MACATAWA BANK CORP
Form 10-K
February 21, 2013

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

FORM 10-K

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

For the fiscal year ended December 31, 2012

OR

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

For the transition period from _______ to ________

Commission file number 000-25927

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

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

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

Registrant's telephone number, including area code: (616) 820-1444
Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Exchange Act: None

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained in this form and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. o

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

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

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, as of June 30, 2012, was $85,507,285 based on the closing sale price of $3.41 as reported on the Nasdaq Stock Market. There were 27,203,825 outstanding shares of the Company's common stock as of February 21, 2013.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held May 7, 2013 are incorporated by reference into Part III of this report.

MACATAWA BANK CORPORATION
FORM 10-K ANNUAL REPORT
TABLE OF CONTENTS

Table of Contents

Forward-Looking Statements

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

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of this report. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

Table of Contents

PART I

ITEM 1: Business.

As used in this report, the terms "we," "us," "our" and "Company" mean Macatawa Bank Corporation and its subsidiaries, unless the context indicates another meaning. The term "Bank" means Macatawa Bank.

Overview

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. The Company was incorporated in 1997. Our business is concentrated in a single industry segment - commercial banking. Through our wholly-owned subsidiary, Macatawa Bank, we offer a full range of commercial and personal banking services, including checking, savings and certificates of deposit accounts, cash management, safe deposit boxes, trust services and commercial, mortgage and consumer loans through our twenty-six branch offices and a lending and operation service facility in Ottawa County, Kent County and northern Allegan County, Michigan. Other services we offer include ATMs, internet banking, telephone banking and debit cards. The Bank provides various brokerage services, including discount brokerage through Infinex, personal financial planning and consultation regarding mutual funds.

At December 31, 2012, we had total assets of $1.56 billion, total loans of $1.05 billion, total deposits of $1.29 billion and shareholders' equity of $130.5 million. We recognized net income of $35.5 million in 2012, a substantial improvement over the prior two years, and we experienced our eleventh consecutive quarter of net income to end 2012. Positively impacting our net income for 2012 was a $18.9 million reversal of our deferred tax asset valuation allowance as we determined it to be more likely than not that we will be able to utilize our deferred tax asset against future taxable income. During 2012, 2011 and 2010, our interest income accounted for approximately 79%, 80% and 81%, respectively, of our operating revenues and our non-interest income accounted for approximately 21%, 20% and 19%, respectively, of our operating revenues. For additional information about our financial condition and results of operations, see our consolidated financial statements and related notes included in this report.

In response to our losses during 2008, 2009 and the first quarter of 2010, our Board of Directors implemented additional corporate governance practices and disciplined business and banking principles, including more conservative lending principles. The focus of our management team turned from growth in our business to executing these disciplined business and banking procedures and policies designed to limit future losses, preserve capital and improve operational efficiencies. In addition, the Board of Directors added experienced members to provide further oversight and guidance. These and other efforts were reflected in our results of operations for the past two years with lower levels of charge-offs and provisions for loan losses, reductions in operating expenses and reductions in balance sheet totals resulting in improvement in our regulatory capital and liquidity ratios. We successfully completed our shareholder rights offering and public offering of common stock in June 2011 resulting in net proceeds of $20.3 million and contributed $10.0 million of the proceeds from the stock offering to the Bank, retaining the remaining $10.3 million at the holding company. As of December 31, 2012, the Company's and the Bank's risk-based regulatory capital ratios were the highest they have ever been. The Bank was categorized as "well capitalized" at December 31, 2012.

On February 22, 2010, Macatawa Bank entered into a Consent Order with the Federal Deposit Insurance Corporation ("FDIC") and the Michigan Office of Financial and Insurance Regulation ("OFIR"), the primary banking regulators of the Bank. The Company also entered into a Written Agreement with the Federal Reserve Bank of Chicago ("FRB") with an effective date of July 23, 2010. Upon completion of the Bank's 2011 joint examination, the FDIC and OFIR terminated the Bank's Consent Order effective March 2, 2012. In connection with the termination of the Consent Order, the Bank reached an understanding with the regulators in the form of a Memorandum of Understanding ("MOU").

On October 26, 2012, the FRB terminated the Written Agreement. In connection with the termination of the Written Agreement, the Board of Directors adopted a resolution requiring the Company to obtain written approval from the FRB before declaring or paying any dividends, increasing holding company debt (including the issuance of trust preferred securities), or redeeming any capital stock.

For more information about the Consent Order, Written Agreement and MOU, see “Regulatory Developments” and our consolidated financial statements and related notes included in this report.

Table of Contents

Also within the past three years, much progress has been made at reducing our nonperforming assets. The following table reflects period end balances of these nonperforming assets as well as total loan delinquencies.

(dollars in thousands)	December 31, 2012	December 31, 2011	December 31, 2010
Nonperforming loans	$ 16,003	$ 28,946	$ 75,361
Other repossessed assets	6	---	50
Other real estate owned	51,582	66,438	57,984
Total nonperforming assets	$ 67,591	$ 95,384	$ 133,395
Total loan delinquencies 30 days or greater past due	$ 7,887	$ 13,138	$ 55,748

Earnings in recent years have been severely impacted by high costs associated with administration and disposition of nonperforming assets. These costs, including losses on repossessed and foreclosed properties, were $10.0 million and $15.6 million for the years ended December 31, 2012 and 2011, respectively. During 2012, we added $9.2 million in other real estate and sold $18.7 million, allowing for a meaningful reduction in our year-end balance. We expect a significant reduction in the amount of new additions to other real estate in 2013 and continued sales volume, which should allow for reductions in carrying costs in 2013.

Our earnings in 2012 and 2011 were favorably impacted by a negative provision for loan losses of $7.1 million and $4.7 million, respectively. As discussed in detail later in Item 7 of this report under the heading "Allowance for Loan Losses", this was primarily a result of a large recovery taken in the first quarter of 2012 and also impacted by the decline in our historical charge-off levels from prior years. We do not expect a similar level of negative provision for loan losses in 2013.

The following table reflects the provision for loan losses for the past three years along with certain metrics that impact the determination of the level of the provision for loan losses.

(dollars in thousands)	For The Year Ended December 31		
	2012	2011	2010
Provision for loan losses	$(7,100)	$(4,700)	$22,460
Net charge-offs	802	11,085	29,657
Net charge-offs to average loans	0.08 %	0.99 %	2.18 %
Nonperforming loans to total loans	1.52 %	2.70 %	6.19 %
Loans transferred to ORE to average loans	0.88 %	3.42 %	3.32 %
Performing troubled debt restructurings (“TDRs”) to average loans	6.24 %	5.15 %	1.91 %

The State of Michigan entered into a recession earlier than the rest of the country and experienced heavy job loss as a result of the concentration the state has related to the automotive industry. Our market areas of Grand Rapids and Holland fared better than the state as a whole, but nevertheless the impact of our local economy on our results has been profound. The recession and job loss impacted housing values, commercial real estate values and consumer activity. Improvement has been evident during 2011 and 2012. The state’s unemployment rate at the end of 2012 was 8.9%, no longer the highest in the country and down dramatically from 15.2% in June 2009. The Holland area unemployment was 5.5%, and the Grand Rapids area unemployment was 5.6% at the end of 2012. Residential housing values and commercial real estate property values decreased significantly over the past few years, but have shown recent signs of stabilization, with some of our newer appraisals tending to reflect values at or above prior year values.

It also appears that the housing market in our primary market area is beginning to show signs of stabilization. In the Grand Rapids market during 2012, there were 28% more single family home starts than in 2011. Similarly, in the Holland-Grand Haven/Lakeshore region, there were 42% more single family home starts in 2012 than in 2011. Also, these markets are now seeing activity in duplex, condominium and apartment starts after years of virtually no activity.

Over the past two years, we have reduced our balance of loans outstanding, diversified our commercial loan portfolio, reduced concentrations to residential real estate developers and increased our consumer loan portfolio and residential mortgage activity as a percentage of overall production. This has included adding experienced residential mortgage lenders and pulling back on commercial loan production in some cases. Our loans to residential developers have decreased from $66.3 million at December 31, 2011 to $48.9 million at December 31, 2012. In addition, overall commercial real estate loans have decreased from $795.3 million at December 31, 2011 to $762.7 million at December 31, 2012. Consumer loans have increased in 2012, totaling $289.7 million at December 31, 2012, compared to $275.7 million at December 31, 2011. With our improved financial condition and successful capital raise in 2011, our focus has shifted from shrinkage in our loan portfolio to stabilizing our loan balances and growing certain portfolios in 2013.

Table of Contents

We have no material foreign loans, assets or activities. No material part of our business is dependent on a single customer or very few customers. Our loan portfolio is not concentrated in any one industry.

Our headquarters and administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424, and our telephone number is (616) 820-1444. Our internet website address is www.macatawabank.com. We make available free of charge through this website our annual report on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after filing or furnishing such reports with the Securities and Exchange Commission. The information on our website address is not incorporated by reference into this report, and the information on the website is not part of this report.

Regulatory Developments

Termination of Consent Order with Macatawa Bank and its Regulators

On February 22, 2010, the Bank entered into a Consent Order with the FDIC and OFIR, the primary banking regulators of the Bank. The Bank agreed to the terms of the negotiated Consent Order without admitting or denying any charges of unsafe or unsound banking practices. The Consent Order imposed no fines or penalties on the Bank. As a result of the improvement in our financial condition and results of operations, our implementation of additional corporate governance practices and disciplined business and banking principles, and our compliance with the Consent Order, upon completion of the Bank's 2011 joint examination by the FDIC and OFIR, the FDIC and OFIR terminated the Consent Order effective March 2, 2012.

In connection with the termination of the Consent Order, the Bank reached an understanding with the regulators in the form of a MOU, which maintains many of the controls and procedures put in place by the Bank in response to the Consent Order, including: maintenance of a Tier 1 Leverage Capital Ratio of at least 8%, formulating and submitting a written plan of action on each asset classified as Substandard in the Report of Examination ("ROE"), charge-off of all assets classified as "Loss" in the ROE, submission of a written Profit Plan, Board review of the adequacy of the allowance for loan and lease losses each quarter and the receipt of prior written consent of the FDIC and OFIR before the Bank declares or pays any dividends. We believe the Bank was in compliance, in all material respects, with each of these requirements as of the date of this report.

Termination of Written Agreement with Macatawa Bank Corporation and its Regulator

The Company formally entered into a Written Agreement with the FRB. The Written Agreement became effective on July 29, 2010. Effective October 26, 2012, the FRB terminated the Written Agreement due to the improvement in the Company. In connection with the termination of the Written Agreement, the Board of Directors adopted a resolution requiring the Company to obtain written approval from the FRB before declaring or paying any dividends, increasing holding company debt (including the issuance of trust preferred securities), or redeeming any capital stock.

Table of Contents

Products and Services

Loan Portfolio

We have historically offered a broad range of loan products to business customers, including commercial and industrial and commercial real estate loans, and to retail customers, including residential mortgage and consumer loans. Given current soft economic conditions, new commercial loan origination activity has been significantly lower than it was when economic conditions were stronger. However, select, well-managed loan renewal activity is taking place. Following is a discussion of our various types of lending activities.

Commercial and Industrial Loans

Our commercial and industrial lending portfolio contains loans with a variety of purposes and security, including loans to finance operations and equipment. Generally, our commercial and industrial lending has been limited to borrowers headquartered, or doing business, in our primary market area. These credit relationships typically require the satisfaction of appropriate loan covenants and debt formulas, and generally require that the Bank be the primary depository bank of the business. These loan covenants and debt formulas are monitored through periodic, required reporting of accounts receivable aging schedules and financial statements, and in the case of larger business operations, reviews or audits by independent professional firms.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself and economic conditions. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial Real Estate Loans

Our commercial real estate loans consist primarily of construction and development loans and multi-family and other non-residential real estate loans.

Construction and Development Loans. These consist of construction loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments.

This portfolio was particularly adversely affected by job losses, declines in real estate value, declines in home sale volumes, and declines in new home building. Declining real estate values resulted in sharp increases in losses, particularly in the land development and construction loan portfolios to residential developers. We curtailed this type of lending beginning in 2008. During the past several years, we made a significant effort to reduce exposure to residential land development and other construction and development loans.

Multi-Family and Other Non-Residential Real Estate Loans. These are permanent loans secured by multi-family and other non-residential real estate and include loans secured by apartment buildings, condominiums, small office buildings, small business facilities, medical facilities and other non-residential building properties, substantially all of which are located within our primary market area.

Multi-family and other non-residential real estate loans generally present a higher level of risk than loans secured by owner occupied one- to four-family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of these loans is typically dependent upon the successful operation of the related real estate project. For example, if leases are not obtained or renewed, or a bankruptcy court modifies a lease term, or a major tenant is unable to fulfill its lease obligations, cash flow from the project will be reduced. If cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Retail Loans

Our retail loans are loans to consumers and consist primarily of residential mortgage loans and consumer loans.

Table of Contents

Residential Mortgage Loans. We originate construction loans to individuals for the construction of their residences and owner-occupied residential mortgage loans, which are generally long-term with either fixed or adjustable interest rates. Our general policy is to sell the majority of our fixed rate residential mortgage loans in the secondary market due primarily to the interest rate risk associated with these loans.

During 2010, we sold the majority of our loan originations in the secondary market to support our goal of shrinking the loan portfolio and preserving capital. We retained loans representing only approximately 10% of the dollar volume originated. Relationships were established with new investors in 2010 and 2011, allowing us to continue our historical practice of originating and selling most of our fixed rate mortgage loan volume. During 2011 and 2012, in an effort to further diversify our loan concentrations, we increased our targeted retention of residential mortgage loans, resulting in a $25.7 million increase in balances held in portfolio at December 31, 2012 compared to December 31, 2011. For 2012, we retained loans representing 34.6% of the total dollar volume originated.

Our borrowers generally qualify and are underwritten using industry standards for quality residential mortgage loans. We do not originate loans that are considered "sub-prime". Residential mortgage loan originations derive from a number of sources, including advertising, direct solicitation, real estate broker referrals, existing borrowers and depositors, builders and walk-in customers. Loan applications are accepted at most of our offices. The substantial majority of these loans are secured by one-to-four family properties in our market area.

Consumer Loans. We originate a variety of different types of consumer loans, including automobile loans, home equity lines of credit and installment loans, home improvement loans, deposit account loans and other loans for household and personal purposes. We also originate home equity lines of credit utilizing the same underwriting standards as for home equity installment loans. Home equity lines of credit are revolving line of credit loans. The majority of our existing home equity line of credit portfolio has variable rates with floors and ceilings, interest only payments and a maximum maturity of ten years.

The underwriting standards that we employ for consumer loans include a determination of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes a comparison of the value of the security, if any, in relation to the proposed loan amount. Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Table of Contents

Loan Portfolio Composition

The following table reflects the composition of our loan portfolio and the corresponding percentage of our total loans represented by each class of loans as of the dates indicated.

(Dollars in thousands)	December 31								
	2012		2011		2010		2009		200
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount
Real estate - construction (1)	$89,631	8 %	$90,191	8 %	$133,228	11 %	$162,615	11 %	$237,108
Real estate - mortgage	408,338	40 %	478,076	45 %	535,961	44 %	640,437	42 %	690,525
Commercial and industrial	264,690	25 %	227,051	21 %	264,679	22 %	369,523	24 %	451,826
Total Commercial	762,659	73 %	795,318	74 %	933,868	77 %	1,172,575	77 %	1,379,45
Residential mortgage	182,625	17 %	156,891	15 %	135,227	11 %	163,074	11 %	203,954
Consumer	107,064	10 %	118,766	11 %	148,101	12 %	175,167	12 %	190,650
Total loans	$1,052,348	100%	$1,070,975	100%	$1,217,196	100%	$1,510,816	100%	$1,774,06
Less:									
Allowance for loan losses	(23,739)		(31,641)		(47,426)		(54,623)		(38,262
Total loans receivable, net	$1,028,609		$1,039,334		$1,169,770		$1,456,193		$1,735,80

(1) Consists of construction and development loans.

At December 31, 2012, there was no concentration of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the table above.

Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table shows the amount of total loans outstanding at December 31, 2012 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

(Dollars in thousands)	Maturing			
	Within One Year	After One, But Within Five Years	After Five Years	Total
Real estate - construction (1)	$53,188	$17,001	$7,128	$77,317
Real estate – mortgage	132,847	232,672	55,133	420,652
Commercial and industrial	134,529	116,037	14,124	264,690
Total Commercial	320,564	365,710	76,385	762,659
Residential mortgage	7,857	385	174,383	182,625
Consumer	12,042	39,313	55,709	107,064
Total Loans	$340,463	$405,408	$306,477	$1,052,348

	Maturing or Repricing			
Loans above:				
With predetermined interest rates	$110,304	$233,976	$128,945	$473,225
With floating or adjustable rates	515,853	21,315	26,570	563,738
Total (excluding nonaccrual loans)	$626,157	$255,291	$155,515	$1,036,963
Nonaccrual loans				15,385
Total Loans				$1,052,348

(1) Consists of construction and development loans.

Table of Contents

Nonperforming Assets

The following table shows the composition and amount of our nonperforming assets.

	December 31				
(Dollars in thousands)	2012	2011	2010	2009	2008
Nonaccrual loans	$15,385	$26,876	$74,761	$95,725	$89,049
Loans 90 days or more delinquent and still accruing	618	2,070	600	8,160	3,200
Total nonperforming loans (NPLs)	16,003	28,946	75,361	103,885	92,249
Foreclosed assets	51,582	66,438	57,984	37,184	19,516
Repossessed assets	6	---	50	124	306
Total nonperforming assets (NPAs)	67,591	95,384	133,395	141,193	112,071
Accruing troubled debt restructurings (TDRs) (1)	65,024	55,679	25,395	18,000	---
Total NPAs and accruing TDRs	$132,615	$151,063	$158,790	$159,193	$112,071
NPLs to total loans	1.52 %	2.70 %	6.19 %	6.88 %	5.20 %
NPAs to total assets	4.33 %	6.33 %	8.45 %	7.71 %	5.21 %

(1) Comprised of approximately $51.8 million and $40.9 million of commercial loans and $13.2 million and $14.8 million of residential mortgage loans at December 31, 2012 and 2011, respectively, whose terms have been restructured. Interest is being accrued on these loans under their restructured terms as they are less than 90 days past due.

Interest income totaling $4.0 million was recorded in 2012 on loans that were on a non-accrual status or classified as restructured as of December 31, 2012. Additional interest income of $959,000 would have been recorded during 2012 on these loans had they been current in accordance with their original terms. More information about the elevated levels of nonperforming loan balances in 2012 and 2011 and our policy for placing loans on non-accrual status may be found in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Loans at December 31, 2012 that were classified as substandard or worse per our internal risk rating system not included in the nonperforming assets table above that would cause management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms are discussed in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition." At December 31, 2012, there were no other interest-bearing assets that would be required to be disclosed under Industry Guide 3, Item III, C. 1. or 2. if such assets were loans.

Table of Contents

Loan Loss Experience

The following is a summary of our loan balances at the end of each period and the daily average balances of these loans. It also includes changes in the allowance for loan losses arising from loans charged-off and recoveries on loans previously charged-off, and additions to the allowance which we have expensed.

	December 31				
(Dollars in thousands)	2012	2011	2010	2009	2008
Loans:					
Average daily balance of loans for the year	$1,041,833	$1,120,857	$1,360,548	$1,637,143	$1,762,102
Amount of loans outstanding at end of period	1,052,348	1,070,975	1,217,196	1,510,816	1,774,063
Allowance for loan losses:					
Balance at beginning of year	$31,641	$47,426	$54,623	$38,262	$33,422
Addition/(Reduction) to allowance charged to operations	(7,100)	(4,700)	22,460	74,340	37,435
Loans charged-off:					
Real estate – construction (1)	(1,455)	(3,014)	(9,768)	(29,237)	(15,754)
Real estate – mortgage	(1,751)	(7,967)	(11,499)	(17,952)	(11,005)
Commercial and industrial	(1,245)	(2,935)	(7,400)	(10,632)	(5,651)
Total Commercial	(4,451)	(13,916)	(28,667)	(57,821)	(32,410)
Residential mortgage	(2,257)	(1,559)	(1,364)	(613)	(223)
Consumer	(788)	(976)	(1,806)	(1,508)	(684)
Total charge-offs	(7,496)	(16,451)	(31,837)	(59,942)	(33,317)
Recoveries:					
Real estate - construction (1)	5,521	2,541	613	142	310
Real estate - mortgage	319	802	663	157	8
Commercial and industrial	547	1,727	694	1,608	348
Total Commercial	6,387	5,070	1,970	1,907	666
Residential mortgage	142	39	115	13	28
Consumer	165	257	95	43	28
Total recoveries	6,694	5,366	2,180	1,963	722
Net charge-offs	(802)	(11,085)	(29,657)	(57,979)	(32,595)
Balance at end of year	$23,739	$31,641	$47,426	$54,623	$38,262
Ratios:					
Net charge-offs to average loans outstanding	.08%	.99%	2.18%	3.54%	1.85%
Allowance for loan losses to loans outstanding at year end	2.26%	2.95%	3.90%	3.62%	2.16%
Allowance for loan losses to nonperforming loans at year end	148.34%	109.31%	62.93%	52.58%	41.48%

(1) Consists of construction and development loans.

Additional information about our allowance for loan losses, including the factors which influenced management’s judgment in determining the amount of the additions to the allowance charged to operating expense, may be found in Item 7 of this report under the heading "Allowance for Loan Losses" in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Table of Contents

Allocation of the Allowance for Loan Losses

The following table shows the allocation of the allowance for loan loss at the dates indicated to the extent specific allocations have been determined relative to particular loans.

(Dollars in thousands)	December 31									
	2012		2011		2010		2009		2008	
	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans
Commercial and commercial real estate	$19,952	73 %	$26,820	74 %	$42,011	77 %	$51,856	77 %	$35,427	78 %
Residential mortgage	2,544	17 %	3,093	15 %	2,155	11 %	1,263	11 %	982	11 %
Consumer	1,243	10 %	1,728	11 %	3,260	12 %	1,504	12 %	1,853	11 %
Total	$23,739	100 %	$31,641	100 %	$47,426	100 %	$54,623	100 %	$38,262	100 %

Deposit Portfolio

We offer a broad range of deposit services, including checking accounts, savings accounts and time deposits of various types. Transaction accounts and savings and time certificates are tailored to the principal market area at rates competitive with those offered in the area. All deposit accounts are insured by the FDIC up to the maximum amount permitted by law.

We solicit deposit services from individuals, businesses, associations, churches, nonprofit organizations, financial institutions and government authorities. Deposits are gathered primarily from the communities we serve through our network of 26 branches. We offer business and consumer checking accounts, regular and money market savings accounts, and certificates of deposit with many term options. We operate in a competitive environment, competing with other local banks similar in size and with significantly larger regional banks. We monitor rates at other financial institutions in the area to ascertain that our rates are competitive with the market. We also attempt to offer a wide variety of products to meet the needs of our customers. We set our deposit pricing to be competitive with other banks in our market area.

We have also utilized alternative funding sources as needed, including short-term borrowings, advances from the Federal Home Loan Bank of Indianapolis or the Federal Reserve Bank of Chicago, securities sold under agreements to repurchase ("repo borrowings") and certificates of deposit purchased from brokers.

Before November of 2008, we purchased brokered deposits to supplement funding needs from time to time. These are time accounts originated outside of our local market area. The Bank has not accepted or renewed brokered deposits since November of 2008. There were no brokered deposits remaining at December 31, 2012 or 2011.

Deposit Portfolio Composition