consumer	6	65	3	24
Total	**72**	**$ 13,887**	**24**	**$ 4,421**

The Corporation did not restructure any loans through the forbearance of principal or accrued interest during 2011.

The Corporation has been successful in its efforts to restructure loans to reduce foreclosures. Of the 163 troubled debt restructurings granted since December 31, 2008, only 6 have defaulted.

Nonperforming Assets

The following table summarizes the Corporation s nonperforming assets as of December 31:

	2011	2010	2009	2008	2007
Nonaccrual loans	$ 6,389	$ 5,610	$ 8,522	$ 11,175	$ 4,156
Accruing loans past due 90 days or more	760	486	768	1,251	1,727
Total nonperforming loans	**7,149**	**6,096**	**9,290**	**12,426**	**5,883**
Other real estate owned	1,867	2,039	1,141	2,770	1,376
Repossessed assets	9	28	16	153	
Total nonperforming assets	**$ 9,025**	**$ 8,163**	**$ 10,447**	**$ 15,349**	**$ 7,259**
Nonperforming loans as a % of total loans	**0.95%**	**0.83%**	**1.28%**	**1.69%**	**0.96%**

Nonperforming assets as a % of total assets	**0.67%**	**0.67%**	**0.91%**	**1.35%**	**0.76%**

Loans are placed in nonaccrual status when the foreclosure process has begun, generally after a loan is 90 days past due, unless they are well secured and in the process of collection. Upon transferring the loans to nonaccrual status, an evaluation to determine the net realizable value of the underlying collateral is performed. This evaluation is used to help determine if any charge downs are necessary. Loans may be placed back on accrual status after six months of continued performance.

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The following table summarizes the Corporation s nonaccrual loan balances by type as of December 31:

	2011	2010	2009	2008	2007
Commercial and agricultural	$ 4,805	$ 4,140	$ 5,810	$ 8,059	$ 1,959
Residential mortgage	1,584	1,470	2,657	3,092	2,185
Consumer installment			55	24	12
	$ 6,389	$ 5,610	$ 8,522	$ 11,175	$ 4,156

Included in nonaccrual commercial and agricultural loans was one loan with a balance of $1,900 as of December 31, 2011 and $2,679 as of December 31, 2010. As of December 31, 2011, there was no specific allocation established for this loan as it has been charged down to reflect the current market value of the real estate, while there was a specific allocation established in the amount of $345 as of December 31, 2010. Nonaccrual commercial and agricultural loans also included one loan with a balance of $1,014 as of December 31, 2011, for which there was no specific allocation established as the net realizable value of the loan s underlying collateral exceeded the loan s outstanding balance. Commercial and agricultural nonaccrual loans included one credit with a balance of $1,800 as of December 31, 2009 which was subsequently transferred to other real estate owned in the third quarter of 2010. There were no other individually significant credits included in nonaccrual loans as of December 31, 2011, 2010, 2009, 2008, or 2007.

Included in the nonaccrual loan balances above were credits currently classified as restructured loans as of December 31:

	2011	2010	2009	2008
Commercial and agricultural	$ 520	$ 115	$ 1,692	$ 1,985
Residential mortgage	497	573	424	
	$ 1,017	$ 688	$ 2,116	$ 1,985

The Corporation had no restructured loans in nonaccrual status as of December 31, 2007.

The Corporation has devoted considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge off. To management s knowledge, all loans that are deemed to be impaired have been recognized. A continued decline in real estate values may require further write downs of loans in foreclosure and other real estate owned and could potentially have an adverse impact on the Corporation s financial performance.

Based on management s analysis, the allowance for loan losses is considered appropriate as of December 31, 2011. Management will continue to closely monitor its overall credit quality to ensure that the allowance for loan losses remains appropriate.

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Noninterest Income

The following table shows the changes in noninterest income between the years ended December 31:

	2011	2010	Change $	Change %	2009	Change $	Change %
Service charges and fees							
NSF and overdraft fees	$ 2,500	$ 2,809	$ (309)	-11.0%	$ 3,187	$ (378)	-11.9%
ATM and debit card fees	1,736	1,492	244	16.4%	1,218	274	22.5%
Trust fees	979	896	83	9.3%	814	82	10.1%
Mortgage servicing fees	732	760	(28)	-3.7%	724	36	5.0%
Service charges on deposit accounts	324	333	(9)	-2.7%	344	(11)	-3.2%
Net originated mortgage servicing rights (loss) income	(293)	47	(340)	N/M	514	(467)	-90.9%
All other	140	143	(3)	-2.1%	112	31	27.7%
Total service charges and fees	**6,118**	**6,480**	**(362)**	**-5.6%**	**6,913**	**(433)**	**-6.3%**
Gain on sale of mortgage loans	**538**	**610**	**(72)**	**-11.8%**	**886**	**(276)**	**-31.2%**
Net (loss) gain on trading securities	**(78)**	**(94)**	**16**	**17.0%**	**80**	**(174)**	**N/M**
Net gain on borrowings measured at fair value	**181**	**227**	**(46)**	**-20.3%**	**289**	**(62)**	**-21.5%**
Gain on sale of available-for-sale investment securities	**3**	**348**	**(345)**	**-99.1%**	**648**	**(300)**	**-46.3%**
Other							
Earnings on corporate owned life insurance policies	609	663	(54)	-8.1%	641	22	3.4%
Brokerage and advisory fees	545	573	(28)	-4.9%	521	52	10.0%
Corporate Settlement Solutions joint venture	(182)	11	(193)	N/M	(122)	133	N/M
All other	484	482	2	0.4%	300	182	60.7%
Total other	**1,456**	**1,729**	**(273)**	**-15.8%**	**1,340**	**389**	**29.0%**
Total noninterest income	**$ 8,218**	**$ 9,300**	**$ (1,082)**	**-11.6%**	**$ 10,156**	**$ (856)**	**-8.4%**

Significant changes in noninterest income are detailed below:

Management continuously analyzes various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, the Corporation makes any necessary adjustments to ensure that its fee structure is within the range of its competitors, while at the same time making sure that the fees remain fair to deposit customers. NSF and overdraft fees have been steadily declining over the past two years, with the decline accelerating in the third quarter of 2010 as a result of new regulatory guidance issued by the Federal Reserve Bank. The Corporation anticipates that NSF and overdraft fees will approximate current levels in 2012.

The increases in ATM and debit card fees are primarily the result of the increased usage of debit cards by customers. As management does not anticipate any significant changes to the ATM and debit card fee structures, these fees are expected to continue to increase as the usage of debit cards increases.

Trust fees have increased primarily due to increases in the size of the managed portfolio. As management anticipates continued growth in trust services, it anticipates trust fees to continue to increase in 2012.

Net originated mortgage servicing rights (OMSR) represent the fair value of servicing rights of loans sold to the secondary market, with changes in the fair value recorded in earnings. Changes in the fair value of OMSR are primarily driven by fluctuations in the

balance of loans sold to the secondary market and by offering rates on new residential mortgages. The losses incurred in 2011 were a result of historically low interest rates which increases the likelihood of refinancing activity, thus reducing the value of OMSR.

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As a result of lower than normal residential mortgage rates, the Corporation experienced increases in the volume of loans sold to the secondary market during 2009, leading to a corresponding increase in gains from the sale of mortgage loans in 2009. As the demand for new mortgages declined in 2010 and 2011, so did the gain from the sale of mortgage loans. The Corporation anticipates that the gain on sale of mortgages will remain at the current levels in 2012.

Fluctuations in the gains and losses related to trading securities and borrowings carried at fair value are caused by interest rate variances. Management does not anticipate any significant fluctuations in net trading activities in 2012 as significant interest rate changes are not expected.

The Corporation continually analyzes its available-for-sale investment portfolio for advantageous selling opportunities.

The Corporation s earnings from its joint venture in Corporate Settlement Solutions (a title insurance agency) have been negatively impacted by expenses incurred to enhance the services offered as well as expand their market area.

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

Noninterest Expenses

The following table shows the changes in noninterest expenses between the years ended December 31:

			Change			Change	
	2011	2010	$	%	2009	$	%
Compensation and benefits							
Leased employee salaries	$ 14,377	$ 13,697	$ 680	5.0%	$ 13,494	$ 203	1.5%
Leased employee benefits	4,902	4,837	65	1.3%	4,745	92	1.9%
All other	13	18	(5)	-27.8%	19	(1)	-5.3%
Total compensation and benefits	**19,292**	**18,552**	**740**	**4.0%**	**18,258**	**294**	**1.6%**
Occupancy							
Property taxes	470	505	(35)	-6.9%	439	66	15.0%
Utilities	462	423	39	9.2%	393	30	7.6%
Outside services	587	524	63	12.0%	433	91	21.0%
Depreciation	605	584	21	3.6%	546	38	7.0%
Building repairs	262	243	19	7.8%	288	(45)	-15.6%
All other	84	72	12	16.7%	71	1	1.4%
Total occupancy	**2,470**	**2,351**	**119**	**5.1%**	**2,170**	**181**	**8.3%**
Furniture and equipment							
Depreciation	1,916	1,938	(22)	-1.1%	1,803	135	7.5%
Computer / service contracts	1,898	1,779	119	6.7%	1,676	103	6.1%
ATM and debit card fees	629	595	34	5.7%	621	(26)	-4.2%
All other	54	32	22	68.8%	46	(14)	-30.4%
Total furniture and equipment	**4,497**	**4,344**	**153**	**3.5%**	**4,146**	**198**	**4.8%**
FDIC insurance premiums	**1,086**	**1,254**	**(168)**	**-13.4%**	**1,730**	**(476)**	**-27.5%**

Other							
Marketing and community relations	1,174	1,093	81	7.4%	894	199	22.3%
Foreclosed asset and collection	576	916	(340)	-37.1%	831	85	10.2%
Legal fees	302	382	(80)	-20.9%	415	(33)	-8.0%
Audit and SOX compliance fees	714	710	4	0.6%	546	164	30.0%
Consulting fees	386	167	219	131.1%	201	(34)	-16.9%
Directors fees	842	887	(45)	-5.1%	923	(36)	-3.9%
Amortization of deposit premium	299	338	(39)	-11.5%	375	(37)	-9.9%
Education and travel	526	499	27	5.4%	395	104	26.3%
Postage and freight	388	395	(7)	-1.8%	472	(77)	-16.3%
Printing and supplies	405	420	(15)	-3.6%	529	(109)	-20.6%
All other	1,573	1,499	74	4.9%	1,798	(299)	-16.6%
Total other	**7,185**	**7,306**	**(121)**	**-1.7%**	**7,379**	**(73)**	**-1.0%**
Total noninterest expenses	**$ 34,530**	**$ 33,807**	**$ 723**	**2.1%**	**$ 33,683**	**$ 124**	**0.4%**

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Significant changes in noninterest expenses are detailed below:

Leased employee salaries increased during 2011 due to annual merit increases and staff additions. These staff additions have allowed the Corporation to continue to grow as well as to comply with new regulations, including the Dodd-Frank Act. Leased employee benefits fluctuate from period to period primarily as a result of changes in health care related expenses. The Corporation anticipates adding to staffing levels in 2012 to ensure compliance with new regulations set forth in the Dodd-Frank Act, which is estimated to increase salary and benefits by $331.

FDIC insurance premium expense decreased in 2011 due to changes to the assessment rates on April 1, 2011. Premiums declined between 2009 and 2010 as a result of an FDIC special assessment of $479 in September 2009. Management expects FDIC insurance premiums to decline slightly in 2012 due to the changes in assessment rates.

The increase in marketing and community relations in 2011 was primarily the result of a new initiative to track customer service satisfaction as well as the enhancement of the Corporation s website. The increase in marketing and community relations expenses in 2010 was primarily related to an increase in charitable contributions. Charitable contributions were essentially unchanged between 2010 and 2011 with no significant changes expected in 2012.

While foreclosed asset and collection expenses remain at historically high levels, they have declined significantly from 2010. Management anticipates that these expenses will approximate current levels in 2012.

The Corporation s legal expenses can fluctuate from period to period based on the volume of foreclosures as well as expenses related to the Corporation s ongoing operations, including regulatory compliance. The Corporation does not anticipate any significant fluctuations in legal expenses in 2012.

Audit and SOX compliance fees fluctuate due to the timing of the performance of recurring audit procedures.

Director fees declined in 2011 due to the retirement of several directors. Director fees are expected to approximate current levels in 2012.

The Corporation places a strong emphasis on customer service. To help enhance customer service satisfaction, the Corporation has made a significant investment in various training programs. These programs coupled with the customer service tracking initiative (noted above) will increase service levels which will increase shareholder value. Management expects that education related expenses to remain at current levels in 2012.

Postage and freight expenses have declined, and are expected to continue to decline, as a result of fewer special mailings as well as an increase in the Corporation s customer s usage of electronic statements.

Printing and supplies expenses have steadily declined since 2009 as the Corporation has instituted a document imaging solution decreasing the amount of paper and related supplies. Management anticipates this trend to continue in 2012.

The increase in consulting fees is due to succession planning for key executives to help the Board of Directors and management identify, attract, and retain future leaders.

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

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ANALYSIS OF CHANGES IN FINANCIAL CONDITION

The following table shows the composition and changes in the Corporation s balance sheet as of December 31:

	2011	2010	Change $	Change %
ASSETS				
Cash and cash equivalents	$ 28,590	$ 18,109	$ 10,481	57.88%
Certificates of deposit held in other financial institutions	8,924	15,808	(6,884)	-43.55%
Trading securities	4,710	5,837	(1,127)	-19.31%
Available-for-sale securities	425,120	330,724	94,396	28.54%
Mortgage loans available-for-sale	3,205	1,182	2,023	171.15%
Loans	750,291	735,304	14,987	2.04%
Allowance for loan losses	(12,375)	(12,373)	(2)	0.02%
Premises and equipment	24,626	24,627	(1)	0.00%
Corporate owned life insurance	22,075	17,466	4,609	26.39%
Accrued interest receivable	5,848	5,456	392	7.18%
Equity securities without readily determinable fair values	17,189	17,564	(375)	-2.14%
Goodwill and other intangible assets	46,792	47,091	(299)	-0.63%
Other assets	12,930	19,015	(6,085)	-32.00%
TOTAL ASSETS	**$ 1,337,925**	**$ 1,225,810**	**$ 112,115**	**9.15%**
LIABILITIES AND SHAREHOLDERS EQUITY				
Liabilities				
Deposits	$ 958,164	$ 877,339	$ 80,825	9.21%
Borrowed funds	216,136	194,917	21,219	10.89%
Accrued interest payable and other liabilities	8,842	8,393	449	5.35%
Total liabilities	**1,183,142**	**1,080,649**	**102,493**	**9.48%**
Shareholders equity	**154,783**	**145,161**	**9,622**	**6.63%**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,337,925**	**$ 1,225,810**	**$ 112,115**	**9.15%**

As shown above, the Corporation enjoyed strong balance sheet growth since December 31, 2010. The primary driver behind this growth was excellent demand for deposit products. As loan demand did not keep pace with the increase in deposits, the Corporation increased its holdings in available-for-sale investment securities.

A discussion of changes in balance sheet amounts by major categories follows:

Certificates of deposit held in other financial institutions

During 2011, the Corporation reinvested maturities of certificates of deposit held in other financial institutions into available-for-sale investment securities to increase net interest margins (as the yields on available-for-sale investment securities exceeded the potential reinvestment rates for certificates of deposits held in other financial institutions during the year). This trend is likely to continue in 2012.

Trading securities

Trading securities are carried at fair value. The Corporation s overall intent is to maintain a trading portfolio to enhance the ongoing restructuring of assets and liabilities as part of our interest rate risk management objectives (See Note 4 Trading Securities of the Consolidated Financial Statements). Due to the current interest rate environment, the Corporation has allowed this balance to decline.

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The following is a schedule of the carrying value of trading securities as of December 31:

	2011	2010	2009
States and political subdivisions	$ 4,710	$ 5,837	$ 9,962
Mortgage-backed			3,601
Total	$ 4,710	$ 5,837	$ 13,563

Available-for-sale investment securities

The primary objective of the Corporation s investing activities is to provide for safety of the principal invested. Secondary considerations include the need for earnings, liquidity, and the Corporation s overall exposure to changes in interest rates. Securities currently classified as available-for-sale are stated at fair value.

The following is a schedule of the carrying value of investment securities available-for-sale as of December 31:

	2011	2010	2009
Government sponsored enterprises	$ 397	$ 5,404	$ 19,471
States and political subdivisions	174,938	169,717	151,730
Auction rate money market preferred	2,049	2,865	2,973
Preferred stocks	5,033	6,936	7,054
Mortgage-backed securities	143,602	102,215	67,734
Collateralized mortgage obligations	99,101	43,587	10,104
Total	$ 425,120	$ 330,724	$ 259,066

Excluding those holdings in government sponsored enterprises and municipalities within the state of Michigan, there were no investments in securities of any one issuer that exceeded 10% of shareholders equity. The Corporation has a policy prohibiting investments in securities that it deems are unsuitable due to their inherent credit or market risks. Prohibited investments include stripped mortgage backed securities, zero coupon bonds, nongovernment agency asset backed securities, and structured notes. The Corporation s holdings in mortgage-backed securities and collateralized mortgage obligations include only government agencies and government sponsored agencies as the Corporation holds no investments in private label mortgage-backed securities or collateralized mortgage obligations.

The following is a schedule of maturities of available-for-sale investment securities (at fair value) and their weighted average yield as of December 31, 2011. Weighted average yields have been computed on a fully taxable-equivalent basis using a tax rate of 34%. Auction rate money market preferred securities are long term floating rate instruments for which interest rates are set at periodic auctions. At each successful auction, the Corporation has the option to sell the security at par value. Additionally, the issuers of auction rate securities generally have the right to redeem or refinance the debt. Because of their variable monthly payments, auction rate money market preferreds, preferred stocks, mortgage-backed securities, and collateralized mortgage obligations are not reported by a specific maturity group. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Maturing									
	Within One Year		After One Year But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Securities with Variable Monthly Payments or Continual Call Dates	
	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)
Government sponsored enterprises	$		$		$ 397	7.91	$		$	
States and political subdivisions	8,441	3.24	35,904	4.12	93,189	3.87	37,404	2.84		
Mortgage-backed securities			271	5.68	73,974	1.91	69,357	1.97		
Collateralized mortgage obligations									99,101	2.76
Auction rate money market preferred									2,049	4.92
Preferred stocks									5,033	4.30
Total	**$ 8,441**	**3.24**	**$ 36,175**	**4.13**	**$ 167,560**	**3.01**	**$ 106,761**	**2.28**	**$ 106,183**	**2.88**

Loans

The largest component of earning assets is loans. The proper management of credit and market risk inherent in the loan portfolio is critical to the financial well-being of the Corporation. To control these risks, the Corporation has adopted strict underwriting standards. These standards include specific criteria against lending outside the Corporation s defined market areas, lending limits to a single borrower, and strict loan to collateral value limits. The Corporation also monitors and limits loan concentrations extended to distressed industries. The Corporation has no foreign loans and there were no concentrations greater than 10% of total loans that are not disclosed as a separate category in the following table.

The following table presents the composition of the loan portfolio for the years ended December 31:

	2011	2010	2009	2008	2007
Commercial	$ 365,714	$ 348,852	$ 340,274	$ 324,806	$ 238,306
Agricultural	74,645	71,446	64,845	58,003	47,407
Residential real estate mortgage	278,360	284,029	285,838	319,397	297,937
Installment	31,572	30,977	32,359	33,179	29,037
	$ 750,291	$ 735,304	$ 723,316	$ 735,385	$ 612,687

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The following table presents the change in the loan categories for the years ended December 31:

	2011		2010		2009	
	$ Change	% Change	$ Change	% Change	$ Change	% Change
Commercial	$ 16,862	4.8%	$ 8,578	2.5%	$ 15,468	4.8%
Agricultural	3,199	4.5%	6,601	10.2%	6,842	11.8%
Residential real estate mortgage	(5,669)	-2.0%	(1,809)	-0.6%	(33,559)	-10.5%
Installment	595	1.9%	(1,382)	-4.3%	(820)	-2.5%
	$ 14,987	2.0%	$ 11,988	1.7%	$ (12,069)	-1.6%

A substantial portion of the increase in total loans as of December 31, 2008 compared to December 31, 2007 was a result of the acquisition of Greenville Financial Corporation in January 2008. Pursuant to the acquisition, the Corporation purchased gross loans totaling $88,613.

Corporate owned life insurance

During the third quarter of 2011, the Corporation purchased an additional $4,000 of corporate owned life insurance policies. The Corporation purchased these additional policies to provide additional coverage for key employees, while also generating ongoing earnings as the cash surrender values of the policies increase.

Equity securities without readily determinable fair values

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost and investments in nonconsolidated entities accounted for under the equity method of accounting (see Note 1 Nature of Operations and Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements).

Deposits

The main source of funds for the Corporation is deposits. The following table presents the composition of the deposit portfolio as of December 31:

	2011	2010	2009	2008	2007
Noninterest bearing deposits	$ 119,072	$ 104,902	$ 96,875	$ 97,546	$ 84,846
Interest bearing demand deposits	163,653	142,259	128,111	113,973	105,526
Savings deposits	193,902	177,817	157,020	182,523	196,682
Certificates of deposit	395,777	386,435	356,594	340,976	311,976
Brokered certificates of deposit	54,326	53,748	50,933	28,185	28,197
Internet certificates of deposit	31,434	12,178	13,119	12,427	6,246
Total	**$ 958,164**	**$ 877,339**	**$ 802,652**	**$ 775,630**	**$ 733,473**

The following table presents the change in the deposit categories for the years ended December 31:

	2011		2010		2009	
	$ Change	% Change	$ Change	% Change	$ Change	% Change
Noninterest bearing deposits	$ 14,170	13.5%	$ 8,027	8.3%	$ (671)	-0.7%
Interest bearing demand deposits	21,394	15.0%	14,148	11.0%	14,138	12.4%
Savings deposits	16,085	9.0%	20,797	13.2%	(25,503)	-14.0%
Certificates of deposit	9,342	2.4%	29,841	8.4%	15,618	4.6%

Brokered certificates of deposit	578	1.1%	2,815	5.5%	22,748	80.7%
Internet certificates of deposit	19,256	158.1%	(941)	-7.2%	692	5.6%
Total	**$ 80,825**	**9.2%**	**$ 74,687**	**9.3%**	**$ 27,022**	**3.5%**

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As shown in the preceding table, the Corporation has experienced strong deposit growth since December 30, 2010. This growth was the result of the Corporation offering products with competitive rates and terms, as well as focused marketing efforts to increase deposit market share in the communities served. While management anticipates that deposits will continue to increase in 2012, it is expected to be at a lower rate than 2011.

The following table shows the average balances and corresponding interest rates paid on deposit accounts as of December 31:

	2011		2010		2009	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest bearing demand deposits	$ 113,726		$ 102,812		$ 94,408	
Interest bearing demand deposits	152,530	0.12%	137,109	0.11%	116,412	0.13%
Savings deposits	192,999	0.25%	169,579	0.23%	177,538	0.22%
Time deposits	467,931	2.19%	430,892	2.55%	398,356	3.27%
Total	$ 927,186		$ 840,392		$ 786,714	

The remaining maturity of time certificates and other time deposits of $100 or more as of December 31, 2011 was as follows:

Maturity	
Within 3 months	$ 42,270
Within 3 to 6 months	25,357
Within 6 to 12 months	63,423
Over 12 months	104,266
Total	**$ 235,316**

Borrowed Funds

The following table summarizes the Corporation s borrowings as of December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Federal Home Loan Bank advances	$ 142,242	3.16%	$ 113,423	3.64%
Securities sold under agreements to repurchase without stated maturity dates	57,198	0.25%	45,871	0.25%
Securities sold under agreements to repurchase with stated maturity dates	16,696	3.51%	19,623	3.28%
Federal funds purchased			16,000	0.60%
Total	**$ 216,136**	**2.42%**	**$ 194,917**	**2.56%**

The maturity and weighted average interest rates of FHLB advances are as follows as of December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Fixed rate advances due 2011	$		$ 10,086	3.96%
One year putable advances due 2011			1,000	4.75%
Fixed rate advances due 2012	17,000	2.97%	17,000	2.97%
One year putable advances due 2012	15,000	4.10%	15,000	4.10%

Fixed rate advances due 2013	5,242	4.14%	5,337	4.14%
One year putable advances due 2013	5,000	3.15%	5,000	3.15%
Fixed rate advances due 2014	25,000	3.16%	25,000	3.16%
Fixed rate advances due 2015	45,000	3.30%	25,000	4.63%
Fixed rate advances due 2016	10,000	2.15%		
Fixed rate advances due 2017	20,000	2.56%	10,000	2.35%
Total	**$ 142,242**	**3.16%**	**$ 113,423**	**3.64%**

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The maturity and weighted average interest rates of securities sold under agreements to repurchase with stated maturity dates are as follows at December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Repurchase agreements due 2011	$		$ 858	1.51%
Repurchase agreements due 2012	428	2.08%	1,013	2.21%
Repurchase agreements due 2013	5,000	4.51%	5,127	4.45%
Repurchase agreements due 2014	10,869	3.12%	12,087	3.00%
Repurchase agreements due 2015	399	3.25%	538	3.25%
Total	**$ 16,696**	**3.51%**	**$ 19,623**	**3.28%**

Contractual Obligations and Loan Commitments

The Corporation has various financial obligations, including contractual obligations and commitments, which may require future cash payments. The following schedule summarizes the Corporation s non-cancelable obligations and future minimum payments as of December 31, 2011:

	Minimum Payments Due by Period				
	Due in One Year or Less	After One Year But Within Three Years	After Three Years But Within Five Years	After Five Years	Total
Deposits with no stated maturity	$ 476,627	$	$	$	$ 476,627
Certificates of deposit with stated maturities	265,299	110,092	99,094	7,052	481,537
Borrowed funds					
Short term borrowings	57,198				57,198
Long term borrowings	32,428	96,510	10,000	20,000	158,938
Total borrowed funds	89,626	96,510	10,000	20,000	216,136
Total contractual obligations	**$ 831,552**	**$ 206,602**	**$ 109,094**	**$ 27,052**	**$ 1,174,300**

The Corporation also has loan commitments that may impact liquidity. The following schedule summarizes the Corporation s loan commitments and expiration dates by period as of December 31, 2011. Since many of these commitments historically have expired without being drawn upon, the total amount of these commitments does not necessarily represent future cash requirements of the Corporation.

	Expiration Dates by Period				
	Due in One Year or Less	After One Year But Within Three Years	After Three Years But Within Five Years	After Five Years	Total
Unused commitments to extend credit	$ 61,415	$ 27,740	$ 10,591	$ 3,076	$ 102,822
Undisbursed loans	21,806				21,806
Standby letters of credit	4,461				4,461
Total loan commitments	**$ 87,682**	**$ 27,740**	**$ 10,591**	**$ 3,076**	**$ 129,089**

Capital

The capital of the Corporation consists primarily of common stock, including shares to be issued, retained earnings, and accumulated other comprehensive income. The Corporation offers dividend reinvestment and employee, director, and shareholder stock purchase plans. Under the provisions of these plans, the Corporation

issued 115,359 shares of common stock generating $2,192 of capital during 2011, and 124,904 shares of common stock generating $2,203 of capital in 2010. The Corporation also generates capital through the Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (the Directors Plan), its equity compensation plan (See Note 17 Benefit Plans of Notes to Consolidated Financial Statements). Pursuant to this plan, the Corporation generated $615 and $650 of capital in 2011 and 2010, respectively.

The Board of Directors has adopted a common stock repurchase plan. This plan was approved to enable the Corporation to repurchase the Corporation s common stock for reissuance to the dividend reinvestment plan, the employee stock purchase plan and for distributions from the Directors Plan. During 2011 and 2010 the Corporation repurchased 120,441 shares of common stock at an average price of $18.30 and 138,970 shares of common stock at an average price of $18.40, respectively.

Accumulated other comprehensive loss decreased $4,198 in 2011 and consists of $5,498 of unrealized gains on available-for-sale investment securities which was offset by a $1,300 increase in unrecognized pension cost. These amounts are net of tax.

The Federal Reserve Board s current recommended minimum primary capital to assets requirement is 6.0%. The Corporation s Tier 1 capital to average assets ratio, which consists of shareholders equity plus the allowance for loan losses less goodwill and acquisition intangibles, was 8.18% at December 31, 2011. There are no commitments for significant capital expenditures.

The Federal Reserve Board has established a minimum risk based capital standard. Under this standard, a framework has been established that assigns risk weights to each category of on and off-balance-sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. The minimum standard is 8%, of which at least 4% must consist of equity capital net of goodwill and acquisition intangibles. The following table sets forth the percentages required under the Risk Based Capital guidelines and the Corporation s values at December 31:

	2011	2010	Required
Equity Capital	12.92%	12.72%	4.00%
Secondary Capital	1.25%	1.25%	4.00%
Total Capital	14.17%	13.97%	8.00%

Isabella Bank Corporation s secondary capital includes only the allowance for loan losses. The percentage for the secondary capital under the required column is the maximum amount allowed from all sources.

The Federal Reserve Board also prescribes minimum capital requirements for the Corporation s subsidiary Bank. At December 31, 2011, the Bank exceeded these minimums. For further information regarding the Bank s capital requirements, refer to Note 16 Minimum Regulatory Capital Requirements of the Notes to Consolidated Financial Statements,

Fair Value

The Corporation utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale, trading securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as loans held-for-sale, foreclosed assets, originated mortgage servicing rights, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

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The table below represents the activity in Level 3 inputs measured on a recurring basis for the year ended December 31:

	2011	2010
Level 3 inputs - January 1	$ 9,801	$ 10,027
Calls	(1,000)	
Transfer to Level 1 inputs	(5,033)	
Transfer to Level 2 inputs	(2,049)	
Net unrealized losses on available-for-sale investment securities	(1,719)	(226)
Level 3 inputs - December 31	$	$ 9,801

Securities classified as Level 3 in 2010 included securities in less liquid markets and included auction rate money market preferred securities and preferred stocks. Due to the limited trading of these securities during 2010, the Corporation utilized a discounted cash flow analysis to determine fair values on December 31, 2010. This analysis considered the creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institution debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources and ranged from 3.90% to 6.90% as of December 31, 2010. During 2011, the markets for these securities have normalized and established regular trading patterns. As a result of this normalization, the Corporation measured preferred stocks with fair values of $5,033 utilizing Level 1 inputs and auction rate money market preferred securities with fair values of $2,049 utilizing Level 2 inputs based on the trade price of similar securities as of December 31, 2011.

For further information regarding fair value measurements see Note 1, Nature of Operations and Summary of Significant Accounting Policies and Note 20, Fair Value of the Consolidated Financial Statements.

Interest Rate Sensitivity

Interest rate sensitivity is determined by the amount of earning assets and interest bearing liabilities repricing within a specific time period, and their relative sensitivity to a change in interest rates. Management strives to achieve reasonable stability in the net interest margin through periods of changing interest rates. One tool used by management to measure interest rate sensitivity is gap analysis. As shown in the following table, the gap analysis depicts the Corporation s position for specific time periods and the cumulative gap as a percentage of total assets.

Trading securities are included in the 0 to 3 month time frame due to their repricing characteristics. Fixed interest rate investment securities are scheduled according to their contractual maturity. Fixed rate loans are included in the appropriate time frame based on their scheduled amortization. Variable rate loans, which totaled $162,653 as of December 31, 2011, are included in the time frame of their earliest repricing. Time deposit liabilities are scheduled based on their contractual maturity except for variable rate time deposits in the amount of $1,559 that are included in the 0 to 3 month time frame.

Savings, NOW accounts, and money market accounts have no contractual maturity date and are believed to be predominantly noninterest rate sensitive by management. These accounts have been classified in the gap table according to their estimated withdrawal rates based upon management s analysis of deposit runoff over the past five years. Management believes this runoff experience is consistent with its expectation for the future. As of December 31, 2011, the Corporation had a negative cumulative gap within one year. A negative gap position results when more liabilities, within a specified time frame, mature or reprice than assets.

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The following table shows the time periods and the amount of assets and liabilities available for interest rate repricing as of December 31, 2011. The interest rate sensitivity information for investment securities is based on the expected prepayments and call dates versus stated maturities. For purposes of this analysis, nonaccrual loans and the allowance for loan losses are excluded.

	0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years
Interest sensitive assets				
Trading securities	$ 4,710	$	$	$
Investment securities	40,976	63,583	182,965	137,596
Loans	59,872	147,565	459,290	77,175
Total	**$ 105,558**	**$ 211,148**	**$ 642,255**	**$ 214,771**
Interest sensitive liabilities				
Borrowed funds	$ 67,440	$ 22,429	$ 106,267	$ 20,000
Time deposits	74,500	191,206	208,779	7,052
Savings	19,591	47,365	103,845	23,101
Interest bearing demand	15,621	38,273	82,568	27,191
Total	**$ 177,152**	**$ 299,273**	**$ 501,459**	**$ 77,344**
Cumulative gap	$ (71,594)	$ (159,719)	$ (18,923)	$ 118,504
Cumulative gap as a % of assets	(5.35) %	(11.94) %	(1.41) %	8.86%

The following table shows the maturity of commercial and agricultural loans outstanding at December 31, 2011. Also provided are the amounts due after one year, classified according to the sensitivity to changes in interest rates.

	1 Year or Less	1 to 5 Years	Over 5 Years	Total
Commercial and agricultural	$ 120,463	$ 276,367	$ 43,529	$ 440,359
Interest sensitivity				
Loans maturing after one year that have:				
Fixed interest rates		$ 238,963	$ 32,178	
Variable interest rates		37,404	11,351	
Total		**$ 276,367**	**$ 43,529**	

Liquidity

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

The primary sources of the Corporation s liquidity are cash and cash equivalents, certificates of deposit held in other financial institutions, trading securities, and available-for-sale investment securities, excluding auction rate money market preferred securities and preferred stock as of December 31, 2010 due to their illiquidity. These categories totaled $467,344 or 34.9% of assets as of December 31, 2011 as compared to $360,677 or 29.4% in 2010. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments discussed in the accompanying notes to consolidated financial statements. Liquidity varies significantly daily, based on customer activity.

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The following table summarizes the Corporation s sources and uses of cash for the years ended December 31:

	2011	2010	$ Variance
Net cash provided by operating activities	$ 18,860	$ 26,521	$ (7,661)
Net cash used in investing activities	(105,203)	(103,877)	(1,326)
Net cash provided by financing activities	96,824	70,983	25,841
Increase (decrease) in cash and cash equivalents	10,481	(6,373)	16,854
Cash and cash equivalents January 1	18,109	24,482	(6,373)
Cash and cash equivalents December 31	$ 28,590	$ 18,109	$ 10,481

The primary source of funds for the Corporation is deposits. The Corporation emphasizes interest bearing time deposits as part of its funding strategy. The Corporation also seeks noninterest bearing deposits, or checking accounts, to expand its customer base, while reducing the Corporation s cost of funds.

The Corporation has the ability to borrow from the Federal Home Loan Bank, the Federal Reserve Bank, and through various correspondent banks as federal funds purchased. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including Federal Home Loan Bank Advances, Federal Reserve Bank Discount Window Advances, and repurchase agreements, require the Corporation to pledge assets, typically in the form of certificates of deposits held in other financial institutions, investment securities, or loans as collateral.

The Corporation had the ability to borrow up to an additional $110,069, based on the assets currently pledged as collateral. The Corporation has pledged eligible mortgage loans and investment securities as collateral for any such borrowings.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The Corporation s primary market risks are interest rate risk and liquidity risk. The Corporation has no significant foreign exchange risk and does not utilize interest rate swaps or derivatives, except for interest rate locks and forward loan commitments, in the management of its interest rate risk. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on the Corporation s interest income and cash flows. The Corporation does have a significant amount of loans extended to borrowers in agricultural production. The cash flow of such borrowers and ability to service debt is largely dependent on commodity prices. The Corporation mitigates these risks by using conservative price and production yields when calculating a borrower s available cash flow to service their debt.

Interest rate risk (IRR) is the exposure of the Corporation s net interest income, its primary source of income, to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution s interest earning assets and its interest bearing liabilities. IRR is the fundamental method in which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to the Corporation s earnings and capital.

The Federal Reserve Board, the Corporation s primary Federal regulator, has adopted a policy requiring the Board of Directors and senior management to effectively manage the various risks that can have a material impact on the safety and soundness of the Corporation. The risks include credit, interest rate, liquidity, operational, and reputational. The Corporation has policies, procedures, and internal controls for measuring and managing these risks. Specifically, the IRR policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to the Board of Directors.

The Corporation uses several techniques to manage IRR. The first method is gap analysis. Gap analysis measures the cash flows and/or the earliest repricing of the Corporation s interest bearing assets and liabilities. This analysis is useful for measuring trends in the repricing characteristics of the balance sheet. Significant assumptions are required in this process because of the imbedded repricing options contained in assets and liabilities. A substantial portion of the Corporation s assets are invested in loans and investment securities with issuer call options. Residential real estate and other consumer loans have imbedded options that allow the borrower to repay the balance prior to maturity without penalty, while commercial and agricultural loans have prepayment penalties. The amount of prepayments is dependent upon many factors, including the interest rate of a given loan in comparison to the current interest rate for residential mortgages, the level of sales of used homes, and the overall availability of credit in the market place. Generally, a decrease in interest rates will result in an increase in the Corporation s cash flows from these assets. A significant portion of the Corporation s securities are callable or subject to prepayment. The call option is more likely to be exercised in a period of decreasing interest rates. Investment securities, other than those that are callable, do not have any significant imbedded options. Savings and checking deposits may generally be withdrawn on request without prior notice. The timing of cash flows from these deposits is estimated based on historical experience. Time deposits have penalties that discourage early withdrawals.

The second technique used in the management of IRR is to combine the projected cash flows and repricing characteristics generated by the gap analysis and the interest rates associated with those cash flows to project future interest income. By changing the amount and timing of the cash flows and the repricing interest rates of those cash flows, the Corporation can project the effect of changing interest rates on its interest income. Based on the projections prepared for the year ended December 31, 2011, the Corporation s net interest income would decrease slightly during a period of increasing interest rates.

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The following tables provide information about the Corporation s assets and liabilities that are sensitive to changes in interest rates as of December 31, 2011 and 2010. The Corporation has no interest rate swaps, futures contracts, or other derivative financial options. The principal amounts of assets and time deposits maturing were calculated based on the contractual payment and maturity dates. Savings and NOW accounts are based on management s estimate of their future cash flows.

(dollars in thousands)	December 31, 2011							Fair Value
	2012	2013	2014	2015	2016	Thereafter	Total	12/31/11
Rate sensitive assets								
Other interest bearing assets	$ 8,775	$ 4,125	$ 100	$	$	$	$ 13,000	$ 13,053
Average interest rates	1.18%	1.33%	0.35%				1.22%	
Trading securities	$ 3,156	$ 1,031	$ 523	$	$	$	$ 4,710	$ 4,710
Average interest rates	3.34%	2.48%	2.49%				3.06%	
Fixed interest rate securities	$ 104,559	$ 61,421	$ 48,659	$ 37,777	$ 35,108	$ 137,596	$ 425,120	$ 425,120
Average interest rates	2.98%	2.84%	2.91%	2.93%	3.21%	3.01%	2.98%	
Fixed interest rate loans	$ 141,867	$ 140,390	$ 90,852	$ 75,690	$ 76,985	$ 61,854	$ 587,638	$ 606,524
Average interest rates	6.24%	6.08%	5.94%	5.99%	5.40%	5.15%	5.90%	
Variable interest rate loans	$ 70,783	$ 25,267	$ 20,803	$ 18,853	$ 11,631	$ 15,316	$ 162,653	$ 162,653
Average interest rates	5.87%	3.97%	4.05%	3.68%	4.00%	3.98%	4.78%	
Rate sensitive liabilities								
Borrowed funds	$ 89,869	$ 15,000	$ 25,869	$ 45,398	$ 20,000	$ 20,000	$ 216,136	$ 227,780
Average interest rates	1.42%	3.93%	3.13%	3.30%	2.67%	2.56%	2.41%	
Savings and NOW accounts	$ 120,850	$ 78,313	$ 51,291	$ 34,006	$ 22,803	$ 50,292	$ 357,555	$ 357,555
Average interest rates	0.20%	0.19%	0.18%	0.17%	0.15%	0.15%	0.18%	
Fixed interest rate time deposits	$ 264,147	$ 62,883	$ 46,802	$ 55,493	$ 43,601	$ 7,052	$ 479,978	$ 498,085
Average interest rates								