

INDEPENDENT BANK CORP /MI/  
Form 10-Q  
August 03, 2018

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2018

Commission file number 0-7818

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

Michigan 38-2032782  
(State or jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification Number)

4200 East Beltline, Grand Rapids, Michigan 49525  
(Address of principal executive offices)

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

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

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

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

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

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

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

|                            |                               |
|----------------------------|-------------------------------|
| Common stock, no par value | 24,150,855                    |
| Class                      | Outstanding at August 3, 2018 |

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## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

INDEX

|  | <u>Number(s)</u> |
|--|------------------|
| PART I - <u>Financial Information</u>  |                  |
| Item 1. <u>Condensed Consolidated Statements of Financial Condition June 30, 2018 and December 31, 2017</u>                | 3                |
| <u>Condensed Consolidated Statements of Operations Three- and Six-month periods ended June 30, 2018 and 2017</u>           | 4                |
| <u>Condensed Consolidated Statements of Comprehensive Income Three- and Six-month periods ended June 30, 2018 and 2017</u> | 5                |
| <u>Condensed Consolidated Statements of Cash Flows Six-month periods ended June 30, 2018 and 2017</u>                      | 6                |
| <u>Condensed Consolidated Statements of Shareholders' Equity Six-month periods ended June 30, 2018 and 2017</u>            | 7                |
| <u>Notes to Interim Condensed Consolidated Financial Statements</u>  | 8-66             |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                       | 67-90            |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 91               |
| Item 4. <u>Controls and Procedures</u>   | 91               |
| PART II  |                  |
| - <u>Other Information</u>   |                  |
| Item 1A <u>Risk Factors</u>  | 92               |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 92               |
| Item 6. <u>Exhibits</u>  | 93               |

Index

FORWARD-LOOKING STATEMENTS

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

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

This list provides examples of factors that could affect the results described by forward-looking statements contained in this report, but the list is not intended to be all-inclusive.

In addition, factors that may cause actual results to differ from expectations regarding the April 1, 2018 acquisition of TCSB Bancorp, Inc. include, but are not limited to, the reaction to the transaction of the companies’ customers, employees and counterparties; customer disintermediation; inflation; expected synergies, cost savings and other financial benefits of the transaction might not be realized within the expected timeframes or might be less than projected; credit and interest rate risks associated with the parties’ respective businesses, customers, borrowings, repayment, investment, and deposit practices; general economic conditions, either nationally or in the market areas in which the parties operate or anticipate doing business, are less favorable than expected; new regulatory or legal requirements or obligations; and other risks.

The risk factors disclosed in Part I – Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017, as updated by any new or modified risk factors disclosed in Part II – Item 1A of any subsequently filed Quarterly Report on Form 10-Q, include all known risks our management believes could materially affect the results described by forward-looking statements in this report. However, those risks may not be the only risks we face. Our results of operations, cash flows, financial position, and prospects could also be materially and adversely affected by additional factors that are not presently known to us that we currently consider to be immaterial, or that develop after the date of this report. We cannot assure you that our future results will meet expectations. While we believe the forward-looking statements in this report are reasonable, you should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. We do not undertake, and expressly disclaim, any obligation to update or alter any statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.



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

|  | June 30,<br>2018<br>(unaudited)      | December 31,<br>2017 |
|--|--------------------------------------|----------------------|
|  | (In thousands, except share amounts) |                      |
| Assets   |                                      |                      |
| Cash and due from banks  | \$ 36,433                            | \$ 36,994            |
| Interest bearing deposits                                      | 22,278                               | 17,744               |
| Cash and Cash Equivalents                                      | 58,711                               | 54,738               |
| Interest bearing deposits - time                               | 2,478                                | 2,739                |
| Equity securities at fair value                                | 336                                  | -                    |
| Trading securities   | -                                    | 455                  |
| Securities available for sale                                  | 450,593                              | 522,925              |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 16,321                               | 15,543               |
| Loans held for sale, carried at fair value                     | 50,915                               | 39,436               |
| Loans held for sale, carried at lower of cost or fair value    | 13,216                               | -                    |
| Loans  |                                      |                      |
| Commercial   | 1,106,987                            | 853,260              |
| Mortgage   | 988,622                              | 849,530              |
| Installment  | 371,708                              | 316,027              |
| Total Loans  | 2,467,317                            | 2,018,817            |
| Allowance for loan losses                                      | (23,504 )                            | (22,587 )            |
| Net Loans  | 2,443,813                            | 1,996,230            |
| Other real estate and repossessed assets                       | 1,689                                | 1,643                |
| Property and equipment, net                                    | 39,660                               | 39,149               |
| Bank-owned life insurance                                      | 54,573                               | 54,572               |
| Deferred tax assets, net                                       | 11,426                               | 15,089               |
| Capitalized mortgage loan servicing rights                     | 21,848                               | 15,699               |
| Other intangibles  | 7,004                                | 1,586                |
| Goodwill   | 29,012                               | -                    |
| Accrued income and other assets                                | 32,927                               | 29,551               |
| Total Assets   | \$ 3,234,522                         | \$ 2,789,355         |
| Liabilities and Shareholders' Equity                           |                                      |                      |
| Deposits   |                                      |                      |
| Non-interest bearing   | \$ 871,959                           | \$ 768,333           |
| Savings and interest-bearing checking                          | 1,226,492                            | 1,064,391            |
| Reciprocal   | 66,540                               | 50,979               |
| Time   | 389,118                              | 374,872              |
| Brokered time  | 226,407                              | 141,959              |
| Total Deposits   | 2,780,516                            | 2,400,534            |
| Other borrowings   | 40,584                               | 54,600               |
| Subordinated debentures  | 39,354                               | 35,569               |
| Accrued expenses and other liabilities                         | 36,985                               | 33,719               |
| Total Liabilities  | 2,897,439                            | 2,524,422            |
| Shareholders' Equity   |                                      |                      |

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|   |              |              |
|---|--------------|--------------|
| Preferred stock, no par value, 200,000 shares authorized; none issued or outstanding  | -            | -            |
| Common stock, no par value, 500,000,000 shares authorized; issued and outstanding:<br>24,143,044 shares at June 30, 2018 and 21,333,869 shares at December 31, 2017 | 389,195      | 324,986      |
| Accumulated deficit   | (42,898 )    | (54,054 )    |
| Accumulated other comprehensive loss  | (9,214 )     | (5,999 )     |
| Total Shareholders' Equity  | 337,083      | 264,933      |
| Total Liabilities and Shareholders' Equity  | \$ 3,234,522 | \$ 2,789,355 |

See notes to interim condensed consolidated financial statements (unaudited)

Index

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

|   | Three months                             |           | Six months ended                |           |
|---|--|-----------|---------------------------------|-----------|
|   | ended<br>June 30,<br>2018<br>(unaudited) | 2017      | June 30,<br>2018<br>(unaudited) | 2017      |
|   | (In thousands, except per share amounts) |           |                                 |           |
| Interest Income                                     |  |           |                                 |           |
| Interest and fees on loans                          | \$ 29,674                                | \$ 19,949 | \$ 53,027                       | \$ 39,807 |
| Interest on securities                              |  |           |                                 |           |
| Taxable   | 2,720                                    | 2,781     | 5,355                           | 5,535     |
| Tax-exempt  | 444                                      | 511       | 923                             | 966       |
| Other investments                                   | 265                                      | 292       | 595                             | 604       |
| Total Interest Income                               | 33,103                                   | 23,533    | 59,900                          | 46,912    |
| Interest Expense                                    |  |           |                                 |           |
| Deposits  | 3,209                                    | 1,478     | 5,496                           | 2,921     |
| Other borrowings and subordinated debentures        | 914                                      | 563       | 1,488                           | 1,033     |
| Total Interest Expense                              | 4,123                                    | 2,041     | 6,984                           | 3,954     |
| Net Interest Income                                 | 28,980                                   | 21,492    | 52,916                          | 42,958    |
| Provision for loan losses                           | 650                                      | 583       | 965                             | 224       |
| Net Interest Income After Provision for Loan Losses | 28,330                                   | 20,909    | 51,951                          | 42,734    |
| Non-interest Income                                 |  |           |                                 |           |
| Service charges on deposit accounts                 | 3,095                                    | 3,175     | 6,000                           | 6,184     |
| Interchange income                                  | 2,504                                    | 2,005     | 4,750                           | 3,927     |
| Net gains (losses) on assets                        |  |           |                                 |           |
| Mortgage loans                                      | 3,255                                    | 3,344     | 5,826                           | 5,915     |
| Securities  | 9  | (34 )     | (164 )                          | (7 )      |
| Mortgage loan servicing, net                        | 1,235                                    | (158 )    | 3,456                           | 667       |
| Other   | 2,217                                    | 2,114     | 4,160                           | 4,099     |
| Total Non-interest Income                           | 12,315                                   | 10,446    | 24,028                          | 20,785    |
| Non-interest Expense                                |  |           |                                 |           |
| Compensation and employee benefits                  | 15,869                                   | 13,380    | 30,337                          | 27,527    |
| Occupancy, net                                      | 2,170                                    | 1,920     | 4,434                           | 4,062     |
| Data processing                                     | 2,251                                    | 1,937     | 4,129                           | 3,874     |
| Merger related expenses                             | 3,082                                    | -         | 3,256                           | -         |
| Furniture, fixtures and equipment                   | 1,019                                    | 1,005     | 1,986                           | 1,982     |
| Communications                                      | 704                                      | 678       | 1,384                           | 1,361     |
| Loan and collection                                 | 692                                      | 670       | 1,369                           | 1,083     |
| Interchange expense                                 | 661                                      | 292       | 1,259                           | 575       |
| Advertising   | 543                                      | 519       | 984                             | 1,025     |
| Legal and professional                              | 456                                      | 389       | 834                             | 826       |
| FDIC deposit insurance                              | 250                                      | 202       | 480                             | 400       |
| Credit card and bank service fees                   | 106                                      | 136       | 202                             | 327       |
| Other   | 1,958                                    | 1,633     | 3,242                           | 3,288     |
| Total Non-interest Expense                          | 29,761                                   | 22,761    | 53,896                          | 46,330    |
| Income Before Income Tax                            | 10,884                                   | 8,594     | 22,083                          | 17,189    |
| Income tax expense                                  | 2,067                                    | 2,663     | 4,105                           | 5,284     |



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|                             |         |         |          |          |
|-----------------------------|---------|---------|----------|----------|
| Net Income                  | \$8,817 | \$5,931 | \$17,978 | \$11,905 |
| Net Income Per Common Share |         |         |          |          |
| Basic                       | \$0.37  | \$0.28  | \$0.79   | \$0.56   |
| Diluted                     | \$0.36  | \$0.27  | \$0.78   | \$0.55   |
| Dividends Per Common Share  |         |         |          |          |
| Declared                    | \$0.15  | \$0.10  | \$0.30   | \$0.20   |
| Paid                        | \$0.15  | \$0.10  | \$0.30   | \$0.20   |

See notes to interim condensed consolidated financial statements (unaudited)

Index

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

|  | Three months<br>ended<br>June 30,<br>2018 |         | Six months ended<br>June 30,<br>2018 |          |
|--|---|---------|--------------------------------------|----------|
|  | 2017                                      | 2017    | 2017                                 | 2017     |
|  | (unaudited)                               |         |                                      |          |
|  | (In thousands)                            |         |                                      |          |
| Net income   | \$8,817                                   | \$5,931 | \$17,978                             | \$11,905 |
| Other comprehensive income (loss), before tax  |   |         |                                      |          |
| Securities available for sale  |   |         |                                      |          |
| Unrealized gains (losses) arising during period  | (1,198)                                   | 4,095   | (5,063)                              | 7,718    |
| Change in unrealized gains (losses) for which a portion of other than temporary impairment has been recognized in earnings | (2 )                                      | 107     | (3 )                                 | 85       |
| Reclassification adjustments for (gains) losses included in earnings   | 26  | (11 )   | 45                                   | (117 )   |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale                 | (1,174)                                   | 4,191   | (5,021)                              | 7,686    |
| Income tax expense (benefit)   | (246 )                                    | 1,467   | (1,054)                              | 2,690    |
| Unrealized gains (losses) recognized in other comprehensive income (loss) on securities available for sale, net of tax     | (928 )                                    | 2,724   | (3,967)                              | 4,996    |
| Derivative instruments   |   |         |                                      |          |
| Unrealized gain arising during period  | 327                                       | -       | 1,011                                | -        |
| Reclassification adjustment for income recognized in earnings  | (53 )                                     | -       | (59 )                                | -        |
| Unrealized gains recognized in other comprehensive income (loss) on derivative instruments                                 | 274                                       | -       | 952                                  | -        |
| Income tax expense   | 58  | -       | 200                                  | -        |
| Unrealized gains recognized in other comprehensive income (loss) on derivative instruments, net of tax                     | 216                                       | -       | 752                                  | -        |
| Other comprehensive income (loss)  | (712 )                                    | 2,724   | (3,215)                              | 4,996    |
| Comprehensive income   | \$8,105                                   | \$8,655 | \$14,763                             | \$16,901 |

See notes to interim condensed consolidated financial statements (unaudited)

Index

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

|   | Six months ended June 30,  |            |
|---|----------------------------|------------|
|   | 2018                       | 2017       |
|   | (unaudited - In thousands) |            |
| Net Income  | \$ 17,978                  | \$ 11,905  |
| Adjustments to Reconcile Net Income to Net Cash From Operating Activities   |                            |            |
| Proceeds from sales of loans held for sale  | 210,641                    | 189,654    |
| Disbursements for loans held for sale   | (214,952 )                 | (193,486 ) |
| Provision for loan losses   | 965                        | 224        |
| Deferred income tax expense   | 4,518                      | 7,589      |
| Deferred loan fees and costs  | (2,457 )                   | (3,002 )   |
| Net depreciation, amortization of intangible assets and premiums and accretion of discounts on securities, loans and interest bearing deposits - time | 3,192                      | 3,119      |
| Net gains on mortgage loans   | (5,826 )                   | (5,915 )   |
| Net losses on securities  | 164                        | 7          |
| Share based compensation  | 848                        | 916        |
| Increase in accrued income and other assets   | (3,377 )                   | (1,627 )   |
| Increase in accrued expenses and other liabilities  | 1,604                      | 3,959      |
| Total Adjustments   | (4,680 )                   | 1,438      |
| Net Cash From Operating Activities  | 13,298                     | 13,343     |
| Cash Flow Used in Investing Activities  |                            |            |
| Proceeds from the sale of securities available for sale   | 31,445                     | 7,830      |
| Proceeds from maturities, prepayments and calls of securities available for sale  | 88,131                     | 99,634     |
| Purchases of securities available for sale  | (47,054 )                  | (69,824 )  |
| Proceeds from the sale of interest bearing deposits - time  | 2,474                      | -          |
| Proceeds from the maturity of interest bearing deposits - time  | 1,842                      | 250        |
| Net increase in portfolio loans (loans originated, net of principal payments)   | (181,365 )                 | (202,167 ) |
| Proceeds from the sale of portfolio loans   | 16,460                     | -          |
| Acquisition of TCSB Bancorp Inc., less cash received  | 23,516                     | -          |
| Cash received from the sale of Mepco Finance Corporation assets, net  | -                          | 33,446     |
| Proceeds from bank-owned life insurance   | 474                        | 523        |
| Proceeds from the sale of other real estate and repossessed assets  | 889                        | 3,548      |
| Capital expenditures  | (2,033 )                   | (1,904 )   |
| Net Cash Used in Investing Activities   | (65,221 )                  | (128,664 ) |
| Cash Flow From Financing Activities   |                            |            |
| Net increase in total deposits  | 92,273                     | 20,500     |
| Net decrease in other borrowings  | (3,093 )                   | (1 )       |
| Proceeds from Federal Home Loan Bank Advances   | 1,044,000                  | 242,000    |
| Payments of Federal Home Loan Bank Advances   | (1,069,287 )               | (165,908 ) |
| Dividends paid  | (6,823 )                   | (4,266 )   |
| Proceeds from issuance of common stock  | 147                        | 57         |
| Share based compensation withholding obligation   | (1,321 )                   | (487 )     |
| Net Cash From Financing Activities  | 55,896                     | 91,895     |
| Net Increase (Decrease) in Cash and Cash Equivalents  | 3,973                      | (23,426 )  |
| Cash and Cash Equivalents at Beginning of Period  | 54,738                     | 83,194     |
| Cash and Cash Equivalents at End of Period  | \$ 58,711                  | \$ 59,768  |
| Cash paid during the period for   |                            |            |
| Interest  | \$ 6,545                   | \$ 3,768   |

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|   |        |       |
|---|--------|-------|
| Income taxes  | 120    | 499   |
| Transfers to other real estate and repossessed assets     | 641    | 1,014 |
| Transfer of loans to held for sale                        | 13,216 | -     |
| Purchase of securities available for sale not yet settled | -      | 4,366 |

See notes to interim condensed consolidated financial statements (unaudited)

6

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Index

## INDEPENDENT BANK CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders' Equity

|   | Six months ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2018                         | 2017      |
|   | (unaudited)                  |           |
|   | (In thousands)               |           |
| Balance at beginning of period  | \$264,933                    | \$248,980 |
| Cumulative effect of change in accounting                                     | -                            | 352       |
| Balance at beginning of period, as adjusted                                   | 264,933                      | 249,332   |
| Net income  | 17,978                       | 11,905    |
| Cash dividends declared   | (6,823 )                     | (4,266 )  |
| Acquisition of TCSB Bancorp, Inc.   | 64,536                       | -         |
| Issuance of common stock  | 147                          | 57        |
| Share based compensation  | 848                          | 916       |
| Share based compensation withholding obligation                               | (1,321 )                     | (487 )    |
| Net change in accumulated other comprehensive loss, net of related tax effect | (3,215 )                     | 4,996     |
| Balance at end of period  | \$337,083                    | \$262,453 |

See notes to interim condensed consolidated financial statements (unaudited)

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Preparation of Financial Statements

The condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2017 included in our Annual Report on Form 10-K.

In our opinion, the accompanying unaudited condensed consolidated financial statements contain all the adjustments necessary to present fairly our consolidated financial condition as of June 30, 2018 and December 31, 2017, and the results of operations for the three and six-month periods ended June 30, 2018 and 2017. The results of operations for the three and six-month periods ended June 30, 2018, are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made in the prior period financial statements to conform to the current period presentation. Our critical accounting policies include the determination of the allowance for loan losses, the valuation of capitalized mortgage loan servicing rights and the valuation of deferred tax assets. Refer to our 2017 Annual Report on Form 10-K for a disclosure of our accounting policies.

2. New Accounting Standards

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-02, “Leases (Topic 842)”. This ASU amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the balance sheet while recognizing expense on the income statement in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. This amended guidance is effective for us on January 1, 2019 and is not expected to have a material impact on our consolidated operating results or financial condition. Based on a review of our operating leases that we currently have in place we do not expect a material change in the recognition, measurement and presentation of lease expense or impact on cash flow. While the primary impact will be the recognition of certain operating leases on our Condensed Consolidated Statements of Financial Condition this impact is not expected to be material.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments”. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU will replace today’s “incurred loss” approach with an “expected loss” model for instruments measured at amortized cost. For securities available for sale, allowances will be recorded rather than reducing the carrying amount as is done under the current other-than-temporary impairment model. This ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. This amended guidance is effective for us on January 1, 2020. We began evaluating this ASU in 2016 and have formed a committee that includes personnel from various areas of Independent Bank (the “Bank”) that meets regularly to discuss the implementation of the ASU. We are currently in the process of gathering data and reviewing loss methodologies and have engaged third party resources that will assist us in the implementation of this ASU. While we have not yet determined what the impact will be on our consolidated operating results or financial condition by the nature of the implementation of an expected loss model compared to an incurred loss approach, we would expect our allowance for loan losses (“AFL”) to increase under this ASU.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers (Topic 606)”, (“ASU 2014-09”). This ASU supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this ASU specifies the accounting for some costs to obtain or fulfill a contract with a customer. We adopted this ASU using the modified retrospective approach with no impact to our accumulated deficit at January 1, 2018. Financial instruments for the most part and related contractual rights and obligations which are the sources of the majority of our operating revenue are excluded from the scope of this amended guidance. Those operating revenue streams that are included in the scope of this amended guidance were not materially impacted. Results for reporting periods beginning after January 1, 2018 are presented under this ASU while prior period amounts continue to be reported in accordance with legacy GAAP. The impact of the adoption of this ASU on our Condensed Consolidated Statements of Operations for the three and six month periods ending June 30, 2018 is summarized in the table below. In addition, see note #17 for further discussion on our accounting policies for operating revenue streams that are included in the scope of this amended guidance.

The impact of the adoption of ASU 2014-09 on our Condensed Consolidated Statement of Operations follows:

|  | As<br>Reported | Under<br>Legacy GAAP | Impact of<br>ASU 2014-09 |     |
|--|----------------|----------------------|--------------------------|-----|
|  | (In thousands) |                      |                          |     |
| Three months ended June 30, 2018           |                |                      |                          |     |
| Non-interest income - Interchange income   | \$ 2,504       | \$ 2,144             | \$ 360                   | (1) |
| Non-interest expense - interchange expense | \$ 661         | \$ 301               | 360                      | (1) |
| Impact on net income                       |                |                      | \$ -                     |     |
| Six months ended June 30, 2018             |                |                      |                          |     |
| Non-interest income - Interchange income   | \$ 4,750       | \$ 4,082             | \$ 668                   | (1) |
| Non-interest expense - interchange expense | \$ 1,259       | \$ 591               | 668                      | (1) |
| Impact on net income                       |                |                      | \$ -                     |     |



(1) Represents certain costs charged by payment networks that were previously netted against interchange income.

9

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Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities”. This ASU amends existing guidance related to the accounting for certain financial assets and liabilities. These amendments, among other things, require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset and eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This amended guidance was effective for us on January 1, 2018. The adoption of this of this ASU did not have a material impact on our consolidated operating results or financial condition. As a result of the adoption of this ASU our equity securities previously classified as trading securities are now classified as equity securities at fair value on our June 30, 2018 Condensed Consolidated Statement of Financial Condition. In addition, this amended guidance impacted certain fair value disclosure items (see note #12).

In January 2017, the FASB issued ASU 2017-01, “Business Combinations (Topic 805), Clarifying the Definition of a Business”. This new ASU clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses which distinction determines whether goodwill is recorded or not. This amended guidance was effective for us on January 1, 2018, and did not have a material impact on our consolidated operating results or financial condition.

In January 2017, the FASB issued ASU 2017-4, “Intangibles – Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment”. This new ASU amends the requirement that entities compare the implied fair value of goodwill with its carrying amount as part of step 2 of the goodwill impairment test. As a result, entities should perform their annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognize an impairment if the carrying amount exceeds the reporting unit’s fair value. This amended guidance is effective for us on January 1, 2020 with early application permitted. Due to our recent acquisition (see note #16) and expectations this ASU will be relevant to us in 2018 we elected to adopt this amended guidance as of January 1, 2018. The adoption of this ASU did not have a material impact on our consolidated operating results or financial condition.

In February 2018, the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”. This new ASU allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. As a result, this amended guidance eliminates the stranded tax effects resulting from the Tax Cuts and Jobs Act and will improve the usefulness of information reported to financial statement users. This amended guidance is effective for us on January 1, 2019, with early application permitted in any period for which financial statements have not yet been issued. We elected to adopt this amended guidance during the fourth quarter of 2017 and it resulted in a \$0.04 million reclassification between accumulated other comprehensive loss and accumulated deficit.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

3. Securities

Securities available for sale consist of the following:

|  | Amortized Unrealized |         |         | Fair Value |
|--|----------------------|---------|---------|------------|
|  | Cost                 | Gains   | Losses  |            |
|  | (In thousands)       |         |         |            |
| June 30, 2018                                    |                      |         |         |            |
| U.S. agency                                      | \$23,094             | \$3     | \$285   | \$22,812   |
| U.S. agency residential mortgage-backed          | 131,317              | 874     | 2,190   | 130,001    |
| U.S. agency commercial mortgage-backed           | 9,659                | 1       | 276     | 9,384      |
| Private label mortgage-backed                    | 30,593               | 392     | 702     | 30,283     |
| Other asset backed                               | 77,292               | 170     | 182     | 77,280     |
| Obligations of states and political subdivisions | 146,941              | 343     | 3,205   | 144,079    |
| Corporate  | 33,285               | 64      | 514     | 32,835     |
| Trust preferred                                  | 1,959                | -       | 61      | 1,898      |
| Foreign government                               | 2,069                | -       | 48      | 2,021      |
| Total  | \$456,209            | \$1,847 | \$7,463 | \$450,593  |
| December 31, 2017                                |                      |         |         |            |
| U.S. Treasury                                    | \$898                | \$-     | \$-     | \$898      |
| U.S. agency                                      | 25,667               | 82      | 67      | 25,682     |
| U.S. agency residential mortgage-backed          | 137,785              | 1,116   | 983     | 137,918    |
| U.S. agency commercial mortgage-backed           | 9,894                | 36      | 170     | 9,760      |
| Private label mortgage-backed                    | 29,011               | 428     | 330     | 29,109     |
| Other asset backed                               | 93,811               | 202     | 115     | 93,898     |
| Obligations of states and political subdivisions | 174,073              | 755     | 1,883   | 172,945    |
| Corporate  | 47,365               | 578     | 90      | 47,853     |
| Trust preferred                                  | 2,929                | -       | 127     | 2,802      |
| Foreign government                               | 2,087                | -       | 27      | 2,060      |
| Total  | \$523,520            | \$3,197 | \$3,792 | \$522,925  |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Less Than Twelve |                   | Twelve Months or More |                   | Total      |                   |
|--|------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|  | Fair Value       | Unrealized Losses | Fair Value            | Unrealized Losses | Fair Value | Unrealized Losses |
| (In thousands)                                   |                  |                   |                       |                   |            |                   |
| June 30, 2018                                    |                  |                   |                       |                   |            |                   |
| U.S. agency                                      | \$ 13,530        | \$ 211            | \$ 7,843              | \$ 74             | \$ 21,373  | \$ 285            |
| U.S. agency residential mortgage-backed          | 39,328           | 988               | 31,119                | 1,202             | 70,447     | 2,190             |
| U.S. agency commercial mortgage-backed           | 4,294            | 57                | 4,996                 | 219               | 9,290      | 276               |
| Private label mortgage-backed                    | 16,797           | 423               | 4,107                 | 279               | 20,904     | 702               |
| Other asset backed                               | 27,318           | 109               | 11,003                | 73                | 38,321     | 182               |
| Obligations of states and political subdivisions | 75,486           | 1,534             | 38,012                | 1,671             | 113,498    | 3,205             |
| Corporate  | 20,679           | 395               | 3,862                 | 119               | 24,541     | 514               |
| Trust preferred                                  | -                | -                 | 1,898                 | 61                | 1,898      | 61                |
| Foreign government                               | -                | -                 | 2,021                 | 48                | 2,021      | 48                |
| Total  | \$ 197,432       | \$ 3,717          | \$ 104,861            | \$ 3,746          | \$ 302,293 | \$ 7,463          |
| December 31, 2017                                |                  |                   |                       |                   |            |                   |
| U.S. agency                                      | \$ 5,466         | \$ 26             | \$ 5,735              | \$ 41             | \$ 11,201  | \$ 67             |
| U.S. agency residential mortgage-backed          | 22,198           | 229               | 40,698                | 754               | 62,896     | 983               |
| U.S. agency commercial mortgage-backed           | 2,181            | 34                | 3,994                 | 136               | 6,175      | 170               |
| Private label mortgage-backed                    | 11,390           | 92                | 4,396                 | 238               | 15,786     | 330               |
| Other asset backed                               | 20,352           | 40                | 16,648                | 75                | 37,000     | 115               |
| Obligations of states and political subdivisions | 76,574           | 936               | 28,246                | 947               | 104,820    | 1,883             |
| Corporate  | 14,440           | 33                | 3,943                 | 57                | 18,383     | 90                |
| Trust preferred                                  | -                | -                 | 2,802                 | 127               | 2,802      | 127               |
| Foreign government                               | 489              | 10                | 1,571                 | 17                | 2,060      | 27                |
| Total  | \$ 153,090       | \$ 1,400          | \$ 108,033            | \$ 2,392          | \$ 261,123 | \$ 3,792          |

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

U.S. agency, U.S. agency residential mortgage-backed securities and U.S. agency commercial mortgage backed securities — at June 30, 2018, we had 46 U.S. agency, 135 U.S. agency residential mortgage-backed and 18 U.S. agency commercial mortgage-backed securities whose fair market value is less than amortized cost. The unrealized losses are largely attributed to increases in interest rates since acquisition and widening spreads to Treasury bonds. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Private label mortgage backed securities — at June 30, 2018, we had 29 of this type of security whose fair value is less than amortized cost. Unrealized losses are primarily due to credit spread widening and increases in interest rates since their acquisition.

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

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

Other asset backed — at June 30, 2018, we had 75 other asset backed securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Obligations of states and political subdivisions — at June 30, 2018, we had 342 municipal securities whose fair value is less than amortized cost. The unrealized losses are primarily due to wider benchmark pricing spreads and increases in interest rates since acquisition. Tax exempt securities have been negatively impacted by lower federal tax rates signed into law in December, 2017. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Corporate — at June 30, 2018, we had 30 corporate securities whose fair value is less than amortized cost. The unrealized losses are primarily due to credit spread widening and increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

Trust preferred securities — at June 30, 2018, we had two trust preferred securities whose fair value is less than amortized cost. Both of our trust preferred securities are single issue securities issued by a trust subsidiary of a bank holding company. The pricing of trust preferred securities has suffered from credit spread widening.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

One of the securities is rated by a major rating agency as investment grade while the other one is non-rated. The non-rated issue is a relatively small bank and was never rated. The issuer of this non-rated trust preferred security, which had a total amortized cost of \$1.0 million and total fair value of \$0.97 million as of June 30, 2018, continues to have satisfactory credit metrics and make interest payments.

The following table breaks out our trust preferred securities in further detail as of June 30, 2018 and December 31, 2017:

|                            | June 30, 2018  |                     | December 31, 2017 |                     |
|----------------------------|----------------|---------------------|-------------------|---------------------|
|                            | Fair Value     | Net Unrealized Loss | Fair Value        | Net Unrealized Loss |
|                            | (In thousands) |                     |                   |                     |
| Trust preferred securities |                |                     |                   |                     |
| Rated issues               | \$935          | \$ (27 )            | \$ 1,860          | \$ (69 )            |
| Unrated issues             | 963            | (34 )               | 942               | (58 )               |

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

Foreign government — at June 30, 2018, we had two foreign government securities whose fair value is less than amortized cost. The unrealized losses are primarily due to increases in interest rates since acquisition. As management does not intend to liquidate these securities and it is more likely than not that we will not be required to sell these securities prior to recovery of these unrealized losses, no declines are deemed to be other than temporary.

We recorded no credit related OTTI charges in our Condensed Consolidated Statements of Operations related to securities available for sale during the three and six month periods ended June 30, 2018 and 2017, respectively.

At June 30, 2018, three private label mortgage-backed securities had credit related OTTI and are summarized as follows:

|                                | Super Senior Security | Senior Senior Security | Senior Support Security | Total   |
|--------------------------------|-----------------------|------------------------|-------------------------|---------|
|                                | (In thousands)        |                        |                         |         |
| Fair value                     | \$887                 | \$ 873                 | \$ 46                   | \$1,806 |
| Amortized cost                 | 737                   | 704                    | -                       | 1,441   |
| Non-credit unrealized loss     | -                     | -                      | -                       | -       |
| Unrealized gain                | 150                   | 169                    | 46                      | 365     |
| Cumulative credit related OTTI | 757                   | 457                    | 380                     | 1,594   |

Each of these securities is receiving principal and interest payments similar to principal reductions in the underlying collateral. All three of these securities have unrealized gains at June 30, 2018. The original amortized cost (current amortized cost excluding cumulative credit related OTTI) for each of these securities has been permanently adjusted

downward for previously recorded credit related OTTI. The unrealized loss (based on original amortized cost) for these securities is now less than previously recorded credit related OTTI amounts.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Three months ended<br>June 30,<br>2018 |          | Six months ended<br>June 30,<br>2018 |          |
|--|--|----------|--------------------------------------|----------|
|  | 2017                                   | 2018     | 2017                                 | 2018     |
|  | (In thousands)                         |          | (In thousands)                       |          |
| Balance at beginning of period   | \$ 1,594                               | \$ 1,594 | \$ 1,594                             | \$ 1,594 |
| Additions to credit losses on securities for which no previous OTTI was recognized | -                                      | -        | -                                    | -        |
| Increases to credit losses on securities for which OTTI was previously recognized  | -                                      | -        | -                                    | -        |
| Balance at end of period   | \$ 1,594                               | \$ 1,594 | \$ 1,594                             | \$ 1,594 |

The amortized cost and fair value of securities available for sale at June 30, 2018, by contractual maturity, follow:

|  | Amortized Cost | Fair Value |
|--|----------------|------------|
|  | (In thousands) |            |
| Maturing within one year                       | \$ 16,943      | \$ 16,925  |
| Maturing after one year but within five years  | 79,682         | 78,851     |
| Maturing after five years but within ten years | 61,039         | 59,771     |
| Maturing after ten years                       | 49,684         | 48,098     |
|  | 207,348        | 203,645    |
| U.S. agency residential mortgage-backed        | 131,317        | 130,001    |
| U.S. agency commercial mortgage-backed         | 9,659          | 9,384      |
| Private label mortgage-backed                  | 30,593         | 30,283     |
| Other asset backed                             | 77,292         | 77,280     |
| Total  | \$ 456,209     | \$ 450,593 |

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

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

|      | Realized       |       |        |
|------|----------------|-------|--------|
|      | Proceeds       | Gains | Losses |
|      | (In thousands) |       |        |
| 2018 | \$ 31,445      | \$ 81 | \$ 126 |
| 2017 | 7,830          | 117   | -      |

Certain preferred stocks have been classified as equity securities at fair value in our Condensed Consolidated Statement of Financial Condition beginning on January 1, 2018. Previously these preferred stocks were classified as trading securities. See note #2. During the six months ended June 30, 2018 and 2017 we recognized losses on these preferred stocks of \$0.119 million and \$0.124 million, respectively, that are included in net gains (losses) on securities in the Condensed Consolidated Statements of Operations. These amounts relate to preferred stock still held at each respective period end.





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

4. Loans

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

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

|                                      | Commercial     | Mortgage | Installment | Subjective Allocation | Total    |
|--------------------------------------|----------------|----------|-------------|-----------------------|----------|
|                                      | (In thousands) |          |             |                       |          |
| 2018                                 |                |          |             |                       |          |
| Balance at beginning of period       | \$6,026        | \$ 8,621 | \$ 795      | \$ 7,629              | \$23,071 |
| Additions (deductions)               |                |          |             |                       |          |
| Provision for loan losses            | (362 )         | 216      | 138         | 658                   | 650      |
| Recoveries credited to the allowance | 434            | 177      | 235         | -                     | 846      |
| Loans charged against the allowance  | (25 )          | (718 )   | (320 )      | -                     | (1,063 ) |
| Balance at end of period             | \$6,073        | \$ 8,296 | \$ 848      | \$ 8,287              | \$23,504 |
| 2017                                 |                |          |             |                       |          |
| Balance at beginning of period       | \$5,088        | \$ 8,109 | \$ 911      | \$ 5,930              | \$20,038 |
| Additions (deductions)               |                |          |             |                       |          |
| Provision for loan losses            | (39 )          | 38       | 73          | 511                   | 583      |
| Recoveries credited to the allowance | 202            | 191      | 264         | -                     | 657      |
| Loans charged against the allowance  | (151 )         | (193 )   | (348 )      | -                     | (692 )   |
| Balance at end of period             | \$5,100        | \$ 8,145 | \$ 900      | \$ 6,441              | \$20,586 |

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

|                                      | Commercial     | Mortgage | Installment | Subjective Allocation | Total    |
|--------------------------------------|----------------|----------|-------------|-----------------------|----------|
|                                      | (In thousands) |          |             |                       |          |
| 2018                                 |                |          |             |                       |          |
| Balance at beginning of period       | \$5,595        | \$ 8,733 | \$ 864      | \$ 7,395              | \$22,587 |
| Additions (deductions)               |                |          |             |                       |          |
| Provision for loan losses            | (497 )         | 363      | 207         | 892                   | 965      |
| Recoveries credited to the allowance | 1,040          | 357      | 463         | -                     | 1,860    |
| Loans charged against the allowance  | (65 )          | (1,157 ) | (686 )      | -                     | (1,908 ) |
| Balance at end of period             | \$6,073        | \$ 8,296 | \$ 848      | \$ 8,287              | \$23,504 |
| 2017                                 |                |          |             |                       |          |
| Balance at beginning of period       | \$4,880        | \$ 8,681 | \$ 1,011    | \$ 5,662              | \$20,234 |
| Additions (deductions)               |                |          |             |                       |          |
| Provision for loan losses            | (100 )         | (661 )   | 206         | 779                   | 224      |
| Recoveries credited to the allowance | 606            | 677      | 503         | -                     | 1,786    |
| Loans charged against the allowance  | (286 )         | (552 )   | (820 )      | -                     | (1,658 ) |
| Balance at end of period             | \$5,100        | \$ 8,145 | \$ 900      | \$ 6,441              | \$20,586 |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Commercial     | Mortgage  | Installment | Subjective<br>Allocation | Total       |
|--|----------------|-----------|-------------|--------------------------|-------------|
|  | (In thousands) |           |             |                          |             |
| June 30, 2018                                    |                |           |             |                          |             |
| Allowance for loan losses                        |                |           |             |                          |             |
| Individually evaluated for impairment            | \$772          | \$5,302   | \$233       | \$-                      | \$6,307     |
| Collectively evaluated for impairment            | 5,301          | 2,994     | 615         | 8,287                    | 17,197      |
| Loans acquired with deteriorated credit quality  | -              | -         | -           | -                        | -           |
| Total ending allowance balance                   | \$6,073        | \$8,296   | \$848       | \$8,287                  | \$23,504    |
| Loans  |                |           |             |                          |             |
| Individually evaluated for impairment            | \$10,708       | \$49,886  | \$3,796     |                          | \$64,390    |
| Collectively evaluated for impairment            | 1,097,576      | 942,074   | 368,558     |                          | 2,408,208   |
| Loans acquired with deteriorated credit quality  | 1,823          | 651       | 362         |                          | 2,836       |
| Total loans recorded investment                  | 1,110,107      | 992,611   | 372,716     |                          | 2,475,434   |
| Accrued interest included in recorded investment | 3,120          | 3,989     | 1,008       |                          | 8,117       |
| Total loans                                      | \$1,106,987    | \$988,622 | \$371,708   |                          | \$2,467,317 |
| December 31, 2017                                |                |           |             |                          |             |
| Allowance for loan losses                        |                |           |             |                          |             |
| Individually evaluated for impairment            | \$837          | \$5,725   | \$277       | \$-                      | \$6,839     |
| Collectively evaluated for impairment            | 4,758          | 3,008     | 587         | 7,395                    | 15,748      |
| Total ending allowance balance                   | \$5,595        | \$8,733   | \$864       | \$7,395                  | \$22,587    |
| Loans  |                |           |             |                          |             |
| Individually evaluated for impairment            | \$8,420        | \$53,179  | \$3,945     |                          | \$65,544    |
| Collectively evaluated for impairment            | 847,140        | 799,629   | 313,005     |                          | 1,959,774   |
| Total loans recorded investment                  | 855,560        | 852,808   | 316,950     |                          | 2,025,318   |
| Accrued interest included in recorded investment | 2,300          | 3,278     | 923         |                          | 6,501       |
| Total loans                                      | \$853,260      | \$849,530 | \$316,027   |                          | \$2,018,817 |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 90+<br>and<br>Still Non-<br>Accrual<br>(In thousands) | Total Non-<br>Performing<br>Loans |
|---|---|-----------------------------------|
| June 30, 2018   |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$-   | \$ -                              |
| Land, land development and construction - real estate | - 2,402   | 2,402                             |
| Commercial and industrial                             | - 487   | 487                               |
| Mortgage  |   |                                   |
| 1-4 family  | - 3,737   | 3,737                             |
| Resort lending  | - 1,098   | 1,098                             |
| Home equity - 1st lien                                | - 409   | 409                               |
| Home equity - 2nd lien                                | - 278   | 278                               |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 150   | 150                               |
| Home equity - 2nd lien                                | - 297   | 297                               |
| Boat lending  | - 107   | 107                               |
| Recreational vehicle lending                          | - 14  | 14                                |
| Other   | - 103   | 103                               |
| Total recorded investment                             | \$- \$9,082   | \$ 9,082                          |
| Accrued interest included in recorded investment      | \$- \$-   | \$ -                              |
| December 31, 2017                                     |   |                                   |
| Commercial  |   |                                   |
| Income producing - real estate                        | \$- \$30  | \$ 30                             |
| Land, land development and construction - real estate | - 9   | 9                                 |
| Commercial and industrial                             | - 607   | 607                               |
| Mortgage  |   |                                   |
| 1-4 family  | - 5,130   | 5,130                             |
| Resort lending  | - 1,223   | 1,223                             |
| Home equity - 1st lien                                | - 326   | 326                               |
| Home equity - 2nd lien                                | - 316   | 316                               |
| Installment   |   |                                   |
| Home equity - 1st lien                                | - 141   | 141                               |
| Home equity - 2nd lien                                | - 159   | 159                               |
| Boat lending  | - 100   | 100                               |
| Recreational vehicle lending                          | - 25  | 25                                |
| Other   | - 118   | 118                               |
| Total recorded investment                             | \$- \$8,184   | \$ 8,184                          |
| Accrued interest included in recorded investment      | \$- \$-   | \$ -                              |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

An aging analysis of loans by class follows:

|   | Loans Past Due |               |          | Total     | Loans not<br>Past Due | Total<br>Loans |
|---|----------------|---------------|----------|-----------|-----------------------|----------------|
|   | 30-59<br>days  | 60-89<br>days | 90+ days |           |                       |                |
| (In thousands)  |                |               |          |           |                       |                |
| June 30, 2018   |                |               |          |           |                       |                |
| Commercial  |                |               |          |           |                       |                |
| Income producing - real estate                        | \$-            | \$ 234        | \$ 59    | \$ 293    | \$ 365,473            | \$ 365,766     |
| Land, land development and construction - real estate | 2,402          | -             | -        | 2,402     | 59,353                | 61,755         |
| Commercial and industrial                             | 266            | 149           | -        | 415       | 682,171               | 682,586        |
| Mortgage  |                |               |          |           |                       |                |
| 1-4 family  | 2,583          | 792           | 3,737    | 7,112     | 776,934               | 784,046        |
| Resort lending  | 512            | -             | 1,098    | 1,610     | 82,706                | 84,316         |
| Home equity - 1st lien                                | 435            | -             | 409      | 844       | 44,440                | 45,284         |
| Home equity - 2nd lien                                | 440            | 72            | 278      | 790       | 78,175                | 78,965         |
| Installment   |                |               |          |           |                       |                |
| Home equity - 1st lien                                | 435            | 51            | 150      | 636       | 8,486                 | 9,122          |
| Home equity - 2nd lien                                | 134            | 30            | 297      | 461       | 7,942                 | 8,403          |
| Boat lending  | 19             | 2             | 107      | 128       | 159,158               | 159,286        |
| Recreational vehicle lending                          | 45             | 42            | 14       | 101       | 113,097               | 113,198        |
| Other   | 162            | 36            | 103      | 301       | 82,406                | 82,707         |
| Total recorded investment                             | \$ 7,433       | \$ 1,408      | \$ 6,252 | \$ 15,093 | \$ 2,460,341          | \$ 2,475,434   |
| Accrued interest included in recorded investment      | \$ 62          | \$ 20         | \$ -     | \$ 82     | \$ 8,035              | \$ 8,117       |
| December 31, 2017                                     |                |               |          |           |                       |                |
| Commercial  |                |               |          |           |                       |                |
| Income producing - real estate                        | \$-            | \$ -          | \$ 30    | \$ 30     | \$ 290,466            | \$ 290,496     |
| Land, land development and construction - real estate | 9              | -             | -        | 9         | 70,182                | 70,191         |
| Commercial and industrial                             | 60             | -             | 44       | 104       | 494,769               | 494,873        |
| Mortgage  |                |               |          |           |                       |                |
| 1-4 family  | 1,559          | 802           | 5,130    | 7,491     | 659,742               | 667,233        |
| Resort lending  | 713            | -             | 1,223    | 1,936     | 88,620                | 90,556         |
| Home equity - 1st lien                                | 308            | 38            | 326      | 672       | 34,689                | 35,361         |
| Home equity - 2nd lien                                | 353            | 155           | 316      | 824       | 58,834                | 59,658         |
| Installment   |                |               |          |           |                       |                |
| Home equity - 1st lien                                | 90             | 11            | 141      | 242       | 9,213                 | 9,455          |
| Home equity - 2nd lien                                | 217            | 94            | 159      | 470       | 9,001                 | 9,471          |
| Boat lending  | 59             | 36            | 100      | 195       | 129,777               | 129,972        |
| Recreational vehicle lending                          | 28             | 20            | 25       | 73        | 92,737                | 92,810         |
| Other   | 275            | 115           | 118      | 508       | 74,734                | 75,242         |
| Total recorded investment                             | \$ 3,671       | \$ 1,271      | \$ 7,612 | \$ 12,554 | \$ 2,012,764          | \$ 2,025,318   |
| Accrued interest included in recorded investment      | \$ 43          | \$ 22         | \$ -     | \$ 65     | \$ 6,436              | \$ 6,501       |



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

Impaired loans are as follows:

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
|   | (In thousands)   |                      |
| Impaired loans with no allocated allowance          |                  |                      |
| TDR   | \$587            | \$ 349               |
| Non - TDR   | 2,555            | 175                  |
| Impaired loans with an allocated allowance          |                  |                      |
| TDR - allowance based on collateral                 | 2,638            | 2,482                |
| TDR - allowance based on present value cash flow    | 58,237           | 62,113               |
| Non - TDR - allowance based on collateral           | 90               | 148                  |
| Total impaired loans                                | \$64,107         | \$ 65,267            |
| Amount of allowance for loan losses allocated       |                  |                      |
| TDR - allowance based on collateral                 | \$884            | \$ 684               |
| TDR - allowance based on present value cash flow    | 5,383            | 6,089                |
| Non - TDR - allowance based on collateral           | 40               | 66                   |
| Total amount of allowance for loan losses allocated | \$6,307          | \$ 6,839             |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Impaired loans by class are as follows:

|   | June 30, 2018       |                          |                   | December 31, 2017   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| (In thousands)                                    |                     |                          |                   |                     |                          |                   |
| With no related allowance recorded:               |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | \$-                 | \$-                      | \$ -              | \$-                 | \$-                      | \$ -              |
| Land, land development & construction-real estate | 2,402               | 2,402                    | -                 | -                   | -                        | -                 |
| Commercial and industrial                         | 502                 | 533                      | -                 | 524                 | 549                      | -                 |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 240                 | 871                      | -                 | 2                   | 469                      | -                 |
| Resort lending                                    | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity - 1st lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Home equity - 2nd lien                            | -                   | 34                       | -                 | -                   | -                        | -                 |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | 1                   | 92                       | -                 | 1                   | 69                       | -                 |
| Home equity - 2nd lien                            | -                   | -                        | -                 | -                   | -                        | -                 |
| Boat lending                                      | -                   | -                        | -                 | -                   | -                        | -                 |
| Recreational vehicle lending                      | -                   | -                        | -                 | -                   | -                        | -                 |
| Other   | -                   | 16                       | -                 | -                   | -                        | -                 |
|   | 3,145               | 3,948                    | -                 | 527                 | 1,087                    | -                 |
| With an allowance recorded:                       |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 5,106               | 5,087                    | 335               | 5,195               | 5,347                    | 347               |
| Land, land development & construction-real estate | 154                 | 153                      | 5                 | 166                 | 194                      | 9                 |
| Commercial and industrial                         | 2,544               | 2,629                    | 432               | 2,535               | 2,651                    | 481               |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 34,805              | 36,076                   | 3,103             | 36,848              | 38,480                   | 3,454             |
| Resort lending                                    | 14,617              | 14,649                   | 2,186             | 15,978              | 16,046                   | 2,210             |
| Home equity - 1st lien                            | 67                  | 66                       | 4                 | 173                 | 236                      | 43                |
| Home equity - 2nd lien                            | 157                 | 156                      | 9                 | 178                 | 213                      | 18                |
| Installment                                       |                     |                          |                   |                     |                          |                   |
| Home equity - 1st lien                            | 1,569               | 1,687                    | 94                | 1,667               | 1,804                    | 108               |
| Home equity - 2nd lien                            | 1,731               | 1,750                    | 112               | 1,793               | 1,805                    | 140               |
| Boat lending                                      | 1                   | 5                        | 1                 | 1                   | 5                        | 1                 |
| Recreational vehicle lending                      | 85                  | 85                       | 4                 | 90                  | 90                       | 5                 |
| Other   | 409                 | 435                      | 22                | 393                 | 418                      | 23                |
|   | 61,245              | 62,778                   | 6,307             | 65,017              | 67,289                   | 6,839             |
| Total   |                     |                          |                   |                     |                          |                   |
| Commercial  |                     |                          |                   |                     |                          |                   |
| Income producing - real estate                    | 5,106               | 5,087                    | 335               | 5,195               | 5,347                    | 347               |
| Land, land development & construction-real estate | 2,556               | 2,555                    | 5                 | 166                 | 194                      | 9                 |
| Commercial and industrial                         | 3,046               | 3,162                    | 432               | 3,059               | 3,200                    | 481               |
| Mortgage  |                     |                          |                   |                     |                          |                   |
| 1-4 family  | 35,045              | 36,947                   | 3,103             | 36,850              | 38,949                   | 3,454             |

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|  |          |          |          |          |          |          |
|--|----------|----------|----------|----------|----------|----------|
| Resort lending                                   | 14,617   | 14,649   | 2,186    | 15,978   | 16,046   | 2,210    |
| Home equity - 1st lien                           | 67       | 66       | 4        | 173      | 236      | 43       |
| Home equity - 2nd lien                           | 157      | 190      | 9        | 178      | 213      | 18       |
| Installment                                      |          |          |          |          |          |          |
| Home equity - 1st lien                           | 1,570    | 1,779    | 94       | 1,668    | 1,873    | 108      |
| Home equity - 2nd lien                           | 1,731    | 1,750    | 112      | 1,793    | 1,805    | 140      |
| Boat lending                                     | 1        | 5        | 1        | 1        | 5        | 1        |
| Recreational vehicle lending                     | 85       | 85       | 4        | 90       | 90       | 5        |
| Other  | 409      | 451      | 22       | 393      | 418      | 23       |
| Total  | \$64,390 | \$66,726 | \$ 6,307 | \$65,544 | \$68,376 | \$ 6,839 |
| Accrued interest included in recorded investment | \$283    |          |          | \$277    |          |          |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2018               |                     | 2017               |                     |
|---|--------------------|---------------------|--------------------|---------------------|
|   | Average Investment | Interest Recognized | Average Investment | Interest Recognized |
|   | (In thousands)     |                     |                    |                     |
| With no related allowance recorded                |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | \$-                | \$ -                | \$185              | \$ -                |
| Land, land development & construction-real estate | 1,201              | -                   | -                  | -                   |
| Commercial and industrial                         | 509                | 9                   | 177                | 8                   |
| Mortgage  |                    |                     |                    |                     |
| 1-4 family  | 138                | 3                   | 126                | 5                   |
| Resort lending                                    | -                  | -                   | -                  | -                   |
| Home equity - 1st lien                            | -                  | -                   | -                  | -                   |
| Home equity - 2nd lien                            | -                  | -                   | -                  | -                   |
| Installment                                       |                    |                     |                    |                     |
| Home equity - 1st lien                            | 1                  | 2                   | 1                  | 2                   |
| Home equity - 2nd lien                            | -                  | -                   | -                  | -                   |
| Boat lending                                      | -                  | -                   | -                  | -                   |
| Recreational vehicle lending                      | -                  | -                   | -                  | -                   |
| Other   | -                  | 1                   | -                  | -                   |
|   | 1,849              | 15                  | 489                | 15                  |
| With an allowance recorded                        |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | 5,142              | 70                  | 7,694              | 104                 |
| Land, land development & construction-real estate | 155                | 2                   | 170                | 2                   |
| Commercial and industrial                         | 2,522              | 34                  | 3,237              | 37                  |
| Mortgage  |                    |                     |                    |                     |
| 1-4 family  | 35,345             | 431                 | 39,646             | 494                 |
| Resort lending                                    | 15,098             | 150                 | 16,471             | 150                 |
| Home equity - 1st lien                            | 111                | 1                   | 232                | 2                   |
| Home equity - 2nd lien                            | 167                | 1                   | 186                | 1                   |
| Installment                                       |                    |                     |                    |                     |
| Home equity - 1st lien                            | 1,596              | 25                  | 1,855              | 33                  |
| Home equity - 2nd lien                            | 1,746              | 25                  | 2,228              | 35                  |
| Boat lending                                      | 1                  | -                   | 1                  | -                   |
| Recreational vehicle lending                      | 86                 | 1                   | 104                | 2                   |
| Other   | 414                | 7                   | 369                | 6                   |
|   | 62,383             | 747                 | 72,193             | 866                 |
| Total   |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | 5,142              | 70                  | 7,879              | 104                 |
| Land, land development & construction-real estate | 1,356              | 2                   | 170                | 2                   |
| Commercial and industrial                         | 3,031              | 43                  | 3,414              | 45                  |
| Mortgage  |                    |                     |                    |                     |

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|                              |          |        |          |        |
|------------------------------|----------|--------|----------|--------|
| 1-4 family                   | 35,483   | 434    | 39,772   | 499    |
| Resort lending               | 15,098   | 150    | 16,471   | 150    |
| Home equity - 1st lien       | 111      | 1      | 232      | 2      |
| Home equity - 2nd lien       | 167      | 1      | 186      | 1      |
| Installment                  |          |        |          |        |
| Home equity - 1st lien       | 1,597    | 27     | 1,856    | 35     |
| Home equity - 2nd lien       | 1,746    | 25     | 2,228    | 35     |
| Boat lending                 | 1        | -      | 1        | -      |
| Recreational vehicle lending | 86       | 1      | 104      | 2      |
| Other                        | 414      | 8      | 369      | 6      |
| Total                        | \$64,232 | \$ 762 | \$72,682 | \$ 881 |

22

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | 2018               |                     | 2017               |                     |
|---|--------------------|---------------------|--------------------|---------------------|
|   | Average Investment | Interest Recognized | Average Investment | Interest Recognized |
|   | (In thousands)     |                     |                    |                     |
| With no related allowance recorded:               |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | \$-                | \$ -                | \$296              | \$ -                |
| Land, land development & construction-real estate | 801                | -                   | 10                 | -                   |
| Commercial and industrial                         | 514                | 13                  | 898                | 8                   |
| Mortgage  |                    |                     |                    |                     |
| 1-4 family  | 92                 | 9                   | 85                 | 9                   |
| Resort lending                                    | -                  | -                   | -                  | -                   |
| Home equity - 1st lien                            | -                  | -                   | -                  | -                   |
| Home equity - 2nd lien                            | -                  | -                   | -                  | -                   |
| Installment                                       |                    |                     |                    |                     |
| Home equity - 1st lien                            | 1                  | 4                   | -                  | 3                   |
| Home equity - 2nd lien                            | -                  | -                   | -                  | -                   |
| Boat lending                                      | -                  | -                   | -                  | -                   |
| Recreational vehicle lending                      | -                  | -                   | -                  | -                   |
| Other   | -                  | 1                   | -                  | -                   |
|   | 1,408              | 27                  | 1,289              | 20                  |
| With an allowance recorded:                       |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | 5,160              | 138                 | 7,708              | 209                 |
| Land, land development & construction-real estate | 159                | 4                   | 193                | 4                   |
| Commercial and industrial                         | 2,526              | 66                  | 3,792              | 72                  |
| Mortgage  |                    |                     |                    |                     |
| 1-4 family  | 35,846             | 889                 | 40,331             | 958                 |
| Resort lending                                    | 15,391             | 314                 | 16,613             | 311                 |
| Home equity - 1st lien                            | 131                | 3                   | 233                | 4                   |
| Home equity - 2nd lien                            | 171                | 3                   | 229                | 3                   |
| Installment                                       |                    |                     |                    |                     |
| Home equity - 1st lien                            | 1,619              | 54                  | 1,901              | 67                  |
| Home equity - 2nd lien                            | 1,762              | 52                  | 2,290              | 70                  |
| Boat lending                                      | 1                  | -                   | 1                  | -                   |
| Recreational vehicle lending                      | 87                 | 2                   | 106                | 3                   |
| Other   | 407                | 13                  | 377                | 13                  |
|   | 63,260             | 1,538               | 73,774             | 1,714               |
| Total   |                    |                     |                    |                     |
| Commercial  |                    |                     |                    |                     |
| Income producing - real estate                    | 5,160              | 138                 | 8,004              | 209                 |
| Land, land development & construction-real estate | 960                | 4                   | 203                | 4                   |
| Commercial and industrial                         | 3,040              | 79                  | 4,690              | 80                  |
| Mortgage  |                    |                     |                    |                     |

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|                              |          |          |          |          |
|------------------------------|----------|----------|----------|----------|
| 1-4 family                   | 35,938   | 898      | 40,416   | 967      |
| Resort lending               | 15,391   | 314      | 16,613   | 311      |
| Home equity - 1st lien       | 131      | 3        | 233      | 4        |
| Home equity - 2nd lien       | 171      | 3        | 229      | 3        |
| Installment                  |          |          |          |          |
| Home equity - 1st lien       | 1,620    | 58       | 1,901    | 70       |
| Home equity - 2nd lien       | 1,762    | 52       | 2,290    | 70       |
| Boat lending                 | 1        | -        | 1        | -        |
| Recreational vehicle lending | 87       | 2        | 106      | 3        |
| Other                        | 407      | 14       | 377      | 13       |
| Total                        | \$64,668 | \$ 1,565 | \$75,063 | \$ 1,734 |

23

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

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

Troubled debt restructurings follow:

|                        | June 30, 2018  |            |           |
|------------------------|----------------|------------|-----------|
|                        | Commer         | Retail (1) | Total     |
|                        | (In thousands) |            |           |
| Performing TDRs        | \$7,792        | \$ 50,313  | \$ 58,105 |
| Non-performing TDRs(2) | 245            | 3,112      | (3) 3,357 |
| Total                  | \$8,037        | \$ 53,425  | \$ 61,462 |

|                        | December 31, 2017 |            |           |
|------------------------|-------------------|------------|-----------|
|                        | Commer            | Retail (1) | Total     |
|                        | (In thousands)    |            |           |
| Performing TDRs        | \$7,748           | \$ 52,367  | \$ 60,115 |
| Non-performing TDRs(2) | 323               | 4,506      | (3) 4,829 |
| Total                  | \$8,071           | \$ 56,873  | \$ 64,944 |

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

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

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

We allocated \$6.3 million and \$6.8 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2018 and December 31, 2017, respectively.

During the six months ended June 30, 2018 and 2017, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans generally included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
|   |                           | (Dollars in thousands)                  |  |
| 2018  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -                                    | \$ -                                     |
| Land, land development & construction-real estate | -                         | -                                       | -  |
| Commercial and industrial                         | 2                         | 153                                     | 153                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 1                         | 66                                      | 69                                       |
| Resort lending                                    | -                         | -                                       | -  |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 2                         | 90                                      | 91                                       |
| Home equity - 2nd lien                            | 1                         | 32                                      | 32                                       |
| Boat lending                                      | -                         | -                                       | -  |
| Recreational vehicle lending                      | -                         | -                                       | -  |
| Other   | 1                         | 41                                      | 41                                       |
| Total   | 7                         | \$ 382                                  | \$ 386                                   |
| 2017  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -                                    | \$ -                                     |
| Land, land development & construction-real estate | -                         | -                                       | -  |
| Commercial and industrial                         | 9                         | 653                                     | 653                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 1                         | 32                                      | 32                                       |
| Resort lending                                    | -                         | -                                       | -  |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | -                         | -                                       | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | -                         | -                                       | -  |
| Home equity - 2nd lien                            | 3                         | 204                                     | 205                                      |
| Boat lending                                      | -                         | -                                       | -  |
| Recreational vehicle lending                      | -                         | -                                       | -  |
| Other   | -                         | -                                       | -  |
| Total   | 13                        | \$ 889                                  | \$ 890                                   |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Number<br>of<br>Contracts | Pre-modification<br>Recorded<br>Balance<br>(Dollars in thousands) | Post-modification<br>Recorded<br>Balance |
|---|---------------------------|---|--|
| 2018  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | 1                         | \$ 67   | \$ 67                                    |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | 5                         | 587   | 587                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 4                         | 294   | 280                                      |
| Resort lending                                    | -                         | -   | -  |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | -                         | -   | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 5                         | 188   | 190                                      |
| Home equity - 2nd lien                            | 2                         | 93  | 93                                       |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | 2                         | 76  | 73                                       |
| Total   | 19                        | \$ 1,305  | \$ 1,290                                 |
| 2017  |                           |   |  |
| Commercial  |                           |   |  |
| Income producing - real estate                    | -                         | \$ -  | \$ -                                     |
| Land, land development & construction-real estate | -                         | -   | -  |
| Commercial and industrial                         | 12                        | 786   | 786                                      |
| Mortgage  |                           |   |  |
| 1-4 family  | 2                         | 49  | 49                                       |
| Resort lending                                    | 1                         | 189   | 189                                      |
| Home equity - 1st lien                            | -                         | -   | -  |
| Home equity - 2nd lien                            | -                         | -   | -  |
| Installment                                       |                           |   |  |
| Home equity - 1st lien                            | 2                         | 34  | 37                                       |
| Home equity - 2nd lien                            | 5                         | 249   | 251                                      |
| Boat lending                                      | -                         | -   | -  |
| Recreational vehicle lending                      | -                         | -   | -  |
| Other   | -                         | -   | -  |
| Total   | 22                        | \$ 1,307  | \$ 1,312                                 |

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



Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The troubled debt restructurings described above for 2017 had no impact on the allowance for loan losses and resulted in zero charge offs during the three months ended June 30, 2017, and increased the allowance by \$0.07 million and resulted in zero charge offs during the six months ended June 30, 2017.

There were no troubled debt restructurings that subsequently defaulted within twelve months following the modification during the three and six months periods ended June 30, 2018 and 2017.

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

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

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

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

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

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

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

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Commercial       |              |                             |                          | Total       |
|---|------------------|--------------|-----------------------------|--------------------------|-------------|
|   | Non-watch<br>1-6 | Watch<br>7-8 | Substandard<br>Accrual<br>9 | Non-<br>Accrual<br>10-11 |             |
|   | (In thousands)   |              |                             |                          |             |
| June 30, 2018   |                  |              |                             |                          |             |
| Income producing - real estate                        | \$362,860        | \$2,452      | \$ 454                      | \$ -                     | \$365,766   |
| Land, land development and construction - real estate | 52,832           | 6,509        | 12                          | 2,402                    | 61,755      |
| Commercial and industrial                             | 645,647          | 26,936       | 9,516                       | 487                      | 682,586     |
| Total   | \$1,061,339      | \$35,897     | \$ 9,982                    | \$2,889                  | \$1,110,107 |
| Accrued interest included in total                    | \$2,899          | \$144        | \$ 77                       | \$ -                     | \$3,120     |
| December 31, 2017                                     |                  |              |                             |                          |             |
| Income producing - real estate                        | \$288,869        | \$1,293      | \$ 304                      | \$ 30                    | \$290,496   |
| Land, land development and construction - real estate | 70,122           | 60           | -                           | 9                        | 70,191      |
| Commercial and industrial                             | 463,570          | 28,351       | 2,345                       | 607                      | 494,873     |
| Total   | \$822,561        | \$29,704     | \$ 2,649                    | \$ 646                   | \$855,560   |
| Accrued interest included in total                    | \$2,198          | \$94         | \$ 8                        | \$ -                     | \$2,300     |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                                    | Mortgage (1)   |                   |                            |                            |           |
|------------------------------------|----------------|-------------------|----------------------------|----------------------------|-----------|
|                                    | 1-4<br>Family  | Resort<br>Lending | Home<br>Equity<br>1st Lien | Home<br>Equity<br>2nd Lien | Total     |
|                                    | (In thousands) |                   |                            |                            |           |
| June 30, 2018                      |                |                   |                            |                            |           |
| 800 and above                      | \$105,921      | \$12,496          | \$7,184                    | \$8,580                    | \$134,181 |
| 750-799                            | 327,242        | 32,448            | 17,542                     | 28,804                     | 406,036   |
| 700-749                            | 192,813        | 21,108            | 8,625                      | 19,308                     | 241,854   |
| 650-699                            | 95,852         | 9,246             | 3,055                      | 7,851                      | 116,004   |
| 600-649                            | 29,042         | 4,490             | 530                        | 2,546                      | 36,608    |
| 550-599                            | 13,706         | 1,232             | 778                        | 1,316                      | 17,032    |
| 500-549                            | 7,788          | 949               | 230                        | 1,198                      | 10,165    |
| Under 500                          | 1,729          | 85                | 89                         | 190                        | 2,093     |
| Unknown                            | 9,953          | 2,262             | 7,251                      | 9,172                      | 28,638    |
| Total                              | \$784,046      | \$84,316          | \$45,284                   | \$78,965                   | \$992,611 |
| Accrued interest included in total | \$2,889        | \$364             | \$262                      | \$474                      | \$3,989   |
| December 31, 2017                  |                |                   |                            |                            |           |
| 800 and above                      | \$78,523       | \$11,625          | \$6,169                    | \$7,842                    | \$104,159 |
| 750-799                            | 283,558        | 36,015            | 16,561                     | 24,126                     | 360,260   |
| 700-749                            | 154,239        | 22,099            | 7,317                      | 15,012                     | 198,667   |
| 650-699                            | 84,121         | 12,145            | 2,793                      | 7,420                      | 106,479   |
| 600-649                            | 25,087         | 3,025             | 1,189                      | 2,512                      | 31,813    |
| 550-599                            | 15,136         | 2,710             | 518                        | 1,118                      | 19,482    |
| 500-549                            | 9,548          | 1,009             | 397                        | 1,156                      | 12,110    |
| Under 500                          | 2,549          | 269               | 260                        | 385                        | 3,463     |
| Unknown                            | 14,472         | 1,659             | 157                        | 87                         | 16,375    |
| Total                              | \$667,233      | \$90,556          | \$35,361                   | \$59,658                   | \$852,808 |
| Accrued interest included in total | \$2,456        | \$371             | \$157                      | \$294                      | \$3,278   |

(1) Other than for the TCSB Bancorp, Inc. ("TCSB") acquired loans, credit scores have been updated within the last twelve months.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|                                    | Installment(1) |          |              |              |           |            |
|------------------------------------|----------------|----------|--------------|--------------|-----------|------------|
|                                    | Home           | Home     |              | Recreational |           |            |
|                                    | Equity         | Equity   |              | Vehicle      |           |            |
|                                    | 1st            | 2nd      | Boat Lending | Lending      | Other     | Total      |
|                                    | Lien           | Lien     |              |              |           |            |
|                                    | (In thousands) |          |              |              |           |            |
| June 30, 2018                      |                |          |              |              |           |            |
| 800 and above                      | \$ 607         | \$ 330   | \$ 23,002    | \$ 20,133    | \$ 5,962  | \$ 50,034  |
| 750-799                            | 2,005          | 1,718    | 88,646       | 66,538       | 30,513    | 189,420    |
| 700-749                            | 1,286          | 2,059    | 34,972       | 21,023       | 22,898    | 82,238     |
| 650-699                            | 1,597          | 1,743    | 8,387        | 4,126        | 9,696     | 25,549     |
| 600-649                            | 1,181          | 1,103    | 2,015        | 835          | 2,319     | 7,453      |
| 550-599                            | 945            | 890      | 422          | 368          | 1,025     | 3,650      |
| 500-549                            | 225            | 137      | 448          | 79           | 461       | 1,350      |
| Under 500                          | 58             | 143      | 45           | 22           | 174       | 442        |
| Unknown                            | 1,218          | 280      | 1,349        | 74           | 9,659     | 12,580     |
| Total                              | \$ 9,122       | \$ 8,403 | \$ 159,286   | \$ 113,198   | \$ 82,707 | \$ 372,716 |
| Accrued interest included in total | \$ 37          | \$ 36    | \$ 394       | \$ 288       | \$ 253    | \$ 1,008   |
| December 31, 2017                  |                |          |              |              |           |            |
| 800 and above                      | \$ 815         | \$ 825   | \$ 15,531    | \$ 16,754    | \$ 7,060  | \$ 40,985  |
| 750-799                            | 1,912          | 1,952    | 73,251       | 52,610       | 28,422    | 158,147    |
| 700-749                            | 1,825          | 2,142    | 28,922       | 17,993       | 20,059    | 70,941     |
| 650-699                            | 1,840          | 2,036    | 9,179        | 4,270        | 9,258     | 26,583     |
| 600-649                            | 1,567          | 1,065    | 2,052        | 754          | 2,402     | 7,840      |
| 550-599                            | 950            | 1,028    | 640          | 305          | 871       | 3,794      |
| 500-549                            | 499            | 303      | 281          | 83           | 475       | 1,641      |
| Under 500                          | 32             | 88       | 57           | 6            | 194       | 377        |
| Unknown                            | 15             | 32       | 59           | 35           | 6,501     | 6,642      |
| Total                              | \$ 9,455       | \$ 9,471 | \$ 129,972   | \$ 92,810    | \$ 75,242 | \$ 316,950 |
| Accrued interest included in total | \$ 39          | \$ 43    | \$ 346       | \$ 254       | \$ 241    | \$ 923     |

(1) Other than for the TCSB acquired loans, credit scores have been updated within the last twelve months.

Foreclosed residential real estate properties included in other real estate and repossessed assets on our Condensed Consolidated Statements of Financial Condition totaled \$1.7 million and \$1.6 million at June 30, 2018 and December 31, 2017, respectively. Retail mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements totaled \$0.3 million and \$0.8 million at June 30, 2018 and December 31, 2017, respectively.

In March 2018, we sold \$16.5 million of single-family residential fixed and adjustable rate mortgage loans servicing retained to another financial institution and recognized a gain on sale of \$0.05 million. These mortgage loans were all on properties located in Ohio, had a weighted average interest rate of 3.59% and were sold primarily for asset/liability management purposes.

At June 30, 2018, we had \$13.2 million of single-family residential fixed and adjustable rate mortgage loans classified as held for sale (and carried at the lower of cost or fair value). These loans are expected to be sold on a servicing

retained basis to another financial institution in the third quarter of 2018. These mortgage loans are all on properties located in Ohio and are also being sold primarily for asset/liability management purposes.

30

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Purchase Credit Impaired (“PCI”) Loans

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

As a result of our acquisition of TCSB (see note #16) we purchased loans for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. For these loans that meet the criteria of ASC 310-30 treatment, the carrying amount was as follows:

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
|   | (In thousands)   |                      |
| Commercial  | \$ 1,823         | \$ -                 |
| Mortgage  | 651              | -                    |
| Installment                                       | 362              | -                    |
| Total carrying amount                             | 2,836            | -                    |
| Allowance for loan losses                         | -                | -                    |
| Carrying amount, net of allowance for loan losses | \$ 2,836         | \$ -                 |

The accretable difference on PCI loans is the difference between the expected cash flows and the net present value of expected cash flows with such difference accreted into earnings using the effective yield method over the term of the loans. Accretion recorded as loan interest income totaled \$0.04 million during the three and six months ended June 30, 2018. Accretable yield of PCI loans, or income expected to be collected follows:

|   | Six months ended<br>June 30, |      |
|---|------------------------------|------|
|   | 2018                         | 2017 |
|   | (unaudited)                  |      |
|   | (In thousands)               |      |
| Balance at beginning of period                      | \$ -                         | \$ - |
| New loans purchased                                 | 568                          | -    |
| Accretion of income                                 | (35 )                        | -    |
| Reclassification from (to) nonaccretable difference | -                            | -    |
| Disposals/other adjustments                         | -                            | -    |
| Balance at end of period                            | \$ 533                       | \$ - |





IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

PCI loans purchased during 2018 (all relating to the TCSB acquisition) for which it was probable at acquisition that all contractually required payments would not be collected follows:

|  | (In thousands) |
|--|----------------|
| Contractually required payments                    | \$ 4,213       |
| Non accretable difference                          | (742 )         |
| Cash flows expected to be collected at acquisition | 3,471          |
| Accretable yield                                   | (568 )         |
| Fair value of acquired loans at acquisition        | \$ 2,903       |

Income would not be recognized on certain purchased loans if we could not reasonably estimate cash flows to be collected. We did not have any purchased loans for which we could not reasonably estimate cash flows to be collected.

5. Shareholders' Equity and Earnings Per Common Share

On January 22, 2018, our Board of Directors authorized a share repurchase plan (the "Repurchase Plan") to buy back up to 5% of our outstanding common stock through December 31, 2018. We expect to accomplish the repurchases through open market transactions, though we could affect repurchases through other means, such as privately negotiated transactions. The timing and amount of any share repurchases will depend on a variety of factors, including, among others, securities law restrictions, the trading price of our common stock, regulatory requirements, potential alternative uses for capital, and our financial performance. The Repurchase Plan does not obligate us to acquire any particular amount of common stock, and it may be modified or suspended at any time at our discretion. We expect to fund any repurchases from cash on hand. We did not repurchase any shares of common stock during the six months ended June 30, 2018.

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

|   | Three Months                          |         | Six Months Ended |          |
|---|---------------------------------------|---------|------------------|----------|
|   | Ended<br>June 30,<br>2018             | 2017    | June 30,<br>2018 | 2017     |
|   | (In thousands, except per share data) |         |                  |          |
| Net income  | \$8,817                               | \$5,931 | \$17,978         | \$11,905 |
| Weighted average shares outstanding (1)   | 24,109                                | 21,331  | 22,745           | 21,320   |
| Effect of stock options   | 224                                   | 143     | 179              | 147      |
| Stock units for deferred compensation plan for non-employee directors             | 126                                   | 119     | 125              | 119      |
| Performance share units   | 51                                    | 54      | 50               | 57       |
| Weighted average shares outstanding for calculation of diluted earnings per share | 24,510                                | 21,647  | 23,099           | 21,643   |
| Net income per common share   |                                       |         |                  |          |
| Basic (1)   | \$0.37                                | \$0.28  | \$0.79           | \$0.56   |
| Diluted   | \$0.36                                | \$0.27  | \$0.78           | \$0.55   |

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

32

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Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Weighted average stock options outstanding that were not considered in computing diluted net income per common share because they were anti-dilutive were zero for the three and six month periods ended June 30, 2018 and 2017, respectively.

6. Derivative Financial Instruments

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

33

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | June 30, 2018          |                                |               |
|---|------------------------|--------------------------------|---------------|
|   | Notional<br>Amount     | Average<br>Maturity<br>(years) | Fair<br>Value |
|   | (Dollars in thousands) |                                |               |
| Cash flow hedge designation                             |                        |                                |               |
| Pay-fixed interest rate swap agreements                 | \$25,000               | 3.1                            | \$494         |
| Interest rate cap agreements                            | 90,000                 | 3.3                            | 2,235         |
|   | \$115,000              | 3.3                            | \$2,729       |
|   |                        |                                |               |
| No hedge designation                                    |                        |                                |               |
| Rate-lock mortgage loan commitments                     | \$55,093               | 0.1                            | \$1,202       |
| Mandatory commitments to sell mortgage loans            | 87,640                 | 0.1                            | (233 )        |
| Pay-fixed interest rate swap agreements - commercial    | 83,867                 | 5.9                            | 1,835         |
| Pay-variable interest rate swap agreements - commercial | 83,867                 | 5.9                            | (1,835)       |
| Pay-variable interest rate swap agreements              | 10,000                 | 0.2                            | 36            |
| Purchased options                                       | 3,119                  | 3.0                            | 223           |
| Written options   | 3,119                  | 3.0                            | (223 )        |
| Total   | \$326,705              | 3.1                            | \$1,005       |
|   |                        |                                |               |
|   | December 31, 2017      |                                |               |
|   | Notional<br>Amount     | Average<br>Maturity<br>(years) | Fair<br>Value |
|   | (Dollars in thousands) |                                |               |
| Cash flow hedge designation                             |                        |                                |               |
| Pay-fixed interest rate swap agreements                 | \$15,000               | 3.7                            | \$245         |
| Interest rate cap agreements                            | 45,000                 | 3.5                            | 976           |
|   | \$60,000               | 3.6                            | \$1,221       |
|   |                        |                                |               |
| No hedge designation                                    |                        |                                |               |
| Rate-lock mortgage loan commitments                     | \$25,032               | 0.1                            | \$530         |
| Mandatory commitments to sell mortgage loans            | 56,127                 | 0.1                            | 37            |
| Pay-fixed interest rate swap agreements - commercial    | 75,990                 | 6.2                            | 292           |
| Pay-variable interest rate swap agreements - commercial | 75,990                 | 6.2                            | (292 )        |
| Purchased options                                       | 3,119                  | 3.5                            | 322           |
| Written options   | 3,119                  | 3.5                            | (322 )        |
| Total   | \$239,377              | 4.1                            | \$567         |

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

We use variable-rate and short-term fixed-rate (less than 12 months) debt obligations to fund a portion of our Condensed Consolidated Statements of Financial Condition, which exposes us to variability in interest rates. To meet our asset/liability management objectives, we may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates (“Cash Flow Hedges”). Cash Flow Hedges included certain pay-fixed interest rate swaps and interest rate cap agreements. Pay-fixed interest rate swaps convert the variable-rate cash flows on debt obligations to fixed-rates. Under interest-rate cap agreements, we will receive cash if interest rates rise above a predetermined level. As a result, we effectively have variable-rate debt with an established maximum rate. We pay an upfront premium on interest rate caps which is recognized in earnings in the same period in which the hedged item affects earnings. Unrecognized premiums from interest rate caps aggregated to \$1.5 million at June 30, 2018 and \$0.9 million at December 31, 2017.

We record the fair value of Cash Flow Hedges in accrued income and other assets and accrued expenses and other liabilities on our Condensed Consolidated Statements of Financial Condition. On an ongoing basis, we adjust our Condensed Consolidated Statements of Financial Condition to reflect the then current fair value of Cash Flow Hedges. The related gains or losses are reported in other comprehensive income or loss and are subsequently reclassified into earnings, as a yield adjustment in the same period in which the related interest on the hedged items (variable-rate debt obligations) affect earnings. It is anticipated that approximately \$0.41 million, of unrealized gains on Cash Flow Hedges at June 30, 2018 will be reclassified to earnings over the next twelve months. To the extent that the Cash Flow Hedges are not effective, the ineffective portion of the Cash Flow Hedges is immediately recognized in interest expense. The maximum term of the Cash Flow Hedge at June 30, 2018 is 4.0 years.

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

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

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

We have also entered into a pay-variable interest rate swap agreement unrelated to the commercial loan program noted above. While we have not designated this swap agreement as an accounting hedge the use of this hedge has the expectation to turn certain short-term fixed rate debt into short-term variable rate debt. The change in the swap agreement fair value will be recorded in earnings in our Condensed Consolidated Statement of Operations.

36

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Asset Derivatives                              |                |                              |               | Liability Derivatives        |               |                              |               |
|---|--|----------------|------------------------------|---------------|------------------------------|---------------|------------------------------|---------------|
|   | June 30,<br>2018                               |                | December 31,<br>2017         |               | June 30,<br>2018             |               | December 31,<br>2017         |               |
|   | Balance<br>Sheet<br>Location<br>(In thousands) | Fair<br>Value  | Balance<br>Sheet<br>Location | Fair<br>Value | Balance<br>Sheet<br>Location | Fair<br>Value | Balance<br>Sheet<br>Location | Fair<br>Value |
| Derivatives designated as<br>hedging instruments              |  |                |                              |               |                              |               |                              |               |
| Pay-fixed interest rate<br>swap agreements                    | Other<br>assets                                | \$494          | Other assets                 | \$245         | Other liabilities            | \$-           | Other liabilities            | \$-           |
| Interest rate cap<br>agreements                               | Other<br>assets                                | 2,235<br>2,729 | Other assets                 | 976<br>1,221  | Other liabilities            | -<br>-        | Other liabilities            | -<br>-        |
| Derivatives not<br>designated as hedging<br>instruments       |  |                |                              |               |                              |               |                              |               |
| Rate-lock mortgage loan<br>commitments                        | Other<br>assets                                | 1,202          | Other assets                 | 530           | Other liabilities            | -             | Other liabilities            | -             |
| Mandatory commitments<br>to sell mortgage loans               | Other<br>assets                                | -              | Other assets                 | 37            | Other liabilities            | 233           | Other liabilities            | -             |
| Pay-fixed interest rate<br>swap agreements -<br>commercial    | Other<br>assets                                | 1,976          | Other assets                 | 631           | Other liabilities            | 141           | Other liabilities            | 339           |
| Pay-variable interest rate<br>swap agreements -<br>commercial | Other<br>assets                                | 141            | Other assets                 | 339           | Other liabilities            | 1,976         | Other liabilities            | 631           |
| Pay-variable interest rate<br>swap agreements                 | Other<br>assets                                | 36             | Other assets                 | -             | Other liabilities            | -             | Other liabilities            | -             |
| Purchased options   | Other<br>assets                                | 223            | Other assets                 | 322           | Other liabilities            | -             | Other liabilities            | -             |
| Written options   | Other<br>assets                                | -              | Other assets                 | -             | Other liabilities            | 223           | Other liabilities            | 322           |
|   |  | 3,578          |                              | 1,859         |                              | 2,573         |                              | 1,292         |
| Total derivatives   |  | \$6,307        |                              | \$3,080       |                              | \$2,573       |                              | \$1,292       |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Three Month Periods Ended June 30,

|   | Gain<br>Recognized<br>in<br>Other<br>Comprehensive<br>Income<br>(Loss)<br>(Effective<br>Portion) | Location of<br>Gain<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss into<br>Income<br>(Effective<br>Portion) | Gain<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss into<br>Income<br>(Effective<br>Portion) |       | Location of<br>Gain (Loss)<br>Recognized<br>in Income (1) | Gain (Loss)<br>Recognized<br>in Income (1) |             |
|---|--|---|--|-------|---|--|-------------|
|   | 2018   | 2017  | 2018   | 2017  | 2018  | 2017                                       |             |
|   | (In thousands)   |   |  |       |   |  |             |
| <b>Cash Flow Hedges</b>                                 |  |   |  |       |   |  |             |
| Interest rate cap agreements                            | \$244  | \$ -  | Interest expense   | \$ 45 | \$ -  | Interest expense                           | \$- \$-     |
| Pay-fixed interest rate swap agreements                 | 83   | -   | Interest expense   | 8     | -   | Interest expense                           | (24 ) -     |
| Total   | \$327  | \$ -  |  | \$ 53 | \$ -  |  | \$(24 ) \$- |
| <b>No hedge designation</b>                             |  |   |  |       |   |  |             |
| Rate-lock mortgage loan commitments                     |  |   |  |       | Net gains on mortgage loans                               | \$244                                      | \$65        |
| Mandatory commitments to sell mortgage loans            |  |   |  |       | Net gains on mortgage loans                               | (110)                                      | 190         |
| Pay-fixed interest rate swap agreements - commercial    |  |   |  |       | Interest income   | 487  | (359)       |
| Pay-variable interest rate swap agreements - commercial |  |   |  |       | Interest income   | (487)                                      | 359         |
| Pay-variable interest rate swap agreements              |  |   |  |       | Interest expense  | 36   | -           |
| Purchased options                                       |  |   |  |       | Interest expense  | (6 )                                       | (35 )       |
| Written options   |  |   |  |       | Interest expense  | 6  | 35          |
| Total   |  |   |  |       |   | \$170                                      | \$255       |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Six Month Periods Ended June 30,

|   | Gain<br>Recognized<br>in<br>Other<br>Comprehensive<br>Income<br>(Loss)<br>(Effective<br>Portion)<br>2018 | Location of<br>Gain<br>Reclassified<br>from<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss into<br>Loss into<br>Income<br>(Effective<br>Portion)<br>2017 | Gain<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss into<br>Income<br>(Effective<br>Portion)<br>2018 |       | Location of<br>Gain (Loss)<br>Recognized<br>in Income (1)<br>2017 | Gain (Loss)<br>Recognized<br>in Income (1)<br>2018 |         | Gain (Loss)<br>Recognized<br>in Income (1)<br>2017 |
|---|--|--|--|-------|---|--|---------|--|
| (In thousands)                          |  |  |  |       |   |  |         |  |
| Cash Flow Hedges                        |  |  |  |       |   |  |         |  |
| Interest rate cap agreements            | \$757  | \$ -   | Interest expense   | \$ 52 | \$ -  | Interest expense                                   | \$-     | \$-  |
| Pay-fixed interest rate swap agreements | 254  | -  | Interest expense   | 7     | -   | Interest expense                                   | (12 )   | -  |
| Total                                   | \$1,011  | \$ -   |  | \$ 59 | \$ -  |  | \$(12 ) | \$-  |

No hedge designation

|   |  |  |  |  |                             |         |         |
|---|--|--|--|--|-----------------------------|---------|---------|
| Rate-lock mortgage loan commitments                     |  |  |  |  | Net gains on mortgage loans | \$672   | \$436   |
| Mandatory commitments to sell mortgage loans            |  |  |  |  | Net gains on mortgage loans | (270 )  | (606)   |
| Pay-fixed interest rate swap agreements - commercial    |  |  |  |  | Interest income             | 1,543   | (249)   |
| Pay-variable interest rate swap agreements - commercial |  |  |  |  | Interest income             | (1,543) | 249     |
| Pay-variable interest rate swap agreements              |  |  |  |  | Interest expense            | 36      | -       |
| Purchased options                                       |  |  |  |  | Interest expense            | (99 )   | 34      |
| Written options   |  |  |  |  | Interest expense            | 99      | (34 )   |
| Total   |  |  |  |  |                             | \$438   | \$(170) |

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

7. Intangible Assets

The following table summarizes intangible assets, net of amortization:

|   | June 30, 2018  |              | December 31, 2017 |              |
|---|----------------|--------------|-------------------|--------------|
|   | Gross          |              | Gross             |              |
|   | Carrying       | Accumulated  | Carrying          | Accumulated  |
|   | Amount         | Amortization | Amount            | Amortization |
|   | (In thousands) |              |                   |              |
| Amortized intangible assets - core deposits | \$11,916       | \$ 4,912     | \$ 6,118          | \$ 4,532     |
| Unamortized intangible assets - goodwill    | \$29,012       |              | \$ -              |              |

The \$5.8 million and \$29.0 million increases in the gross carrying amount of core deposit intangibles and goodwill, respectively are the result of our acquisition of TCSB (see note #16). There is no expected residual value relating to the core deposit intangible asset which is expected to be amortized over a period of 10 years (weighted average of 5.2 years).

Amortization of other intangibles has been estimated through 2022 in the following table.

|                                     | (In thousands) |
|-------------------------------------|----------------|
| Six months ending December 31, 2018 | \$ 588         |
| 2019                                | 1,089          |
| 2020                                | 1,020          |
| 2021                                | 970            |
| 2022                                | 785            |
| 2023 and thereafter                 | 2,552          |
| Total                               | \$ 7,004       |

Changes in the carrying amount of goodwill for the six month period ending June 30, 2018 follows:

|                              | (In thousands) |
|------------------------------|----------------|
| Balance at beginning of year | \$ -           |
| Acquired during the year     | 29,012         |
| Balance at end of the period | \$ 29,012      |

8. Share Based Compensation

We maintain share based payment plans that include a non-employee director stock purchase plan and a long-term incentive plan that permits the issuance of share based compensation, including stock options and non-vested share awards. The long-term incentive plan, which is shareholder approved, permits the grant of additional share based awards for up to 0.5 million shares of common stock as of June 30, 2018. The non-employee director stock purchase plan permits the issuance of additional share based payments for up to 0.2 million shares of common stock as of June 30, 2018. Share based awards and payments are measured at fair value at the date of grant and are expensed over the requisite service period. Common shares issued upon exercise of stock options come from currently authorized but

unissued shares.

40

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Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During the three month period ended June 30, 2018 pursuant to our long-term incentive plan, we granted 0.01 million shares of restricted stock to one officer. No long term incentive grants were made during the three months ended June 30, 2017. During the six month periods ended June 30, 2018 and 2017, pursuant to our long-term incentive plan, we granted 0.05 million shares of restricted stock during each period, and 0.02 million performance stock units (“PSU”), during each period to certain officers. Except for 0.002 million shares of restricted stock issued in 2018 that vest ratably over three years, the shares of restricted stock and PSUs cliff vest after a period of three years. The performance feature of the PSUs is based on a comparison of our total shareholder return over the three year period starting on the grant date to the total shareholder return over that period for a banking index of our peers.

Our directors may elect to receive a portion of their quarterly cash retainer fees in the form of common stock (either on a current basis or on a deferred basis pursuant to the non-employee director stock purchase plan referenced above). Shares equal in value to that portion of each director’s fees that he or she has elected to receive in stock are issued each quarter and vest immediately. We issued 0.005 million shares during each six month period ended June 30, of 2018 and 2017 and expensed their value during those same periods.

Total compensation expense recognized for grants pursuant to our long-term incentive plan was \$0.4 million and \$0.7 million during the three and six month periods ended June 30, 2018, respectively, and was \$0.4 million and \$0.8 million during the same periods in 2017, respectively. The corresponding tax benefit relating to this expense was \$0.1 million and \$0.2 million for the three and six month periods ended June 30, 2018, respectively and \$0.2 million and \$0.3 million for the same periods in 2017. Total expense recognized for non-employee director share based payments was \$0.05 million and \$0.11 million during the three and six month periods ended June 30, 2018, respectively, and was \$0.04 million and \$0.07 million during the same periods in 2017, respectively. The corresponding tax benefit relating to this expense was \$0.01 million and \$0.02 million for the three and six month periods ended June 30, 2018, respectively and \$0.01 million and \$0.03 million during the same periods in 2017.

At June 30, 2018, the total expected compensation cost related to non-vested restricted stock and PSUs not yet recognized was \$2.8 million. The weighted-average period over which this amount will be recognized is 2.2 years.

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

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

|  | Number of<br>Shares | Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (Years) | Aggregated<br>Intrinsic<br>Value<br>(In thousands) |
|--|---------------------|------------------------------|--|--|
| Outstanding at January 1, 2018               | 176,055             | \$ 5.24                      |  |  |
| Issued for acquisition (see note #16)        | 187,915             | 9.94                         |  |  |
| Exercised                                    | (105,208 )          | 9.35                         |  |  |
| Forfeited                                    | -                   |                              |  |  |
| Expired                                      | -                   |                              |  |  |
| Outstanding at June 30, 2018                 | 258,762             | \$ 6.98                      | 4.9  | \$ 4,791   |
| Vested and expected to vest at June 30, 2018 | 258,762             | \$ 6.98                      | 4.9  | \$ 4,791   |
| Exercisable at June 30, 2018                 | 258,762             | \$ 6.98                      | 4.9  | \$ 4,791   |

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

|                                | Number<br>of Shares | Weighted-<br>Average<br>Grant Date<br>Fair Value |
|--------------------------------|---------------------|--|
| Outstanding at January 1, 2018 | 290,527             | \$ 15.88   |
| Granted                        | 73,406              | 23.62  |
| Vested                         | (95,958 )           | 13.16  |
| Forfeited                      | (7,786 )            | 18.41  |
| Outstanding at June 30, 2018   | 260,189             | \$ 19.00   |

A summary of weighted-average assumptions used in the Black-Scholes option pricing model for the issue of stock options relating to the acquisition of TCSB (see note #16) during the second quarter of 2018 follows:

|                                       |          |
|---------------------------------------|----------|
| Expected dividend yield               | 2.62 %   |
| Risk-free interest rate               | 2.40     |
| Expected life (in years)              | 3.14     |
| Expected volatility                   | 45.99%   |
| Per share weighted-average fair value | \$ 13.25 |

The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life was obtained using a simplified method that, in general, averaged the vesting term and original contractual term of the stock option. This method was used as relevant historical data of actual exercise activity was very limited. The expected volatility was based on historical volatility of our common stock.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Certain information regarding options exercised during the periods follows:

|                        | Three Months   |        | Six Months Ended |        |
|------------------------|----------------|--------|------------------|--------|
|                        | Ended          |        | June 30,         |        |
|                        | June 30,       | 2017   | 2018             | 2017   |
|                        | 2018           | 2017   | 2018             | 2017   |
|                        | (In thousands) |        |                  |        |
| Intrinsic value        | \$ 1,596       | \$ 195 | \$ 1,674         | \$ 474 |
| Cash proceeds received | \$ 971         | \$ 33  | \$ 984           | \$ 99  |
| Tax benefit realized   | \$ 336         | \$ 68  | \$ 352           | \$ 166 |

9. Income Tax

Income tax expense was \$2.1 million and \$2.7 million during the three month periods ended June 30, 2018 and 2017, respectively and \$4.1 million and \$5.3 million during the six months ended June 30, 2018 and 2017, respectively. On December 22, 2017, "H.R. 1" (also known as the "Tax Cuts and Jobs Act") was signed into law. H.R. 1, among other things, reduced the federal corporate income tax rate to 21% effective January 1, 2018 from 35% during 2017.

Our actual federal income tax expense is different than the amount computed by applying our statutory income tax rate to our income before income tax primarily due to tax-exempt interest income and tax-exempt income from the increase in the cash surrender value on life insurance. In addition, the three and six month periods ending June 30, 2018 include reductions of \$0.1 million and \$0.3 million, respectively, of income tax expense related to impact of the excess value of stock awards that vested and stock options that were exercised as compared to the initial fair values that were expensed. These amounts during the same periods in 2017 were \$0.1 million and \$0.2 million, respectively.

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at both June 30, 2018 and 2017, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

At both June 30, 2018 and December 31, 2017, we had approximately \$0.7 million, of gross unrecognized tax benefits. We do not expect the total amount of unrecognized tax benefits to significantly increase or decrease during the balance of 2018.

10. Regulatory Matters

Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law limit the amount of cash dividends our Bank can pay to us. Under these guidelines, the amount of dividends that may be paid in any calendar year is limited to the Bank's current year net profits, combined with the retained net profits of the preceding two years. Further, the Bank cannot pay a dividend at any time that it has negative undivided profits. As of June 30, 2018, the Bank had positive undivided profits of \$26.9 million. It is not our intent to have dividends paid in amounts that would reduce the capital of our Bank to levels below those which we consider prudent and in accordance with guidelines of regulatory authorities.

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

We are also subject to various regulatory capital requirements. The prompt corrective action regulations establish quantitative measures to ensure capital adequacy and require minimum amounts and ratios of total, Tier 1, and common equity Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets. Failure to meet minimum capital requirements can result in certain mandatory, and possibly discretionary, actions by regulators that could have a material effect on our interim condensed consolidated financial statements. Under capital adequacy guidelines, we must meet specific capital requirements that involve quantitative measures as well as qualitative judgments by the regulators. The most recent regulatory filings as of June 30, 2018 and December 31, 2017, categorized our Bank as well capitalized. Management is not aware of any conditions or events that would have changed the most recent Federal Deposit Insurance Corporation (“FDIC”) categorization.

On July 2, 2013, the Federal Reserve approved a final rule that establishes an integrated regulatory capital framework (the “New Capital Rules”). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The capital conservation buffer began to phase in on January 1, 2016 with 1.875% and 1.25% added to the minimum ratio for adequately capitalized institutions for 2018 and 2017, respectively and 0.625% will be added each subsequent year until fully phased in during 2019. This capital conservation buffer is not reflected in the table that follows. To avoid limits on capital distributions and certain discretionary bonus payments we must meet the minimum ratio for adequately capitalized institutions plus the phased in buffer. The rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity Tier 1 capital, the most loss-absorbing form of capital, and implement strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Our actual capital amounts and ratios follow:

|  | Actual<br>Amount<br>(Dollars in thousands) | Ratio  | Minimum for<br>Adequately<br>Capitalized<br>Institutions<br>Amount | Ratio | Minimum for<br>Well-Capitalized<br>Institutions<br>Amount | Ratio  |
|--|--|--------|--|-------|---|--------|
| June 30, 2018  |  |        |  |       |   |        |
| Total capital to risk-weighted assets                |  |        |  |       |   |        |
| Consolidated   | \$359,585                                  | 14.49% | \$ 198,495   | 8.00  | % NA  | NA     |
| Independent Bank                                     | 335,404                                    | 13.52  | 198,431  | 8.00  | \$248,038   | 10.00% |
| Tier 1 capital to risk-weighted assets               |  |        |  |       |   |        |
| Consolidated   | \$335,033                                  | 13.50% | \$ 148,871   | 6.00  | % NA  | NA     |
| Independent Bank                                     | 310,852                                    | 12.53  | 148,823  | 6.00  | \$198,431   | 8.00%  |
| Common equity tier 1 capital to risk-weighted assets |  |        |  |       |   |        |
| Consolidated   | \$296,903                                  | 11.97% | \$ 111,654   | 4.50  | % NA  | NA     |
| Independent Bank                                     | 310,852                                    | 12.53  | 111,617  | 4.50  | \$161,225   | 6.50%  |
| Tier 1 capital to average assets                     |  |        |  |       |   |        |
| Consolidated   | \$335,033                                  | 10.70% | \$ 125,215   | 4.00  | % NA  | NA     |
| Independent Bank                                     | 310,852                                    | 9.93   | 125,156  | 4.00  | \$156,445   | 5.00%  |
| December 31, 2017                                    |  |        |  |       |   |        |
| Total capital to risk-weighted assets                |  |        |  |       |   |        |
| Consolidated   | \$312,163                                  | 15.16% | \$ 164,782   | 8.00  | % NA  | NA     |
| Independent Bank                                     | 290,188                                    | 14.10  | 164,675  | 8.00  | \$205,843   | 10.00% |
| Tier 1 capital to risk-weighted assets               |  |        |  |       |   |        |
| Consolidated   | \$288,451                                  | 14.00% | \$ 123,586   | 6.00  | % NA  | NA     |
| Independent Bank                                     | 266,476                                    | 12.95  | 123,506  | 6.00  | \$164,675   | 8.00%  |
| Common equity tier 1 capital to risk-weighted assets |  |        |  |       |   |        |
| Consolidated   | \$255,934                                  | 12.43% | \$ 92,690  | 4.50  | % NA  | NA     |
| Independent Bank                                     | 266,476                                    | 12.95  | 92,630   | 4.50  | \$133,798   | 6.50%  |
| Tier 1 capital to average assets                     |  |        |  |       |   |        |
| Consolidated   | \$288,451                                  | 10.57% | \$ 109,209   | 4.00  | % NA  | NA     |
| Independent Bank                                     | 266,476                                    | 9.78   | 109,041  | 4.00  | \$136,301   | 5.00%  |

NA - Not applicable



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The components of our regulatory capital are as follows:

|   | Consolidated     |                         | Independent Bank |                         |
|---|------------------|-------------------------|------------------|-------------------------|
|   | June 30,<br>2018 | December<br>31,<br>2017 | June 30,<br>2018 | December<br>31,<br>2017 |
|   | (In thousands)   |                         |                  |                         |
| Total shareholders' equity  | \$337,083        | \$ 264,933              | \$343,500        | \$ 269,481              |
| Add (deduct)  |                  |                         |                  |                         |
| Accumulated other comprehensive loss for regulatory purposes  | 3,417            | 201                     | 3,417            | 201                     |
| Intangible assets   | (36,016 )        | (1,269 )                | (36,016 )        | (1,269 )                |
| Disallowed deferred tax assets  | (7,581 )         | (7,931 )                | (49 )            | (1,937 )                |
| Common equity tier 1 capital  | 296,903          | 255,934                 | 310,852          | 266,476                 |
| Qualifying trust preferred securities   | 38,130           | 34,500                  | -                | -                       |
| Disallowed deferred tax assets  | -                | (1,983 )                | -                | -                       |
| Tier 1 capital  | 335,033          | 288,451                 | 310,852          | 266,476                 |
| Allowance for loan losses and allowance for unfunded lending commitments limited to 1.25% of total risk-weighted assets | 24,552           | 23,712                  | 24,552           | 23,712                  |
| Total risk-based capital  | \$359,585        | \$ 312,163              | \$335,404        | \$ 290,188              |

11. Fair Value Disclosures

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

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

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

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

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

Securities: Where quoted market prices are available in an active market, securities (equity securities at fair value, trading or available for sale) are classified as Level 1 of the valuation hierarchy. Level 1 securities include certain preferred stocks included in our equity securities at fair value (trading securities as of December 31, 2017) for which there are quoted prices in active markets and US Treasuries (at December 31, 2017) in our securities available for sale portfolio. If quoted market prices are not available for the specific security, then fair values are estimated by (1) using quoted market prices of securities with similar characteristics, (2) matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted prices, or (3) a discounted cash flow analysis whose significant fair value inputs can generally be verified and do not typically involve judgment by management. These securities are classified as Level 2 of the valuation hierarchy and primarily include agency securities, private label mortgage-backed securities, other asset backed securities, obligations of states and political subdivisions, trust preferred securities, corporate securities and foreign government securities.

Loans held for sale: The fair value of mortgage loans held for sale is based on agency cash window loan pricing for comparable assets (recurring Level 2).

Impaired loans with specific loss allocations based on collateral value: From time to time, certain loans are considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. We measure our investment in an impaired loan based on one of three methods: the loan's observable market price, the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2018 and December 31, 2017, all of our impaired loans were evaluated based on either the fair value of the collateral or the present value of expected future cash flows discounted at the loan's effective interest rate. When the fair value of the collateral is based on an appraised value or when an appraised value is not available we record the impaired loan as nonrecurring Level 3. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and thus will typically result in a Level 3 classification of the inputs for determining fair value.

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Fair Value Measurements | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Un-observable Inputs (Level 3) |
|---|-------------------------|--|---|--|
| June 30, 2018:                                    |                         |  |   |  |
| Measured at Fair Value on a Recurring Basis       |                         |  |   |  |
| Assets  |                         |  |   |  |
| Equity securities at fair value                   | \$336                   | \$ 336   | \$ -  | \$ -                                       |
| Securities available for sale                     |                         |  |   |  |
| U.S. agency                                       | 22,812                  | -  | 22,812  | -  |
| U.S. agency residential mortgage-backed           | 130,001                 | -  | 130,001                                       | -  |
| U.S. agency commercial mortgage-backed            | 9,384                   | -  | 9,384   | -  |
| Private label mortgage-backed                     | 30,283                  | -  | 30,283  | -  |
| Other asset backed                                | 77,280                  | -  | 77,280  | -  |
| Obligations of states and political subdivisions  | 144,079                 | -  | 144,079                                       | -  |
| Corporate   | 32,835                  | -  | 32,835  | -  |
| Trust preferred                                   | 1,898                   | -  | 1,898   | -  |
| Foreign government                                | 2,021                   | -  | 2,021   | -  |
| Loans held for sale                               | 50,915                  | -  | 50,915  | -  |
| Capitalized mortgage loan servicing rights        | 21,848                  | -  | -   | 21,848                                     |
| Derivatives (1)                                   | 6,307                   | -  | 6,307   | -  |
| Liabilities                                       |                         |  |   |  |
| Derivatives (2)                                   | 2,573                   | -  | 2,573   | -  |
| Measured at Fair Value on a Non-recurring basis:  |                         |  |   |  |
| Assets  |                         |  |   |  |
| Impaired loans (3)                                |                         |  |   |  |
| Commercial  |                         |  |   |  |
| Income producing - real estate                    | 280                     | -  | -   | 280  |
| Land, land development & construction-real estate | 1                       | -  | -   | 1  |
| Commercial and industrial                         | 970                     | -  | -   | 970  |
| Mortgage  |                         |  |   |  |
| 1-4 family  | 271                     | -  | -   | 271  |
| Resort lending                                    | 282                     | -  | -   | 282  |
| Other real estate (4)                             |                         |  |   |  |

|                |    |   |   |    |
|----------------|----|---|---|----|
| Mortgage       |    |   |   |    |
| 1-4 family     | 71 | - | - | 71 |
| Resort lending | 65 | - | - | 65 |

(1) Included in accrued income and other assets

(2) Included in accrued expenses and other liabilities

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

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

49

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

|   | Fair Value Measurements Using |             |             |        |
|---|-------------------------------|-------------|-------------|--------|
|   | Quoted                        |             |             |        |
|   | Prices                        |             |             |        |
|   | in                            |             |             |        |
|   | Active                        |             |             |        |
|   | Markets                       |             |             |        |
|   | for                           | Significant | Significant |        |
|   | Identical                     | Other       | Un-         |        |
| Fair Value  | Assets                        | Observable  | observable  |        |
| Measure-  | (Level                        | Inputs      | Inputs      |        |
| ments   | 1)                            | (Level 2)   | (Level 3)   |        |
| (In thousands)                                    |                               |             |             |        |
| December 31, 2017:                                |                               |             |             |        |
| Measured at Fair Value on a Recurring Basis:      |                               |             |             |        |
| Assets  |                               |             |             |        |
| Trading securities                                | \$455                         | \$ 455      | \$ -        | \$ -   |
| Securities available for sale                     |                               |             |             |        |
| U.S. Treasury                                     | 898                           | 898         | -           | -      |
| U.S. agency                                       | 25,682                        | -           | 25,682      | -      |
| U.S. agency residential mortgage-backed           | 137,918                       | -           | 137,918     | -      |
| U.S. agency commercial mortgage-backed            | 9,760                         | -           | 9,760       | -      |
| Private label mortgage-backed                     | 29,109                        | -           | 29,109      | -      |
| Other asset backed                                | 93,898                        | -           | 93,898      | -      |
| Obligations of states and political subdivisions  | 172,945                       | -           | 172,945     | -      |
| Corporate   | 47,853                        | -           | 47,853      | -      |
| Trust preferred                                   | 2,802                         | -           | 2,802       | -      |
| Foreign government                                | 2,060                         | -           | 2,060       | -      |
| Loans held for sale                               | 39,436                        | -           | 39,436      | -      |
| Capitalized mortgage loan servicing rights        | 15,699                        | -           | -           | 15,699 |
| Derivatives (1)                                   | 3,080                         | -           | 3,080       | -      |
| Liabilities                                       |                               |             |             |        |
| Derivatives (2)                                   | 1,292                         | -           | 1,292       | -      |
| Measured at Fair Value on a Non-recurring basis:  |                               |             |             |        |
| Assets  |                               |             |             |        |
| Impaired loans (3)                                |                               |             |             |        |
| Commercial  |                               |             |             |        |
| Income producing - real estate                    | 274                           | -           | -           | 274    |
| Land, land development & construction-real estate | 9                             | -           | -           | 9      |
| Commercial and industrial                         | 1,051                         | -           | -           | 1,051  |
| Mortgage  |                               |             |             |        |
| 1-4 family  | 339                           | -           | -           | 339    |
| Resort lending                                    | 207                           | -           | -           | 207    |
| Other real estate (4)                             |                               |             |             |        |
| Mortgage  |                               |             |             |        |
| 1-4 family  | 186                           | -           | -           | 186    |
| Resort lending                                    | 65                            | -           | -           | 65     |



- (1) Included in accrued income and other assets
- (2) Included in accrued expenses and other liabilities
- (3) Only includes impaired loans with specific loss allocations based on collateral value.
- (4) Only includes other real estate with subsequent write downs to fair value.

There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2018 and 2017.

50

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|  | Changes in Fair Values for the six-Month Periods<br>Ended June 30 for Items Measured at Fair Value<br>Pursuant to Election of the Fair Value Option |                   |                        | Total<br>Change<br>in Fair<br>Values<br>Included<br>in Current |
|--|---|-------------------|------------------------|--|
|  | Net Gains (Losses)<br>on Assets   | Mortgage<br>Loans | Loan<br>Servicing, net |  |
|  | Securities  | Loans             | Period<br>Earnings     |  |
|  | (In thousands)  |                   |                        |  |
| 2018                                       |   |                   |                        |  |
| Equity securities at fair value            | \$ (119 )   | \$ -              | \$ -                   | \$ (119 )  |
| Loans held for sale                        | -   | 367               | -                      | 367  |
| Capitalized mortgage loan servicing rights | -   | -                 | 892                    | 892  |
| 2017                                       |   |                   |                        |  |
| Trading securities                         | \$ (124 )   | \$ -              | \$ -                   | \$ (124 )  |
| Loans held for sale                        | -   | 666               | -                      | 666  |
| Capitalized mortgage loan servicing rights | -   | -                 | (1,495 )               | (1,495 )   |

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

The following represent impairment charges recognized during the three and six month periods ended June 30, 2018 and 2017 relating to assets measured at fair value on a non-recurring basis:

Loans which are measured for impairment using the fair value of collateral for collateral dependent loans had a carrying amount of \$2.7 million, with a valuation allowance of \$0.9 million at June 30, 2018, and had a carrying amount of \$2.6 million, with a valuation allowance of \$0.7 million at December 31, 2017. The provision for loan losses included in our results of operations relating to impaired loans was a net expense of \$0.5 million and \$0.1 million for the three month periods ending June 30, 2018 and 2017, respectively, and a net expense of \$0.5 million and \$0.3 million for the six month periods ending June 30, 2018 and 2017, respectively.

Other real estate, which is measured using the fair value of the property, had a carrying amount of \$0.1 million which is net of a valuation allowance of \$0.1 million at June 30, 2018, and a carrying amount of \$0.3 million, which is net of a valuation allowance of \$0.1 million, at December 31, 2017. Charges included in our results of operations relating to other real estate measured at fair value were zero during each of the three and six month periods ended June 30, 2018, and were \$0.03 million and \$0.04 million during the same periods in 2017.



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|   | Capitalized Mortgage Loan Servicing Rights               |           |  |           |
|---|--|-----------|--|-----------|
|   | Three Months Ended<br>June 30,<br>2018<br>(In thousands) |           | Six Months Ended<br>June 30,<br>2017<br>(In thousands) |           |
| Beginning balance                                       | \$ 17,783  | \$ 14,727 | \$ 15,699  | \$ -      |
| Change in accounting                                    | -  | -         | -  | 14,213    |
| Beginning balance, as adjusted                          | 17,783   | 14,727    | 15,699   | 14,213    |
| Total gains (losses) realized and unrealized:           |  |           |  |           |
| Included in results of operations                       | (137 )   | (1,231 )  | 892  | (1,495 )  |
| Included in other comprehensive income (loss)           | -  | -         | -  | -         |
| Purchases, issuances, settlements, maturities and calls | 4,202  | 1,019     | 5,257  | 1,797     |
| Transfers in and/or out of Level 3                      | -  | -         | -  | -         |
| Ending balance  | \$ 21,848  | \$ 14,515 | \$ 21,848  | \$ 14,515 |

Amount of total gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to assets and liabilities still held at June 30

|  |           |             |        |             |
|--|-----------|-------------|--------|-------------|
|  | \$ (137 ) | \$ (1,231 ) | \$ 892 | \$ (1,495 ) |
|--|-----------|-------------|--------|-------------|

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

|  | Asset<br>Fair<br>Value<br>(In thousands) | Valuation<br>Technique                 | Unobservable<br>Inputs   | Range  | Weighted<br>Average              |
|--|--|--|--|--|----------------------------------|
| June 30, 2018                              |  |  |  |  |                                  |
| Capitalized mortgage loan servicing rights | \$ 21,848                                | Present value of net servicing revenue | Discount rate<br>Cost to service<br>Ancillary income<br>Float rate | 10.00% to 13.00 %<br>\$ 42 to \$ 216<br>18 to 36<br>2.89 % | 10.13 %<br>\$ 81<br>23<br>2.89 % |
| December 31, 2017                          |  |  |  |  |                                  |
| Capitalized mortgage loan servicing rights | \$ 15,699                                | Present value of net servicing revenue | Discount rate<br>Cost to service                                   | 9.88% to 11.00 %<br>\$ 66 to \$ 216<br>20 to 36            | 10.11 %<br>\$ 81<br>23           |

|                                   |      |   |      |   |
|-----------------------------------|------|---|------|---|
| Ancillary<br>income<br>Float rate | 2.24 | % | 2.24 | % |
|-----------------------------------|------|---|------|---|

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

|                   | Asset<br>Fair Value<br>(In thousands) | Valuation<br>Technique    | Unobservable<br>Inputs                              | Range            | Weighted<br>Average |
|-------------------|---------------------------------------|---------------------------|---|------------------|---------------------|
| June 30, 2018     |                                       |                           |   |                  |                     |
| Impaired loans    |                                       |                           |   |                  |                     |
| Commercial        | \$1,251                               | Sales comparison approach | Adjustment for differences between comparable sales | (32.5)% to 25.0% | (4.1 )%             |
| Mortgage          | 553                                   | Sales comparison approach | Adjustment for differences between comparable sales | (40.1) to 25.6   | (4.4 )              |
| Other real estate |                                       |                           |   |                  |                     |
| Mortgage          | 136                                   | Sales comparison approach | Adjustment for differences between comparable sales | (33.0) to 44.5   | (2.0 )              |
| December 31, 2017 |                                       |                           |   |                  |                     |
| Impaired loans    |                                       |                           |   |                  |                     |
| Commercial        | 1,334                                 | Sales comparison approach | Adjustment for differences between comparable sales | (32.5)% to 25.0% | (4.5 )%             |
| Mortgage          | 546                                   | Sales comparison approach | Adjustment for differences between comparable sales | (21.1) to 34.1   | (2.7 )              |
| Other real estate |                                       |                           |   |                  |                     |
| Mortgage          | 251                                   | Sales comparison approach | Adjustment for differences between comparable sales | (33.0) to 44.5   | (1.0 )              |

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

|                     | Aggregate<br>Fair Value<br>(In thousands) | Difference | Contractual<br>Principal |
|---------------------|---|------------|--------------------------|
| Loans held for sale |   |            |                          |
| June 30, 2018       | \$50,915                                  | \$ 1,211   | \$ 49,704                |
| December 31, 2017   | 39,436                                    | 844        | 38,592                   |

12. Fair Values of Financial Instruments

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

be a precise estimate. Changes in assumptions could significantly affect the estimates.

53

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Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

As discussed in note #2, we adopted ASU 2016-02 as of January 1, 2018. This new ASU requires entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. All of estimated fair values of our financial instruments in the table below at June 30, 2018 have used this exit price notion. In addition, except as discussed below in the net loans and loans held for sale section, all of our financial assets and liabilities have historically been valued using an exit price notion. This new ASU also removes the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost. The methods and significant assumptions for those financial instruments measured at amortized cost disclosed below are presented for fair values at December 31, 2017.

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

Cash and due from banks and interest bearing deposits: The recorded book balance of cash and due from banks and interest bearing deposits approximate fair value and are classified as Level 1.

Interest bearing deposits - time: Interest bearing deposits - time have been valued based on a model using a benchmark yield curve plus a base spread and are classified as Level 2.

Securities: Financial instrument assets actively traded in a secondary market have been valued using quoted market prices. Equity securities at fair value, trading securities and U.S. Treasury securities available for sale are classified as Level 1 while all other securities available for sale are classified as Level 2 as described in note #11.

Federal Home Loan Bank and Federal Reserve Bank stock: It is not practicable to determine the fair value of FHLB and FRB stock due to restrictions placed on transferability.

Net loans and loans held for sale: The fair value of loans at December 31, 2017 is calculated by discounting estimated future cash flows using estimated market discount rates that reflect credit and interest-rate risk inherent in the loans and do not necessarily represent an exit price. Loans are classified as Level 3. Impaired loans are valued at the lower of cost or fair value as described in note #11. Loans held for sale are classified as Level 2 as described in note #11.

Accrued interest receivable and payable: The recorded book balance of accrued interest receivable and payable approximate fair value and are classified at the same Level as the asset and liability they are associated with.

Derivative financial instruments: The fair value of rate-lock mortgage loan commitments is based on agency cash window loan pricing for comparable assets, the fair value of mandatory commitments to sell mortgage loans is based on mortgage backed security pricing for comparable assets, the fair value of interest rate swap and interest rate cap agreements is derived from proprietary models which utilize current market data whose significant fair value inputs can generally be observed in the market place and do not typically involve judgment by management and the fair value of purchased and written options is based on prices of financial instruments with similar characteristics and do not typically involve judgment by management. Each of these instruments has been classified as Level 2 as described in note #11.



Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Deposits: Deposits without a stated maturity, including demand deposits, savings, NOW and money market accounts, have a fair value equal to the amount payable on demand. Each of these instruments is classified as Level 1. Deposits with a stated maturity, such as time deposits have generally been valued based on the discounted value of contractual cash flows using a discount rate approximating current market rates for liabilities with a similar maturity resulting in a Level 2 classification.

Other borrowings: Other borrowings have been valued based on the discounted value of contractual cash flows using a discount rate approximating current market rates for liabilities with a similar maturity resulting in a Level 2 classification.

Subordinated debentures: Subordinated debentures have generally been valued based on a quoted market price of similar instruments resulting in a Level 2 classification.

55

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IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The estimated recorded book balances and fair values follow:

|  | Recorded<br>Book<br>Balance<br>(In thousands) | Fair<br>Value | Fair Value Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Un-<br>observable<br>Inputs<br>(Level 3) |
|--|---|---------------|---|---|---|
| June 30, 2018                              |   |               |   |   |   |
| Assets                                     |   |               |   |   |   |
| Cash and due from banks                    | \$36,433                                      | \$36,433      | \$36,433  | \$ -  | \$ -  |
| Interest bearing deposits                  | 22,278  | 22,278        | 22,278  | -   | -   |
| Interest bearing deposits - time           | 2,478   | 2,472         | -   | 2,472   | -   |
| Equity securities at fair value            | 336   | 336           | 336   | -   | -   |
| Securities available for sale              | 450,593                                       | 450,593       | -   | 450,593   | -   |
| Federal Home Loan Bank and Federal Reserve |   |               |   |   |   |
| Bank Stock                                 | 16,321  | NA            | NA  | NA  | NA  |
| Net loans and loans held for sale          | 2,507,944                                     | 2,477,253     | -   | 64,131  | 2,413,122   |
| Accrued interest receivable                | 9,722   | 9,722         | 1   | 1,870   | 7,851   |
| Derivative financial instruments           | 6,307   | 6,307         | -   | 6,307   | -   |
| Liabilities                                |   |               |   |   |   |
| Deposits with no stated maturity (1)       | \$2,120,537                                   | \$2,120,537   | \$2,120,537   | \$ -  | \$ -  |
| Deposits with stated maturity (1)          | 659,979                                       | 654,745       | -   | 654,745   | -   |
| Other borrowings                           | 40,584  | 40,604        | -   | 40,604  | -   |
| Subordinated debentures                    | 39,354  | 36,082        | -   | 36,082  | -   |
| Accrued interest payable                   | 1,331   | 1,331         | 86  | 1,245   | -   |
| Derivative financial instruments           | 2,573   | 2,573         | -   | 2,573   | -   |
| December 31, 2017                          |   |               |   |   |   |
| Assets                                     |   |               |   |   |   |
| Cash and due from banks                    | \$36,994                                      | \$36,994      | \$36,994  | \$ -  | \$ -  |
| Interest bearing deposits                  | 17,744  | 17,744        | 17,744  | -   | -   |
| Interest bearing deposits - time           | 2,739   | 2,740         | -   | 2,740   | -   |
| Trading securities                         | 455   | 455           | 455   | -   | -   |
| Securities available for sale              | 522,925                                       | 522,925       | 898   | 522,027   | -   |
| Federal Home Loan Bank and Federal Reserve |   |               |   |   |   |
| Bank Stock                                 | 15,543  | NA            | NA  | NA  | NA  |
| Net loans and loans held for sale          | 2,035,666                                     | 1,962,937     | -   | 39,436  | 1,923,501   |
| Accrued interest receivable                | 8,609   | 8,609         | 1   | 2,192   | 6,416   |
| Derivative financial instruments           | 3,080   | 3,080         | -   | 3,080   | -   |
| Liabilities                                |   |               |   |   |   |

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|                                      |             |             |             |         |     |
|--------------------------------------|-------------|-------------|-------------|---------|-----|
| Deposits with no stated maturity (1) | \$1,845,716 | \$1,845,716 | \$1,845,716 | \$-     | \$- |
| Deposits with stated maturity (1)    | 554,818     | 551,489     | -           | 551,489 | -   |
| Other borrowings                     | 54,600      | 54,918      | -           | 54,918  | -   |
| Subordinated debentures              | 35,569      | 29,946      | -           | 29,946  | -   |
| Accrued interest payable             | 892         | 892         | 48          | 844     | -   |
| Derivative financial instruments     | 1,292       | 1,292       | -           | 1,292   | -   |

Deposits with no stated maturity include reciprocal deposits with a recorded book balance of \$22.0 million and \$13.0 million at June 30, 2018 and December 31, 2017, respectively. Deposits with a stated maturity include (1) reciprocal deposits with a recorded book balance of \$44.5 million and \$38.0 million June 30, 2018 and December 31, 2017, respectively.

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

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

13. Contingent Liabilities

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

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

In connection with the sale of Mepco Finance Corporation (“Mepco”) (see note #15), we agreed to contractually indemnify the purchaser from certain losses it may incur, including as a result of its failure to collect certain receivables it purchased as part of the business as well as breaches of representations and warranties we made in the sale agreement, subject to various limitations. We have not accrued any liability related to these indemnification requirements in our June 30, 2018 Condensed Consolidated Statement of Financial Condition because we believe the likelihood of having to pay any amount as a result of these indemnification obligations is remote. However, if the purchaser is unable to collect the receivables it purchased from Mepco or otherwise encounters difficulties in operating the business, it is possible it could make one or more claims against us pursuant to the sale agreement. In that event, we may incur expenses in defending any such claims and/or amounts paid to such purchaser to resolve such claims. As of June 30, 2018 these receivables balances had declined to \$4.5 million and to date the purchaser has made no claims for indemnification.

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The provision for loss reimbursement on sold loans represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the FHLB). Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The provision for loss reimbursement on sold loans was an expense of \$0.02 million during both three month periods ended June 30, 2018 and 2017 and an expense of \$0.03 million and \$0.05 million for the six month periods ended June 30, 2018 and 2017, respectively. The reserve for loss reimbursements on sold mortgage loans totaled \$0.8 million and \$0.7 million at June 30, 2018 and December 31, 2017, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition. This reserve is based on an analysis of mortgage loans that we have sold which are further categorized by delinquency status, loan to value, and year of origination. The calculation includes factors such as probability of default, probability of loss reimbursement (breach of representation or warranty) and estimated loss severity. We believe that the amounts that we have accrued for incurred losses on sold mortgage loans are appropriate given our analyses. However, future losses could exceed our current estimate.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

14. Accumulated Other Comprehensive Loss (“AOCL”)

A summary of changes in AOCL follows:

|  | Unrealized<br>Gains<br>(Losses)<br>on<br>Securities<br>Available<br>for Sale<br>(In thousands) | Dispropor-<br>tionate<br>Tax Effects<br>from<br>Securities<br>Available<br>for Sale | Unrealized<br>Gains on<br>Cash Flow<br>Hedges | Total      |
|--|--|---|---|------------|
| For the three months ended June 30,                        |  |   |   |            |
| 2018   |  |   |   |            |
| Balances at beginning of period                            | \$ (3,509)   | \$ (5,798 )   | \$ 805  | \$ (8,502) |
| Other comprehensive income (loss) before reclassifications | (949 )   | -   | 258   | (691 )     |
| Amounts reclassified from AOCL                             | 21   | -   | (42 )   | (21 )      |
| Net current period other comprehensive income (loss)       | (928 )   | -   | 216   | (712 )     |
| Balances at end of period                                  | \$ (4,437)   | \$ (5,798 )   | \$ 1,021                                      | \$ (9,214) |
| 2017   |  |   |   |            |
| Balances at beginning of period                            | \$ (738 )  | \$ (5,798 )   | \$ -  | \$ (6,536) |
| Cumulative effect of change in accounting                  | -  | -   | -   | -          |
| Balances at beginning of period, as adjusted               | (738 )   | (5,798 )  | -   | (6,536)    |
| Other comprehensive income (loss) before reclassifications | 2,731  | -   | -   | 2,731      |
| Amounts reclassified from AOCL                             | (7 )   | -   | -   | (7 )       |
| Net current period other comprehensive income (loss)       | 2,724  | -   | -   | 2,724      |
| Balances at end of period                                  | \$ 1,986   | \$ (5,798 )   | \$ -  | \$ (3,812) |
| For the six months ended June 30,                          |  |   |   |            |
| 2018   |  |   |   |            |
| Balances at beginning of period                            | \$ (470 )  | \$ (5,798 )   | \$ 269  | \$ (5,999) |
| Other comprehensive income (loss) before reclassifications | (4,003)  | -   | 799   | (3,204)    |
| Amounts reclassified from AOCL                             | 36   | -   | (47 )   | (11 )      |
| Net current period other comprehensive income (loss)       | (3,967)  | -   | 752   | (3,215)    |
| Balances at end of period                                  | \$ (4,437)   | \$ (5,798 )   | \$ 1,021                                      | \$ (9,214) |
| 2017   |  |   |   |            |
| Balances at beginning of period                            | \$ (3,310)   | \$ (5,798 )   | \$ -  | \$ (9,108) |
| Cumulative effect of change in accounting                  | 300  | -   | -   | 300        |
| Balances at beginning of period, as adjusted               | (3,010)  | (5,798 )  | -   | (8,808)    |
| Other comprehensive income (loss) before reclassifications | 5,072  | -   | -   | 5,072      |
| Amounts reclassified from AOCL                             | (76 )  | -   | -   | (76 )      |
| Net current period other comprehensive income (loss)       | 4,996  | -   | -   | 4,996      |
| Balances at end of period                                  | \$ 1,986   | \$ (5,798 )   | \$ -  | \$ (3,812) |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

| AOCL Component                                     | Amount<br>Reclassified<br>From<br>AOCL<br>(In thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|--|--|--|
| 2018   |  |  |
| Unrealized losses on securities available for sale | \$ (26   | ) Net gains (losses) on securities                                       |
|  | -  | ) Net impairment loss recognized in earnings                             |
|  | (26  | ) Total reclassifications before tax                                     |
|  | (5   | ) Income tax expense   |
|  | \$ (21   | ) Reclassifications, net of tax  |
| Unrealized gains on cash flow hedges               | \$ (53   | ) Interest expense   |
|  | (11  | ) Income tax expense   |
|  | \$ (42   | ) Reclassification, net of tax   |
|  | \$ 21  | Total reclassifications for the period, net of tax                       |
| 2017   |  |  |
| Unrealized gains on securities available for sale  | \$ 11  | Net gains (losses) on securities   |
|  | -  | Net impairment loss recognized in earnings                               |
|  | 11   | Total reclassifications before tax                                       |
|  | 4  | Income tax expense   |
|  | \$ 7   | Reclassifications, net of tax  |



IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

| AOCL Component                                     | Amount<br>Reclassified<br>From<br>AOCL<br>(In thousands) | Affected Line Item in Condensed<br>Consolidated Statements of Operations |
|--|--|--|
| 2018   |  |  |
| Unrealized losses on securities available for sale | \$ (45   | ) Net gains (losses) on securities                                       |
|  | -  | ) Net impairment loss recognized in earnings                             |
|  | (45  | ) Total reclassifications before tax                                     |
|  | (9   | ) Income tax expense   |
|  | \$ (36   | ) Reclassifications, net of tax  |
| Unrealized gains on cash flow hedges               | \$ (59   | ) Interest expense   |
|  | (12  | ) Income tax expense   |
|  | \$ (47   | ) Reclassification, net of tax   |
|  | \$ 11  | Total reclassifications for the period, net of tax                       |
| 2017   |  |  |
| Unrealized gains on securities available for sale  | \$ 117   | Net gains (losses) on securities   |
|  | -  | Net impairment loss recognized in earnings                               |
|  | 117  | Total reclassifications before tax                                       |
|  | 41   | Income tax expense   |
|  | \$ 76  | Reclassifications, net of tax  |

15. Mepco Sale

On December 30, 2016, Mepco executed an Asset Purchase Agreement (the "APA") with Seabury Asset Management LLC ("Seabury"). Pursuant to the terms of the APA, we sold our payment plan processing business, payment plan receivables, and certain other assets to Seabury, who also assumed certain liabilities of Mepco.

This transaction closed on May 18, 2017, with an effective date of May 1, 2017. As a result of the closing, Mepco sold \$33.1 million of net payment plan receivables, \$0.5 million of commercial loans, \$0.2 million of furniture and equipment and \$1.6 million of other assets to Seabury, who also assumed \$2.0 million of specified liabilities. We received cash totaling \$33.4 million and recorded no gain or loss in 2017 as the assets were sold and the liabilities were assumed at book value.

IndexNOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

16. Recent Acquisition

Effective April 1, 2018, we completed the acquisition of all of the issued and outstanding shares of common stock of TCSB through a merger of TCSB into Independent Bank Corporation (“IBCP”), with IBCP as the surviving corporation (the “Merger”). On that same date we also consolidated Traverse City State Bank, TCSB’s wholly-owned subsidiary bank, into Independent Bank (with Independent Bank as the surviving institution). Under the terms of the merger agreement each holder of TCSB common stock received 1.1166 shares of IBCP common stock plus cash in lieu of fractional shares totaling \$0.005 million. TCSB option holders had their options converted into IBCP stock options. As a result we issued 2.71 million shares of common stock and 0.19 million stock options with a fair value of approximately \$64.5 million to the shareholders and option holders of TCSB. The fair value of common stock and stock options issued as the consideration paid for TCSB was determined using the closing price of our common stock on the acquisition date. This acquisition was accounted for under the acquisition method of accounting. Accordingly, we recognized amounts for identifiable assets acquired and liabilities assumed at their estimated acquisition date fair values. TCSB results of operations are included in our results beginning April 1, 2018. Non-interest expense includes \$3.1 million and \$3.3 million of costs incurred during the three and six month periods ended June 30, 2018, respectively related to the Merger. Any remaining merger related costs will be expensed as incurred in future periods.

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

|  | (In thousands) |
|--|----------------|
| Cash and cash equivalents                    | \$ 23,521      |
| Interest bearing deposits - time             | 4,054          |
| Securities available for sale                | 6,066          |
| Federal Home Loan Bank stock                 | 778            |
| Loans, net                                   | 295,799        |
| Property and equipment, net                  | 1,067          |
| Capitalized mortgage loan servicing rights   | 3,047          |
| Accrued income and other assets              | 2,650          |
| Other intangibles (1)                        | 5,798          |
| Total assets acquired                        | 342,780        |
| Deposits                                     | 287,710        |
| Other borrowings                             | 14,345         |
| Subordinated debentures                      | 3,768          |
| Accrued expenses and other liabilities       | 1,429          |
| Total liabilities assumed                    | 307,252        |
| Net assets acquired                          | 35,528         |
| Goodwill                                     | 29,012         |
| Purchase price (fair value of consideration) | \$ 64,540      |

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Management views the disclosed fair values presented above to be provisional. Prior to the end of the one-year measurement period for finalizing acquisition-date fair values, if information becomes available which would indicate adjustments are required to the allocation, such adjustments will be included in the allocation in the reporting period in which the adjustment amounts are determined.

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

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

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

17. Revenue from Contracts with Customers

We account for revenue in accordance with ASC Topic 606, Revenue from Contracts with Customers, which we adopted on January 1, 2018, using the modified retrospective method (see note #2). We derive the majority of our revenue from financial instruments and their related contractual rights and obligations which for the most part are excluded from the scope of ASU 2014-09. These sources of revenue that are excluded from the scope of this amended guidance include interest income, net gains on mortgage loans, net gains (losses) on securities, mortgage loan servicing, net and bank owned life insurance and were approximately 82.8% and 79.7% of total revenues at June 30, 2018 and 2017, respectively.

Material sources of revenue that are included in the scope of ASC Topic 606 include service charges on deposits, other deposit related income, interchange income and investment and insurance commissions and are discussed in the following paragraphs. Generally these sources of revenue are earned at the time the service is delivered or over the course of a monthly period and do not result in any contract asset or liability balance at any given period end. As a result, there were no contract assets or liabilities recorded as of June 30, 2018.

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

Index

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

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

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

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

Disaggregation of our revenue sources by attribute for the three months ending June 30, 2018 follows:

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

## Reconciliation to Condensed Consolidated Statement of Operations:

## Non-interest income - other:

|                                      |         |
|--------------------------------------|---------|
| Other deposit related income         | \$742   |
| Investment and insurance commissions | 483     |
| Bank owned life insurance            | 220     |
| Other                                | 772     |
| Total                                | \$2,217 |

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

Disaggregation of our revenue sources by attribute for the six months ending June 30, 2018 follows:

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

## Reconciliation to Condensed Consolidated Statement of Operations:

## Non-interest income - other:

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

Index

ITEM 2.

Management's Discussion and Analysis  
of Financial Condition and Results of Operations

**Introduction.** The following section presents additional information to assess the financial condition and results of operations of Independent Bank Corporation ("IBCP"), its wholly-owned bank, Independent Bank (the "Bank"), and their subsidiaries. This section should be read in conjunction with the Condensed Consolidated Financial Statements. We also encourage you to read our 2017 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC"). That report includes a list of risk factors that you should consider in connection with any decision to buy or sell our securities.

**Overview.** We provide banking services to customers located primarily in Michigan's Lower Peninsula. As a result, our success depends to a great extent upon the economic conditions in Michigan's Lower Peninsula. At times, we have experienced a difficult economy in Michigan. Economic conditions in Michigan began to show signs of improvement during 2010. Generally, these improvements have continued into 2018, albeit at an uneven pace. In addition, since early- to mid-2009, we have seen an improvement in our asset quality metrics. In particular, since early 2012, we have generally experienced a decline in non-performing assets, lower levels of new loan defaults, and reduced levels of loan net charge-offs.

**Recent Developments.** On December 22, 2017, "H.R. 1" (also known as the "Tax Cuts and Jobs Act") was signed into law. H.R. 1, among other things, reduced the federal corporate income tax rate to 21% effective January 1, 2018. As a result, we concluded that our deferred tax assets, net ("DTA") had to be remeasured. Our DTA represents expected corporate tax benefits anticipated to be realized in the future. The reduction in the federal corporate income tax rate reduces these anticipated future benefits. The remeasurement of our DTA at December 31, 2017 resulted in a reduction of these net assets and a corresponding increase in income tax expense of \$6.0 million that was recorded in the fourth quarter of 2017.

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

We paid aggregate Merger consideration of approximately \$64.5 million in IBCP common stock or stock options for all of the shares of TCSB common stock and TCSB stock options issued and outstanding immediately before the effective time of the Merger. Based on a preliminary valuation of the assets acquired and liabilities assumed in the Merger, we recorded: \$29.0 million of goodwill, a core deposit intangible ("CDI") of \$5.8 million, discounts of \$6.5 million, \$0.4 million and \$1.5 million on loans, time deposits and borrowings, respectively, and a \$0.5 million write-down of property and equipment. The goodwill will be periodically tested for impairment and the CDI will be amortized over a ten year period (\$0.2 million of amortization for this CDI was recorded in the second quarter of 2018). The discounts will be accreted based on the lives of the related assets or liabilities. On or before March 31, 2019, we will finalize the valuation of the assets acquired and liabilities assumed in the Merger and record and disclose any adjustments to the preliminary valuation.

Index

Regulation. On July 2, 2013, the Federal Reserve Board approved a final rule that establishes an integrated regulatory capital framework (the "New Capital Rules"). The rule implements in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In general, under the New Capital Rules, minimum requirements have increased for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the New Capital Rules include a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The 2.5% capital conservation buffer is being phased in ratably over a four-year period that began in 2016. In 2018, 1.875% is being added to the minimum ratio for adequately capitalized institutions. To avoid limits on capital distributions and certain discretionary bonus payments we must meet the minimum ratio for adequately capitalized institutions plus the phased in buffer (now 6.375% in 2018). The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. As to the quality of capital, the New Capital Rules emphasize common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The New Capital Rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. Under the New Capital Rules our existing trust preferred securities are grandfathered as qualifying regulatory capital. As of June 30, 2018 and December 31, 2017 we exceeded all of the capital ratio requirements of the New Capital Rules.

It is against this backdrop that we discuss our results of operations and financial condition in the second quarter and first six months of 2018 as compared to 2017.

Results of Operations

Summary. We recorded net income of \$8.8 million and \$5.9 million, respectively, during the three months ended June 30, 2018 and 2017. The increase in 2018 second quarter results as compared to 2017 primarily reflects increases in net interest income and non-interest income as well as a decrease in income tax expense that were partially offset by increases in the provision for loan losses and in non-interest expense.

We recorded net income of \$18.0 million and \$11.9 million, respectively, during the six months ended June 30, 2018 and 2017. The increase in 2018 year-to-date results as compared to 2017 is primarily due to increases in net interest income and non-interest income as well as a decrease in income tax expense that were partially offset by increases in the provision for loan losses and in non-interest expense.



Index

## Key performance ratios

|                                     | Three months ended |         | Six months ended |         |
|-------------------------------------|--------------------|---------|------------------|---------|
|                                     | June 30,<br>2018   | 2017    | June 30,<br>2018 | 2017    |
| Net income (annualized) to          |                    |         |                  |         |
| Average assets                      | 1.12 %             | 0.92 %  | 1.22 %           | 0.93 %  |
| Average common shareholders' equity | 10.57              | 9.15    | 12.09            | 9.38    |
| Net income per common share         |                    |         |                  |         |
| Basic                               | \$ 0.37            | \$ 0.28 | \$ 0.79          | \$ 0.56 |
| Diluted                             | 0.36               | 0.27    | 0.78             | 0.55    |

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

Our net interest income totaled \$29.0 million during the second quarter of 2018, an increase of \$7.5 million, or 34.8% from the year-ago period. This increase primarily reflects a \$540.7 million increase in average interest-earning assets as well as a 33 basis point increase in our tax equivalent net interest income as a percent of average interest-earning assets (the "net interest margin").

For the first six months of 2018, net interest income totaled \$52.9 million, an increase of \$10.0 million, or 23.2% from 2017. This increase primarily reflects a \$391.2 million increase in average interest-earning assets as well as an 18 basis point increase in our net interest margin.

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

The increase in average interest-earning assets primarily reflects loan growth utilizing funds from increases in deposits and borrowed funds as well as the impact of the Merger. The increase in the net interest margin reflects a change in the mix of average-interest earning assets (higher percentage of loans), increases in short-term market interest rates and the impact of the Merger.

Our net interest income is also adversely impacted by our level of non-accrual loans. In the second quarter and first six months of 2018 non-accrual loans averaged \$7.5 million in each period compared to \$9.0 million and \$10.3 million, respectively for the same periods in 2017. In addition, in the second quarter and first six months of 2018 we had net recoveries of \$0.18 million and \$0.35 million, respectively, of unpaid interest on loans placed on or taken off non-accrual during each period or on loans previously charged-off compared to net recoveries of \$0.13 million and \$0.63 million, respectively, during the same periods in 2017.

Index

## Average Balances and Tax Equivalent Rates

|   | Three Months Ended     |          |                     |               | 2017     |                     |   |
|---|------------------------|----------|---------------------|---------------|----------|---------------------|---|
|   | June 30, 2018          |          |                     |               | Average  |                     |   |
|   | Average                | Interest | Rate <sup>(2)</sup> | Average       | Interest | Rate <sup>(2)</sup> |   |
|   | Balance                |          |                     | Balance       |          |                     |   |
|   | (Dollars in thousands) |          |                     |               |          |                     |   |
| <b>Assets</b>   |                        |          |                     |               |          |                     |   |
| Taxable loans   | \$2,442,159            | \$29,606 | 4.86                | % \$1,779,916 | \$19,919 | 4.49                | % |
| Tax-exempt loans <sup>(1)</sup>                                     | 6,897                  | 85       | 4.94                | 3,037         | 46       | 6.08                |   |
| Taxable securities  | 401,102                | 2,720    | 2.71                | 503,863       | 2,781    | 2.21                |   |
| Tax-exempt securities <sup>(1)</sup>                                | 69,325                 | 559      | 3.23                | 88,731        | 783      | 3.53                |   |
| Interest bearing cash   | 28,187                 | 66       | 0.94                | 32,193        | 53       | 0.66                |   |
| Other investments   | 16,312                 | 199      | 4.89                | 15,543        | 239      | 6.17                |   |
| Interest Earning Assets   | 2,963,982              | 33,235   | 4.49                | 2,423,283     | 23,821   | 3.94                |   |
| Cash and due from banks   | 31,564                 |          |                     | 30,649        |          |                     |   |
| Other assets, net   | 172,650                |          |                     | 144,673       |          |                     |   |
| Total Assets  | \$3,168,196            |          |                     | \$2,598,605   |          |                     |   |
| <b>Liabilities</b>  |                        |          |                     |               |          |                     |   |
| Savings and interest-bearing checking                               | \$1,241,700            | 1,011    | 0.33                | \$1,058,768   | 316      | 0.12                |   |
| Time deposits   | 603,833                | 2,198    | 1.46                | 468,705       | 1,162    | 0.99                |   |
| Other borrowings  | 100,754                | 914      | 3.64                | 68,511        | 563      | 3.30                |   |
| Interest Bearing Liabilities  | 1,946,287              | 4,123    | 0.85                | 1,595,984     | 2,041    | 0.51                |   |
| Non-interest bearing deposits                                       | 855,829                |          |                     | 712,132       |          |                     |   |
| Other liabilities   | 31,454                 |          |                     | 30,394        |          |                     |   |
| Shareholders' equity  | 334,626                |          |                     | 260,095       |          |                     |   |
| Total liabilities and shareholders' equity                          | \$3,168,196            |          |                     | \$2,598,605   |          |                     |   |
| Net Interest Income   |                        | \$29,112 |                     |               | \$21,780 |                     |   |
| Net Interest Income as a Percent of Average Interest Earning Assets |                        |          | 3.93                | %             |          | 3.60                | % |

(1) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 21% in 2018 and 35% in 2017.

(2) Annualized

Index

## Average Balances and Tax Equivalent Rates

|   | Six Months Ended       |          |                     | 2017        |          |                     |
|---|------------------------|----------|---------------------|-------------|----------|---------------------|
|   | June 30,               |          |                     | Average     |          |                     |
|   | Average                | Interest | Rate <sup>(2)</sup> | Average     | Interest | Rate <sup>(2)</sup> |
|   | Balance                |          |                     | Balance     |          |                     |
|   | (Dollars in thousands) |          |                     |             |          |                     |
| <b>Assets</b>   |                        |          |                     |             |          |                     |
| Taxable loans   | \$2,252,492            | \$52,945 | 4.72 %              | \$1,733,225 | \$39,743 | 4.61 %              |
| Tax-exempt loans <sup>(1)</sup>                                     | 4,526                  | 104      | 4.63                | 3,549       | 98       | 5.57                |
| Taxable securities  | 411,619                | 5,355    | 2.60                | 512,586     | 5,535    | 2.16                |
| Tax-exempt securities <sup>(1)</sup>                                | 73,810                 | 1,162    | 3.15                | 83,417      | 1,481    | 3.55                |
| Interest bearing cash   | 30,531                 | 148      | 0.98                | 49,356      | 166      | 0.68                |
| Other investments   | 15,930                 | 447      | 5.66                | 15,543      | 438      | 5.68                |
| Interest Earning Assets   | 2,788,908              | 60,161   | 4.33                | 2,397,676   | 47,461   | 3.98                |
| Cash and due from banks   | 31,848                 |          |                     | 32,212      |          |                     |
| Other assets, net   | 152,912                |          |                     | 149,306     |          |                     |
| Total Assets  | \$2,973,668            |          |                     | \$2,579,194 |          |                     |
| <b>Liabilities</b>  |                        |          |                     |             |          |                     |
| Savings and interest- bearing checking                              | \$1,168,747            | 1,562    | 0.27                | \$1,052,973 | 599      | 0.11                |
| Time deposits   | 584,167                | 3,934    | 1.36                | 475,409     | 2,322    | 0.98                |
| Other borrowings  | 82,920                 | 1,488    | 3.62                | 56,823      | 1,033    | 3.67                |
| Interest Bearing Liabilities  | 1,835,834              | 6,984    | 0.77                | 1,585,205   | 3,954    | 0.50                |
| Non-interest bearing deposits                                       | 807,504                |          |                     | 708,363     |          |                     |
| Other liabilities   | 30,531                 |          |                     | 29,772      |          |                     |
| Shareholders' equity  | 299,799                |          |                     | 255,854     |          |                     |
| Total liabilities and shareholders' equity                          | \$2,973,668            |          |                     | \$2,579,194 |          |                     |
| Net Interest Income   |                        | \$53,177 |                     |             | \$43,507 |                     |
| Net Interest Income as a Percent of Average Interest Earning Assets |                        |          | 3.83 %              |             |          | 3.65 %              |

(1) Interest on tax-exempt loans and securities is presented on a fully tax equivalent basis assuming a marginal tax rate of 21% in 2018 and 35% in 2017.

(2) Annualized

Index

## Reconciliation of Non-GAAP Financial Measures

|   | Three Months |          | Six Months Ended |          |
|---|--------------|----------|------------------|----------|
|   | Ended        |          | June 30,         |          |
|   | June 30,     | 2017     | 2018             | 2017     |
|   | 2018         |          |                  |          |
| (Dollars in thousands)                                |              |          |                  |          |
| Net Interest Margin, Fully Taxable Equivalent ("FTE") |              |          |                  |          |
| Net interest income                                   | \$28,980     | \$21,492 | \$52,916         | \$42,958 |
| Add: taxable equivalent adjustment                    | 132          | 288      | 261              | 549      |
| Net interest income - taxable equivalent              | \$29,112     | \$21,780 | \$53,177         | \$43,507 |
| Net interest margin (GAAP) <sup>(1)</sup>             | 3.92 %       | 3.56 %   | 3.81 %           | 3.61 %   |
| Net interest margin (FTE) <sup>(1)</sup>              | 3.93 %       | 3.60 %   | 3.83 %           | 3.65 %   |

(1) Annualized

Provision for loan losses. The provision for loan losses was an expense of \$0.7 million and \$0.6 million during the three months ended June 30, 2018 and 2017, respectively. During the six-month periods ended June 30, 2018 and 2017, the provision was an expense of \$1.0 million and \$0.2 million, respectively. The provision reflects our assessment of the allowance for loan losses taking into consideration factors such as loan growth, loan mix, levels of non-performing and classified loans and loan net charge-offs. While we use relevant information to recognize losses on loans, additional provisions for related losses may be necessary based on changes in economic conditions, customer circumstances and other credit risk factors. See "Portfolio Loans and asset quality" for a discussion of the various components of the allowance for loan losses and their impact on the provision for loan losses in the second quarter and first half of 2018.

Non-interest income. Non-interest income is a significant element in assessing our results of operations. Non-interest income totaled \$12.3 million during the second quarter of 2018 compared to \$10.4 million in 2017. For the first six months of 2018 non-interest income totaled \$24.0 million compared to \$20.8 million for the first six months of 2017. We adopted Financial Accounting Standards Board Accounting Standards Update 2014-09 "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09") on January 1, 2018, using the modified retrospective method. Although ASU 2014-09 did not have any impact on our January 1, 2018 shareholders' equity or second quarter and year-to-date 2018 net income, it did result in a classification change in non-interest income and non-interest expense as compared to the prior year period. Specifically, in the second quarter and first six months of 2018, interchange income and interchange expense each increased by \$0.4 million and \$0.7 million, respectively, due to classification changes under ASU 2014-09 (also see notes #2 and #17 to the Condensed Consolidated Financial Statements included within this report).

Index

The components of non-interest income are as follows:

## Non-Interest Income

|                                      | Three months ended |          | Six months ended |          |
|--------------------------------------|--------------------|----------|------------------|----------|
|                                      | June 30,           |          | June 30,         |          |
|                                      | 2018               | 2017     | 2018             | 2017     |
|                                      | (In thousands)     |          |                  |          |
| Service charges on deposit accounts  | \$3,095            | \$3,175  | \$6,000          | \$6,184  |
| Interchange income                   | 2,504              | 2,005    | 4,750            | 3,927    |
| Net gains (losses) on assets:        |                    |          |                  |          |
| Mortgage loans                       | 3,255              | 3,344    | 5,826            | 5,915    |
| Securities                           | 9                  | (34 )    | (164 )           | (7 )     |
| Mortgage loan servicing, net         | 1,235              | (158 )   | 3,456            | 667      |
| Investment and insurance commissions | 483                | 467      | 921              | 935      |
| Bank owned life insurance            | 220                | 240      | 476              | 493      |
| Other                                | 1,514              | 1,407    | 2,763            | 2,671    |
| Total non-interest income            | \$12,315           | \$10,446 | \$24,028         | \$20,785 |

Service charges on deposit accounts decreased on both a comparative quarterly and year-to-date basis in 2018 as compared to 2017. These decreases were principally due to lower service charges on commercial accounts and a decrease in non-sufficient funds occurrences.

Interchange income increased on both a comparative quarterly and year-to-date basis in 2018 as compared to 2017 due primarily to the aforementioned impact of ASU 2014-09.

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

## Mortgage Loan Activity

|   | Three months ended     |           | Six months ended |           |
|---|------------------------|-----------|------------------|-----------|
|   | June 30,               |           | June 30,         |           |
|   | 2018                   | 2017      | 2018             | 2017      |
|   | (Dollars in thousands) |           |                  |           |
| Mortgage loans originated   | \$226,264              | \$235,087 | \$385,231        | \$393,168 |
| Mortgage loans sold   | 115,299                | 104,714   | 221,642          | 184,405   |
| Net gains on mortgage loans   | 3,255                  | 3,344     | 5,826            | 5,915     |
| Net gains as a percent of mortgage loans sold ("Loan Sales Margin") | 2.82                   | % 3.19    | % 2.63           | % 3.21    |
| Fair value adjustments included in the Loan Sales Margin            | 0.57                   | 0.32      | 0.35             | 0.27      |

The slight decrease in mortgage loans originated is due primarily to higher interest rates suppressing refinance volumes. Mortgage loans sold increased due to a higher mix of salable loans in our origination volumes. Net gains on mortgage loans decreased in 2018 as compared to 2017 due to a lower Loan Sales Margin as discussed below.

Index

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

Our Loan Sales Margin is impacted by several factors including competition and the manner in which the loan is sold. Net gains on mortgage loans are also impacted by recording fair value accounting adjustments. Excluding the aforementioned fair value accounting adjustments, the Loan Sales Margin would have been 2.25% and 2.87% in the second quarters of 2018 and 2017, respectively and 2.28% and 2.94% for the comparative 2018 and 2017 year-to-date periods, respectively. The decrease in the Loan Sales Margin (excluding fair value adjustments) in 2018 was generally due to a narrowing of primary-to-secondary market pricing spreads due to competitive factors throughout the mortgage banking industry (generally higher mortgage loan interest rates and a decline in refinance volume). The changes in the fair value accounting adjustments are primarily due to changes in the amount of commitments to originate mortgage loans for sale.

Net gains (losses) on securities were relatively nominal for all of the periods presented. We recorded no net impairment losses in either 2018 or 2017 for other than temporary impairment of securities available for sale. (See “Securities.”)

Mortgage loan servicing, net, generated income of \$1.2 million and a loss of \$0.2 million in the second quarters of 2018 and 2017, respectively. For the first six months of 2018, mortgage loan servicing, net, generated income of \$3.5 million as compared to income of \$0.7 million in 2017. This activity is summarized in the following table:

|                                    | Three Months Ended |           | Six Months Ended |           |
|------------------------------------|--------------------|-----------|------------------|-----------|
|                                    | 6/30/2018          | 6/30/2017 | 6/30/2018        | 6/30/2017 |
| Mortgage loan servicing, net:      | (In thousands)     |           |                  |           |
| Revenue, net                       | \$ 1,372           | \$ 1,073  | \$ 2,564         | \$ 2,162  |
| Fair value change due to price     | 518                | (648 )    | 1,976            | (503 )    |
| Fair value change due to pay-downs | (655 )             | (583 )    | (1,084 )         | (992 )    |
| Total                              | \$ 1,235           | \$ (158 ) | \$ 3,456         | \$ 667    |

Index

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

## Capitalized Mortgage Loan Servicing Rights

|   | Three months ended |          | Six months ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30,           |          | June 30,         |          |
|   | 2018               | 2017     | 2018             | 2017     |
|   | (In thousands)     |          |                  |          |
| Balance at beginning of period              | \$17,783           | \$14,727 | \$15,699         | \$13,671 |
| Change in accounting                        | -                  | -        | -                | 542      |
| Balance at beginning of period, as adjusted | 17,783             | 14,727   | 15,699           | 14,213   |
| Servicing rights acquired                   | 3,047              | -        | 3,047            | -        |
| Originated servicing rights capitalized     | 1,155              | 1,019    | 2,210            | 1,797    |
| Change in fair value                        | (137 )             | (1,231 ) | 892              | (1,495 ) |
| Balance at end of period                    | \$21,848           | \$14,515 | \$21,848         | \$14,515 |

At June 30, 2018 we were servicing approximately \$2.21 billion in mortgage loans for others on which servicing rights have been capitalized. This servicing portfolio had a weighted average coupon rate of 4.17% and a weighted average service fee of approximately 25.8 basis points. Capitalized mortgage loan servicing rights at June 30, 2018 totaled \$21.8 million, representing approximately 98.8 basis points on the related amount of mortgage loans serviced for others.

Investment and insurance commissions represent revenues generated on the sale or management of investments and insurance for our customers. These revenues were relatively comparable on both a quarterly and year-to-date basis in 2018 as compared to 2017.

Income from bank owned life insurance declined on both a comparative quarterly and year-to-date basis in 2018 compared to 2017 reflecting a lower crediting rate on our cash surrender value. Our separate account is primarily invested in agency mortgage-backed securities and managed by PIMCO. The crediting rate (on which the earnings are based) reflects the performance of the separate account. The total cash surrender value of our bank owned life insurance was \$54.6 million at both June 30, 2018 and December 31, 2017.

Other non-interest income increased slightly on both a comparative quarterly and year-to-date basis in 2018 compared to 2017, due primarily to an increase in fees earned on interest rate swap agreements for our commercial loan customers.

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

Non-interest expense increased by \$7.0 million to \$29.8 million and by \$7.6 million to \$53.9 million during the three- and six-month periods ended June 30, 2018, respectively, compared to the same periods in 2017. Many of our components of non-interest expense increased in 2018 due to the TCSB Merger.

Index

The components of non-interest expense are as follows:

## Non-Interest Expense

|  | Three months ended |          | Six months ended |           |
|--|--------------------|----------|------------------|-----------|
|  | June 30, 2018      | 2017     | June 30, 2018    | 2017      |
|  | (In thousands)     |          |                  |           |
| Compensation   | \$9,574            | \$8,707  | \$ 18,504        | \$ 18,379 |
| Performance-based compensation                                 | 3,150              | 2,138    | 5,933            | 4,131     |
| Payroll taxes and employee benefits                            | 3,145              | 2,535    | 5,900            | 5,017     |
| Compensation and employee benefits                             | 15,869             | 13,380   | 30,337           | 27,527    |
| Occupancy, net   | 2,170              | 1,920    | 4,434            | 4,062     |
| Data processing  | 2,251              | 1,937    | 4,129            | 3,874     |
| Merger related expenses  | 3,082              | --       | 3,256            | --        |
| Furniture, fixtures and equipment                              | 1,019              | 1,005    | 1,986            | 1,982     |
| Communications   | 704                | 678      | 1,384            | 1,361     |
| Loan and collection  | 692                | 670      | 1,369            | 1,083     |
| Interchange expense  | 661                | 292      | 1,259            | 575       |
| Advertising  | 543                | 519      | 984              | 1,025     |
| Legal and professional   | 456                | 389      | 834              | 826       |
| FDIC deposit insurance   | 250                | 202      | 480              | 400       |
| Amortization of intangible assets                              | 295                | 86       | 381              | 173       |
| Supplies   | 178                | 159      | 343              | 331       |
| Credit card and bank service fees                              | 106                | 136      | 202              | 327       |
| Provision for loss reimbursement on sold loans                 | 20                 | 20       | 31               | 51        |
| Costs (recoveries) related to unfunded lending commitments     | 37                 | 130      | (77              | ) 240     |
| Net (gains) losses on other real estate and repossessed assets | (4                 | ) 91     | (294             | ) 102     |
| Other  | 1,432              | 1,147    | 2,858            | 2,391     |
| Total non-interest expense                                     | \$29,761           | \$22,761 | \$ 53,896        | \$ 46,330 |

Compensation and employee benefits expenses, in total, increased \$2.5 million on a quarterly comparative basis and increased \$2.8 million for the first six months of 2018 compared to the same periods in 2017.

Compensation expense increased by \$0.9 million and \$0.1 million in the second quarter and first six months of 2018, respectively, compared to the same periods in 2017. The second quarter year-over-year increase was primarily due to the TCSB Merger. The reduced increase on a year to date basis is primarily because the first quarter of 2017 included some one-time compensation costs related to the expansion of our mortgage banking operations.

Performance-based compensation increased by \$1.0 million and \$1.8 million in the second quarter and first six months of 2018, respectively, versus the same periods in 2017, due primarily to relative comparative changes in the accrual for anticipated incentive compensation based on our estimated full-year performance as compared to goals. In addition, we introduced a new incentive compensation plan for hourly employees in 2018 that increased performance-based compensation by \$0.15 million and \$0.51 million for the second quarter and first six months of 2018, respectively.



Index

Payroll taxes and employee benefits increased by \$0.6 million and \$0.9 million in the second quarter and first six months of 2018, respectively, compared to the same periods in 2017, due primarily to increases in payroll taxes (due to the aforementioned increases in compensation), higher health care costs (due to increased claims in 2018) and higher 401(k) plan costs (due to an increase in the employer match percentage).

Occupancy, net, increased by \$0.25 million and \$0.37 million in the second quarter and first six months of 2018, respectively, compared to the same periods in 2017, principally due to additional locations acquired in the TCSB Merger and additional loan production offices opened during 2017.

Data processing expenses increased by \$0.3 million for both the second quarter and first six months of 2018, respectively, compared to the same periods in 2017. The second quarter 2018 increase is due to the TCSB Merger. We completed the conversion of TCSB loan and deposit accounts onto our core systems in June 2018. As a result, we anticipate that quarterly data processing costs will decline by approximately \$0.2 million to \$0.3 million from the second quarter 2018 level of \$2.25 million.

Merger related expenses totaled \$3.1 million and \$3.3 million for the second quarter and first six months of 2018, respectively. These expenses include our investment banking fees, certain accounting and legal costs, various contract termination fees, data processing conversion costs, payments made on officer change-in-control contracts, and employee severance costs. We expect to have a minor amount of merger related expenses in the third quarter of 2018 due principally to additional systems conversions (primarily related to document imaging).

Furniture, fixtures and equipment, communications, advertising, legal and professional and supplies expenses were relatively comparable on both a quarterly and year-to-date basis in 2018 as compared to 2017.

Loan and collection expenses reflect costs related to new lending activity as well as the management and collection of non-performing loans and other problem credits. The year-to-date comparative increase is primarily because the first quarter of 2017 included a \$0.2 million reimbursement of previously incurred expenses related to the resolution and payoff of a non-accrual loan.

Interchange expense primarily represents our third-party cost to process debit card transactions. This cost increased in 2018 on both a comparative quarterly and year-to-date basis due primarily to the impact of the implementation of ASU 2014-09 on January 1, 2018. Prior to the first quarter of 2018, certain processing costs were being netted against interchange income. As described above, under ASU 2014-09 these costs are no longer being netted against interchange income but instead are being reported as part of interchange expense.

FDIC deposit insurance expense increased in 2018 on both a comparative quarterly and year-to-date basis due primarily to our increase in total assets.

Index

The amortization of intangible assets relates to the TCSB Merger and prior branch acquisitions and the amortization of the deposit customer relationship value, including core deposit value, which was acquired in connection with those acquisitions. We had remaining unamortized intangible assets of \$7.0 million and \$1.6 million at June 30, 2018 and December 31, 2017, respectively. See note #7 to the Condensed Consolidated Financial Statements for a schedule of future amortization of intangible assets.

Credit card and bank service fees decreased in 2018 on both a comparative quarterly and year-to-date basis primarily due to the sale of our payment plan processing business (Mepco Finance Corporation) in May 2017.

The provision for loss reimbursement on sold loans was an expense of \$0.02 million and \$0.03 million in the second quarter and first six months of 2018, respectively, compared to an expense of \$0.02 million and \$0.05 million in the second quarter and first six months of 2017, respectively. This provision represents our estimate of incurred losses related to mortgage loans that we have sold to investors (primarily Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank of Indianapolis). The small expense provisions in 2018 and 2017 are primarily due to growth in the balance of loans serviced for investors. Since we sell mortgage loans without recourse, loss reimbursements only occur in those instances where we have breached a representation or warranty or other contractual requirement related to the loan sale. The reserve for loss reimbursements on sold mortgage loans totaled \$0.81 million and \$0.67 million at June 30, 2018 and December 31, 2017, respectively. This reserve is included in accrued expenses and other liabilities in our Condensed Consolidated Statements of Financial Condition.

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

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

Other non-interest expenses increased in 2018 on both a comparative quarterly and year-to-date basis due primarily to small increases in several categories of expenses (directors fees, travel and entertainment, certain state franchise taxes, and deposit account/debit card fraud).

Income tax expense. We recorded an income tax expense of \$2.1 million and \$4.1 million in the second quarter and the first six months of 2018, respectively. This compares to an income tax expense of \$2.7 million and \$5.3 million in the second quarter and the first six months of 2017, respectively. As described earlier under "Recent Developments" our statutory federal corporate income tax rate was reduced to 21% (from 35%) effective on January 1, 2018.

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

Index

We assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. The ultimate realization of this asset is primarily based on generating future income. We concluded at June 30, 2018 and 2017 and at December 31, 2017, that the realization of substantially all of our deferred tax assets continues to be more likely than not.

## Financial Condition

**Summary.** Our total assets increased by \$445.2 million during the first six months of 2018 reflecting the TCSB Merger and organic loan growth. The total assets, loans and deposits acquired in the TCSB Merger were approximately \$342.8 million, \$295.8 million (including \$1.3 million of loans held for sale) and \$287.7 million, respectively.

Loans, excluding loans held for sale ("Portfolio Loans"), totaled \$2.47 billion at June 30, 2018, an increase of \$448.5 million, or 22.2%, from December 31, 2017. (See "Portfolio Loans and asset quality.")

Deposits totaled \$2.78 billion at June 30, 2018, compared to \$2.40 billion at December 31, 2017. The \$380.0 million increase in total deposits during the period is primarily due to the TCSB Merger and growth in brokered time deposits.

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

| Securities                    | Unrealized     |         |         | Fair Value |
|-------------------------------|----------------|---------|---------|------------|
|                               | Amortized Cost | Gains   | Losses  |            |
| Securities available for sale |                |         |         |            |
| June 30, 2018                 | \$456,209      | \$1,847 | \$7,463 | \$450,593  |
| December 31, 2017             | 523,520        | 3,197   | 3,792   | 522,925    |

Securities available for sale declined \$72.3 million during the first six months of 2018. Our portfolio of securities available for sale is reviewed quarterly for impairment in value. In performing this review, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates on the market value of the security and (4) an assessment of whether we intend to sell, or it is more likely than not that we will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. For securities that do not meet these recovery criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income (loss). We recorded no impairment losses related to other than temporary impairment on securities available for sale in either of the first six months of 2018 or 2017.

Index

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

|                        | Six months ended<br>June 30, |         |
|------------------------|------------------------------|---------|
|                        | 2018                         | 2017    |
|                        | (In thousands)               |         |
| Proceeds               | \$31,445                     | \$7,830 |
| Gross gains            | \$81                         | \$117   |
| Gross losses           | (126 )                       | -       |
| Net impairment charges | -                            | -       |
| Fair value adjustments | (119 )                       | (124 )  |
| Net losses             | \$(164 )                     | \$(7 )  |

Portfolio Loans and asset quality. In addition to the communities served by our Bank branch and loan production office network, our principal lending markets also include nearby communities and metropolitan areas. Subject to established underwriting criteria, we also may participate in commercial lending transactions with certain non-affiliated banks and make whole loan purchases from other financial institutions. In March 2018, we sold \$16.5 million of single-family residential fixed and adjustable rate mortgage loans servicing retained to another financial institution and recognized a gain on sale of \$0.05 million. These mortgage loans were all on properties located in Ohio and were sold primarily for asset/liability management purposes. At June 30, 2018, we had \$13.2 million of single-family residential fixed and adjustable rate mortgage loans classified as held for sale (and carried at the lower of cost or fair value). These loans are expected to be sold on a servicing retained basis to another financial institution in the third quarter of 2018. These mortgage loans are all on properties located in Ohio and are also being sold primarily for asset/liability management purposes.

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

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

Index

A summary of our Portfolio Loans follows:

|  | June 30,<br>2018 | December 31,<br>2017 |
|--|------------------|----------------------|
|  | (In thousands)   |                      |
| Real estate(1)                                     |                  |                      |
| Residential first mortgages                        | \$757,977        | \$ 672,592           |
| Residential home equity and other junior mortgages | 173,753          | 136,560              |
| Construction and land development                  | 163,138          | 143,188              |
| Other(2)   | 686,618          | 538,880              |
| Consumer   | 353,142          | 291,091              |
| Commercial   | 326,170          | 231,786              |
| Agricultural                                       | 6,519            | 4,720                |
| Total loans  | \$2,467,317      | \$ 2,018,817         |

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

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

Non-performing assets<sup>(1)</sup>

|  | June 30,<br>2018       | December 31,<br>2017 |   |   |
|--|------------------------|----------------------|---|---|
|  | (Dollars in thousands) |                      |   |   |
| Non-accrual loans  | \$ 9,082               | \$ 8,184             |   |   |
| Loans 90 days or more past due and still accruing interest     | --                     | --                   |   |   |
| Total non-performing loans                                     | 9,082                  | 8,184                |   |   |
| Other real estate and repossessed assets                       | 1,689                  | 1,643                |   |   |
| Total non-performing assets                                    | \$ 10,771              | \$ 9,827             |   |   |
| As a percent of Portfolio Loans                                |                        |                      |   |   |
| Non-performing loans   | 0.37                   | 0.41                 | % | % |
| Allowance for loan losses                                      | 0.95                   | 1.12                 |   |   |
| Non-performing assets to total assets                          | 0.33                   | 0.35                 |   |   |
| Allowance for loan losses as a percent of non-performing loans | 258.80                 | 275.99               |   |   |

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

Index

## Troubled debt restructurings ("TDR")

|                         | June 30, 2018  |                      |          |
|-------------------------|----------------|----------------------|----------|
|                         | Commercial     | Retail (1)           | Total    |
|                         | (In thousands) |                      |          |
| Performing TDR's        | \$7,792        | \$ 50,313            | \$58,105 |
| Non-performing TDR's(2) | 245            | 3,112 <sup>(3)</sup> | 3,357    |
| Total                   | \$8,037        | \$ 53,425            | \$61,462 |

|                         | December 31, 2017 |                      |          |
|-------------------------|-------------------|----------------------|----------|
|                         | Commercial        | Retail (1)           | Total    |
|                         | (In thousands)    |                      |          |
| Performing TDR's        | \$7,748           | \$ 52,367            | \$60,115 |
| Non-performing TDR's(2) | 323               | 4,506 <sup>(3)</sup> | 4,829    |
| Total                   | \$8,071           | \$ 56,873            | \$64,944 |

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

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

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

Non-performing loans increased by \$0.9 million during the first six months of 2018 due principally to an increase in non-performing commercial loans. The increase in non-performing commercial loans primarily reflects one relationship moving into non-accrual in the second quarter of 2018. Because of our collateral position, we do not expect any loss from the resolution of this loan relationship.

Non-performing loans exclude performing loans that are classified as troubled debt restructurings ("TDRs"). Performing TDRs totaled \$58.1 million, or 2.4% of total Portfolio Loans, and \$60.1 million, or 3.0% of total Portfolio Loans, at June 30, 2018 and December 31, 2017, respectively. The decrease in the amount of performing TDRs in the first six months of 2018 primarily reflects pay downs and payoffs.

Other real estate and repossessed assets totaled \$1.7 million and \$1.6 million at June 30, 2018 and December 31, 2017, respectively.

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

Index

The following tables reflect activity in and the allocation of the allowance for loan losses (“AFLI”).

## Allowance for loan losses

|   | Six months ended       |                         |          |                         |
|---|------------------------|-------------------------|----------|-------------------------|
|   | June 30,<br>2018       |                         | 2017     |                         |
|   | Loans                  | Unfunded<br>Commitments | Loans    | Unfunded<br>Commitments |
|   | (Dollars in thousands) |                         |          |                         |
| Balance at beginning of period  | \$22,587               | \$ 1,125                | \$20,234 | \$ 650                  |
| Additions (deductions)  |                        |                         |          |                         |
| Provision for loan losses   | 965                    | -                       | 224      | -                       |
| Recoveries credited to allowance                                      | 1,860                  | -                       | 1,786    | -                       |
| Loans charged against the allowance                                   | (1,908 )               | -                       | (1,658 ) | -                       |
| Additions included in non-interest expense                            | -                      | (77 )                   | -        | 240                     |
| Balance at end of period  | \$23,504               | \$ 1,048                | \$20,586 | \$ 890                  |
| Net loans charged against the allowance to average Portfolio<br>Loans | 0.00 %                 |                         | (0.02 )% |                         |

## Allocation of the Allowance for Loan Losses

|  | June 30,<br>2018 | December 31,<br>2017 |
|--|------------------|----------------------|
|  | (In thousands)   |                      |
| Specific allocations                               | \$6,307          | \$ 6,839             |
| Other adversely rated commercial loans             | 1,721            | 1,228                |
| Historical loss allocations                        | 7,189            | 7,125                |
| Additional allocations based on subjective factors | 8,287            | 7,395                |
| Total  | \$23,504         | \$ 22,587            |

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

Index

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

No allowance for loan losses was brought forward on any of the TCSB acquired loans as any credit deterioration evident in the loans was included in the determination of the fair value of the loans at the acquisition date. An allowance for loan losses will be established for any subsequent credit deterioration or adverse changes in expected cash flows.

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

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

The allowance for loan losses increased \$0.9 million to \$23.5 million at June 30, 2018 from \$22.6 million at December 31, 2017 and was equal to 0.95% of total Portfolio Loans at June 30, 2018 compared to 1.12% at December 31, 2017.

Three of the four components of the allowance for loan losses outlined above increased in the first six months of 2018. The allowance for loan losses related to specific loans decreased \$0.5 million in 2018 due primarily to a decline in the balance of individually impaired loans and charge-offs. The allowance for loan losses related to other adversely rated commercial loans increased \$0.5 million in 2018 primarily due to an increase in the balance of such loans included in this component to \$34.8 million at June 30, 2018 from \$27.2 million at December 31, 2017 and \$14.4 million at June 30, 2017. Approximately 55% of the year-over-year increase of \$20.4 million was in the earliest watch stage (7-rated commercial loans), and at the present time, no significant loss is expected on any of these credits. The allowance for loan losses related to historical losses increased \$0.1 million during 2018 due principally to loan growth. The allowance for loan losses related to subjective factors increased \$0.9 million during 2018 primarily due to loan growth.





Index

By comparison, three of the four components of the allowance for loan losses outlined above also increased in the first half of 2017. The allowance for loan losses related to specific loans decreased \$1.9 million in 2017 due primarily to a decline in the balance of individually impaired loans as well as charge-offs. In particular, we received a full payoff in March 2017 on a commercial loan that had a specific reserve of \$1.2 million at December 31, 2016. The allowance for loan losses related to other adversely rated commercial loans increased \$0.1 million in 2017 primarily due to an increase in the balance of such loans included in this component to \$14.4 million at June 30, 2017 from \$11.8 million at December 31, 2016. The allowance for loan losses related to historical losses increased \$1.4 million during 2017 due principally to slight upward adjustments in our probability of default and expected loss rates for commercial loans, an additional component of approximately \$0.6 million added for loans secured by commercial real estate due primarily to emerging risks in this sector (such as retail store closings and potential overdevelopment in certain markets) and loan growth. We also extended our historical lookback period to be more representative of the probability of default and account for infrequent migration events and extremely low levels of watch credits. The allowance for loan losses related to subjective factors increased \$0.8 million during 2017 primarily due to loan growth.

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

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

Deposits totaled \$2.78 billion and \$2.40 billion at June 30, 2018 and December 31, 2017, respectively. The \$380.0 million increase in deposits in the first six months of 2018 is primarily due to the TCSB Merger and growth in brokered time deposits. Reciprocal deposits totaled \$66.5 million and \$51.0 million at June 30, 2018 and December 31, 2017, respectively. These deposits represent demand, money market and time deposits from our customers that have been placed through Promontory Interfinancial Network’s Insured Cash Sweep<sup>®</sup> service and Certificate of Deposit Account Registry Service<sup>®</sup>. These services allow our customers to access multi-million dollar FDIC deposit insurance on deposit balances greater than the standard FDIC insurance maximum.

We cannot be sure that we will be able to maintain our current level of core deposits. In particular, those deposits that are uninsured may be susceptible to outflow. At June 30, 2018, we had approximately \$598.3 million of uninsured deposits. A reduction in core deposits would likely increase our need to rely on wholesale funding sources.

Index

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

Other borrowings, comprised primarily of federal funds purchased and advances from the FHLB, totaled \$40.6 million and \$54.6 million at June 30, 2018 and December 31, 2017, respectively.

As described above, we utilize wholesale funding, including FHLB borrowings and brokered time deposits to augment our core deposits and fund a portion of our assets. At June 30, 2018, our use of such wholesale funding sources (including reciprocal deposits) amounted to approximately \$333.5 million, or 11.8% of total funding (deposits and total borrowings, excluding subordinated debentures). Because wholesale funding sources are affected by general market conditions, the availability of such funding may be dependent on the confidence these sources have in our financial condition and operations. The continued availability to us of these funding sources is not certain, and Brokered CDs may be difficult for us to retain or replace at attractive rates as they mature. Our liquidity may be constrained if we are unable to renew our wholesale funding sources or if adequate financing is not available in the future at acceptable rates of interest or at all. Our financial performance could also be affected if we are unable to maintain our access to funding sources or if we are required to rely more heavily on more expensive funding sources. In such case, our net interest income and results of operations could be adversely affected.

We historically employed derivative financial instruments to manage our exposure to changes in interest rates. During the first six months of 2018 and 2017, we entered into \$4.8 million and \$11.0 million (aggregate notional amounts), respectively, of interest rate swaps with commercial loan customers, which were offset with interest rate swaps that the Bank entered into with a broker-dealer. We recorded \$0.33 million and \$0.16 million of fee income related to these transactions during the first six months of 2018 and 2017, respectively. See note #6 to the Condensed Consolidated Financial Statements included within this report for more information on our derivative financial instruments.

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

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

Index

At June 30, 2018, we had \$534.2 million of time deposits that mature in the next 12 months. Historically, a majority of these maturing time deposits are renewed by our customers. Additionally, \$2.12 billion of our deposits at June 30, 2018, were in account types from which the customer could withdraw the funds on demand. Changes in the balances of deposits that can be withdrawn upon demand are usually predictable and the total balances of these accounts have generally grown or have been stable over time as a result of our marketing and promotional activities. However, there can be no assurance that historical patterns of renewing time deposits or overall growth or stability in deposits will continue in the future.

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

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

We also believe that the available cash on hand at the parent company (including time deposits) of approximately \$23.9 million as of June 30, 2018 provides sufficient liquidity resources at the parent company to meet operating expenses, to make interest payments on the subordinated debentures and to pay a cash dividend on our common stock for the foreseeable future.

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

## Capitalization

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
|   | (In thousands)   |                      |
| Subordinated debentures                     | \$39,354         | \$ 35,569            |
| Amount not qualifying as regulatory capital | (1,224 )         | (1,069 )             |
| Amount qualifying as regulatory capital     | 38,130           | 34,500               |
| Shareholders' equity                        |                  |                      |
| Common stock                                | 389,195          | 324,986              |
| Accumulated deficit                         | (42,898 )        | (54,054 )            |
| Accumulated other comprehensive loss        | (9,214 )         | (5,999 )             |
| Total shareholders' equity                  | 337,083          | 264,933              |
| Total capitalization                        | \$375,213        | \$ 299,433           |

Index

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

As part of the TCSB Merger we acquired TCSB Statutory Trust I (a statutory business trust formed solely to issue capital securities) and assumed approximately \$5.2 million of subordinated debentures that had a fair value of approximately \$3.8 million on April 1, 2018. The trust preferred securities issued by TCSB Statutory Trust I mature in March 2035. The discount recorded on the subordinated debentures will be accreted over their remaining life.

The FRB has issued rules regarding trust preferred securities as a component of the Tier 1 capital of bank holding companies. The aggregate amount of trust preferred securities (and certain other capital elements) are limited to 25 percent of Tier 1 capital elements, net of goodwill (net of any associated deferred tax liability). The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital, subject to restrictions. At the parent company, all of these securities qualified as Tier 1 capital at June 30, 2018 and December 31, 2017. Although the Dodd-Frank Act further limited Tier 1 treatment for trust preferred securities, those new limits did not apply to our outstanding trust preferred securities. Further, the New Capital Rules grandfathered the treatment of our trust preferred securities as qualifying regulatory capital.

Common shareholders' equity increased to \$337.1 million at June 30, 2018 from \$264.9 million at December 31, 2017 due primarily to shares issued in the TCSB Merger and our net income that was partially offset by an increase in our accumulated other comprehensive loss and by dividends that we paid. Our tangible common equity ("TCE") totaled \$301.1 million and \$263.3 million, respectively, at those same dates. Our ratio of TCE to tangible assets was 9.41% and 9.45% at June 30, 2018 and December 31, 2017, respectively. TCE and the ratio of TCE to tangible assets are non-GAAP measures. TCE represents total common equity less intangible assets.

In January 2018, our Board of Directors authorized a share repurchase plan. Under the terms of the 2018 share repurchase plan, we are authorized to buy back up to 5% of our outstanding common stock. This repurchase plan is authorized to last through December 31, 2018. We did not repurchase any shares during the first six months of 2018.

We pay a quarterly cash dividend on our common stock. These dividends totaled \$0.15 per share and \$0.10 per share in the second quarters of 2018 and 2017, respectively. We generally favor a dividend payout ratio between 30% and 50% of net income.

As of June 30, 2018 and December 31, 2017, our Bank (and holding company) continued to meet the requirements to be considered "well-capitalized" under federal regulatory standards (also see note #10 to the Condensed Consolidated Financial Statements included within this report).

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

Index

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

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

## Changes in Market Value of Portfolio Equity and Net Interest Income

| Change in Interest Rates | Market Value Of                               |                | Net Interest Income |                |
|--------------------------|---|----------------|---------------------|----------------|
|                          | Portfolio Equity(1)<br>(Dollars in thousands) | Percent Change | Income(2)           | Percent Change |
| June 30, 2018            |   |                |                     |                |
| 200 basis point rise     | \$ 472,200                                    | (3.55 )%       | \$ 118,800          | 1.02 %         |
| 100 basis point rise     | 485,900                                       | (0.76 )        | 118,800             | 1.02           |
| Base-rate scenario       | 489,600                                       | -              | 117,600             | -              |
| 100 basis point decline  | 468,200                                       | (4.37 )        | 113,300             | (3.66 )        |
| December 31, 2017        |   |                |                     |                |
| 200 basis point rise     | \$ 409,200                                    | (1.23 )%       | \$ 99,100           | 2.27 %         |
| 100 basis point rise     | 417,100                                       | 0.68           | 98,600              | 1.75           |
| Base-rate scenario       | 414,300                                       | -              | 96,900              | -              |
| 100 basis point decline  | 386,400                                       | (6.73 )        | 91,600              | (5.47 )        |

(1) Simulation analyses calculate the change in the net present value of our assets and liabilities, including debt and related financial derivative instruments, under parallel shifts in interest rates by discounting the estimated future cash flows using a market-based discount rate. Cash flow estimates incorporate anticipated changes in prepayment speeds and other embedded options.

(2) Simulation analyses calculate the change in net interest income under immediate parallel shifts in interest rates over the next twelve months, based upon a static statement of financial condition, which includes debt and related financial derivative instruments, and do not consider loan fees.

## Index

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

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

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

## Litigation Matters

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

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

## Critical Accounting Policies

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Accounting and reporting policies for the AFL, capitalized mortgage loan servicing rights, and income taxes are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those that we have used could result in material changes in our consolidated financial position or results of operations. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017.

Index

Item 3.

Quantitative and Qualitative Disclosures about Market Risk

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

Item 4.

Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

With the participation of management, our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) for the period ended June 30, 2018, have concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in Internal Controls.

During the quarter ended June 30, 2018, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

91

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Index

## Part II

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2017.

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

The Company maintains a Deferred Compensation and Stock Purchase Plan for Non-Employee Directors (the "Plan") pursuant to which non-employee directors can elect to receive shares of the Company's common stock in lieu of fees otherwise payable to the director for his or her service as a director. A director can elect to receive shares on a current basis or to defer receipt of the shares, in which case the shares are issued to a trust to be held for the account of the director and then generally distributed to the director after his or her retirement from the Board. Pursuant to this Plan, during the second quarter of 2018, the Company issued 665 shares of common stock to non-employee directors on a current basis and 1,643 shares of common stock to the trust for distribution to directors on a deferred basis. The shares were issued on April 1, 2018, at a price of \$22.90 per share, representing aggregate fees of \$0.05 million. The price per share was the consolidated closing bid price per share of the Company's common stock as of the date of issuance, as determined in accordance with NASDAQ Marketplace Rules. The Company issued the shares pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933 due to the fact that the issuance of the shares was made on a private basis pursuant to the Plan.

The following table shows certain information relating to repurchases of common stock for the three-months ended June 30, 2018:

| Period     | Total Number of Shares Purchased (1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan | Remaining Number of Shares Authorized for Purchase Under the Plan |
|------------|--------------------------------------|------------------------------|---|---|
| April 2018 | -                                    | \$ -                         | -   | 1,066,693   |
| May 2018   | -                                    | -                            | -   | 1,066,693   |
| June 2018  | 255                                  | 26.00                        | -   | 1,066,693   |
| Total      | 255                                  | \$ 26.00                     | -   | 1,066,693   |

(1) Represents shares withheld from the shares that would otherwise have been issued to certain officers in order to satisfy tax withholding obligations resulting from vesting of restricted stock.

Index

Item 6. Exhibits

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

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

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

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

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

101.INS Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Index

SIGNATURES

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

Date August 3, 2018 By/s/ Robert N. Shuster  
Robert N. Shuster, Principal Financial Officer

Date August 3, 2018 By/s/ James J. Twarozynski  
James J. Twarozynski, Principal Accounting Officer