First Internet Bancorp
Form 10-Q
August 15, 2013

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

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period June 30, 2013

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From ________ to ________.

Commission File Number **001-35750**

First Internet Bancorp
(Exact Name of Registrant as Specified in Its Charter)

Indiana (State or Other Jurisdiction of Incorporation or Organization)	**20-3489991** (I.R.S. Employer Identification No.)
8888 Keystone Crossing, Suite 1700 Indianapolis, Indiana (Address of Principal Executive Offices)	**46240** (Zip Code)

(317) 532-7900
(Registrant’s Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer ¨	Accelerated Filer ¨
Non-accelerated Filer ¨ (Do not check if a smaller reporting company)	Smaller Reporting Company þ

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

As of August 12, 2013, the registrant had 2,861,326 shares of common stock issued and outstanding.

Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain “forward-looking statements” within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on First Internet Bancorp’s (“we,” “our,” “us” or the “Company”) current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are generally preceded by terms such as “expects,” “believes,” “anticipates,” “intends” and similar expressions. Such statements are subject to certain risks and uncertainties including changes in economic conditions in our market area, changes in policies by regulatory agencies, the outcome of litigation, fluctuations in interest rates and real estate property values in our market area, demand for loans and deposits in the Company’s market area, changes in the quality or composition of our loan portfolio, changes in accounting principles, laws and regulations, and competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. Additional factors that may affect our results include those discussed in our most recent Annual Report on Form 10-K under the heading “Risk Factors” and in other reports filed with the Securities and Exchange Commission. The Company cautions readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors listed above could affect the Company’s financial performance and could cause the Company’s actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements.

Except as required by law, the Company does not undertake, and specifically disclaims any obligation, to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

PART I

ITEM 1. FINANCIAL STATEMENTS

First Internet Bancorp

Condensed Consolidated Balance Sheets
(Dollar Amounts in Thousands except shares)

	June 30, 2013 (Unaudited)	December 31, 2012
Assets		
Cash and due from banks	$ 1,355	$ 2,881
Interest-bearing demand deposits	14,093	29,632
Total cash and cash equivalents	15,448	32,513
Interest-bearing time deposits	2,500	—
Securities available for sale - at fair value (amortized cost of $196,375 and $153,896)	193,934	156,693
Loans held for sale (includes $27,586 and $0 at fair value, respectively)	42,271	63,234
Loans receivable - net of allowance for loan losses of $5,527 and $5,833	360,800	352,328
Accrued interest receivable	2,271	2,196
Federal Home Loan Bank of Indianapolis stock	2,943	2,943
Cash surrender value of life insurance	11,735	11,539
Premises and equipment, net	6,740	793
Goodwill	4,687	4,687
Other real estate owned	5,156	3,666
Other assets	8,280	5,775
Total assets	$ 656,765	$ 636,367
Liabilities and Shareholders' Equity		
Liabilities		
Non-interest bearing deposits	$ 16,915	$ 13,187
Interest-bearing deposits	544,247	517,504
Total deposits	561,162	530,691
Advances from Federal Home Loan Bank	23,740	40,686
Subordinated debt	2,745	—
Accrued interest payable	100	120
Accrued expenses and other liabilities	7,840	3,520
Total liabilities	595,587	575,017
Commitments and Contingencies		
Shareholders' Equity		
Preferred stock, no par value; 4,913,779 shares authorized; issued and outstanding - none	—	—
Voting common stock, no par value; 45,000,000 shares authorized; 2,815,094 shares issued and outstanding	41,826	41,508

Nonvoting common stock, no par value; 86,221 shares authorized; issued and outstanding - none	—	—
Retained earnings	20,938	18,024
Accumulated other comprehensive income / (loss)	(1,586)	1,818
Total shareholders’ equity	61,178	61,350
Total liabilities and shareholders’ equity	$ 656,765	$ 636,367

See Notes to Condensed Consolidated Financial Statements

1

First Internet Bancorp

Condensed Consolidated Statements of Income – Unaudited
(Dollar Amounts in Thousands except shares and per share data)

	Three Months Ended June 30,	
	2013	2012
Interest Income		
Loans	$ 4,861	$ 4,715
Securities – taxable	902	916
Securities – non-taxable	396	424
Total interest income	6,159	6,055
Interest Expense		
Deposits	1,656	1,826
Other borrowed funds	267	339
Total interest expense	1,923	2,165
Net Interest Income	4,236	3,890
Provision for Loan Losses	24	564
Net Interest Income After Provision for Loan Losses	4,212	3,326
Noninterest Income		
Service charges and fees	179	166
Gain on loans sold	2,249	2,035
Gain on secondary marketing hedge	1,208	—
Other-than-temporary impairment		
Total loss related to other-than-temporarily impaired securities	(15)	(1,429)
Portion of loss recognized in other comprehensive income (loss)	—	1,337
Other-than-temporary impairment loss recognized in net income	(15)	(92)
Gain on sale of securities	19	9
Loss on asset disposals	(8)	(40)
Other	87	97
Total noninterest income	3,719	2,175
Noninterest Expense		
Salaries and employee benefits	2,846	1,914
Marketing, advertising and promotion	455	341
Professional services	561	271
Data processing	232	238
Loan expenses	285	303
Net occupancy expenses	616	365
Deposit insurance premium	115	121
Other	415	240
Total noninterest expense	5,525	3,793
Income Before Income Taxes	2,406	1,708
Income Tax Provision	694	428
Net Income	$ 1,712	$ 1,280
Income Per Share of Common Stock		
Basic	$ 0.59	$ 0.45

Diluted	0.59	0.45
Weighted-Average Number of Common Shares Outstanding		
Basic	2,888,260	2,867,763
Diluted	2,888,260	2,867,763
Dividends Declared Per Share	$ 0.06	$ —

See Notes to Condensed Consolidated Financial Statements

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First Internet Bancorp

Condensed Consolidated Statements of Income – Unaudited
(Dollar Amounts in Thousands except shares and per share data)

	Six Months Ended June 30,	
	2013	2012
Interest Income		
Loans	$9,903	$9,513
Securities – taxable	1,386	1,858
Securities – non-taxable	699	845
Total interest income	11,988	12,216
Interest Expense		
Deposits	3,284	3,647
Other borrowed funds	575	677
Total interest expense	3,859	4,324
Net Interest Income	8,129	7,892
Provision for Loan Losses	158	1,134
Net Interest Income After Provision for Loan Losses	7,971	6,758
Noninterest Income		
Service charges and fees	338	361
Gain on loans sold	5,260	3,785
Gain on secondary market hedge	1,208	—
Other-than-temporary impairment		
Total loss related to other-than-temporarily impaired securities	(994)	(1,429)
Portion of loss recognized in other comprehensive income (loss)	945	1,337
Other-than-temporary impairment loss recognized in net income	(49)	(92)
Gain (loss) on sale of securities	(166)	49
Loss on asset disposals	(87)	(150)
Other	202	190
Total noninterest income	6,706	4,143
Noninterest Expense		
Salaries and employee benefits	5,225	3,905
Marketing, advertising and promotion	827	732
Professional services	1,214	599
Data processing	446	468
Loan expenses	365	488
Net occupancy expenses	934	777
Deposit insurance premium	227	219
Other	850	487
Total noninterest expense	10,088	7,675
Income Before Income Taxes	4,589	3,226
Income Tax Provision	1,389	800
Net Income	$3,200	$2,426
Income Per Share of Common Stock		

Basic	$1.11	$0.85
Diluted	$1.11	$0.85
Weighted-Average Number of Common Shares Outstanding		
Basic	2,887,207	2,866,174
Diluted	2,887,207	2,866,174
Dividends Declared Per Share	$0.12	$—

See Notes to Condensed Consolidated Financial Statements

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First Internet Bancorp

Condensed Consolidated Statements of Comprehensive Income – Unaudited
(Dollar Amounts in Thousands)

	Three Months Ended June 30,	
	2013	2012
Net income	$ 1,712	$ 1,280
Other comprehensive income (loss)		
Net unrealized holding gains (losses) on securities available for sale	(5,048)	1,486
Reclassification adjustment for (gains) realized	(19)	(9)
Net unrealized holding losses on securities available for sale for which an other-than-temporary impairment has been recognized in income	(15)	(1,429)
Reclassification adjustment for other-than-temporary impairment loss recognized in income	15	92
Other comprehensive income (loss) before tax	(5,067)	140
Income tax (provision) benefit	1,774	(42)
Other comprehensive income (loss) - net of tax	(3,293)	98
Comprehensive income (loss)	$ (1,581)	$ 1,378

First Internet Bancorp

Condensed Consolidated Statements of Comprehensive Income – Unaudited
(Dollar Amounts in Thousands)

	Six Months Ended June 30,	
	2013	2012
Net income	$ 3,200	$ 2,426
Other comprehensive income (loss)		
Net unrealized holding gains (losses) on securities available for sale	(4,459)	1,935
Reclassification adjustment for (gains) losses realized	166	(49)
Net unrealized holding losses on securities available for sale for which an other-than-temporary impairment has been recognized in income	(994)	(1,429)
Reclassification adjustment for other-than-temporary impairment loss recognized in income	49	92
Other comprehensive income (loss) before tax	(5,238)	549
Income tax (provision) benefit	1,834	(187)
Other comprehensive income (loss) - net of tax	(3,404)	362
Comprehensive income (loss)	$ (204)	$ 2,788

See Notes to Condensed Consolidated Financial Statements

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First Internet Bancorp

Consolidated Statements of Shareholders' Equity - Unaudited
Six Months Ended June 30, 2013
(Dollar Amounts in Thousands except per share data)

	Voting and Nonvoting Common Stock	Accumulated Other Comprehensive Income	Retained Earnings	Total Shareholders' Equity
Balance, January 1, 2013	$ 41,508	$ 1,818	$ 18,024	$ 61,350
Net income	—	—	3,200	3,200
Other comprehensive loss	—	(3,404)	—	(3,404)
Cash dividends declared ($0.12 per share)	—	—	(286)	(286)
Issuance of common stock warrants	255	—	—	255
Issuance of directors deferred stock rights	63	—	—	63
Balance, June 30, 2013	$ 41,826	$ (1,586)	$ 20,938	$ 61,178

First Internet Bancorp

Condensed Consolidated Statements of Cash Flows – Unaudited
(Dollar Amounts in Thousands)

	Six Months Ended June 30,	
	2013	2012
Operating Activities		
Net income	$ 3,200	$ 2,426
Adjustments to reconcile net income to net cash from operating activities		
Depreciation	268	149
Amortization	997	1,001
Loss from real estate owned	—	67
Increase in cash surrender value of life insurance	(196)	(185)
Provision for loan losses	158	1,134
Deferred income taxes	666	94
Stock compensation expense	60	40
Loss on other-than-temporary impairment of security	49	92
Loss (Gain) from sale of available-for-sale securities	166	(49)
Loans originated for sale	(512,531)	(329,254)
Proceeds from sale of loans	537,627	343,170
Gain on loans sold	(5,260)	(3,785)
Fair value adjustment on loans held-for-sale	1,127	—
Changes in assets and liabilities		
Accrued interest receivable	(75)	(135)
Other assets	(1,321)	358
Accrued expenses and other liabilities	1,028	262
Net cash used in operating activities	25,963	15,385
Investing Activities		
Net change in loans	(9,137)	(13,131)
Net change in interest bearing deposits	(2,500)	—
Loans purchased	—	—
Life insurance purchased	—	(3,000)
Proceeds from liquidation of real estate owned	—	694
Maturities of securities available for sale	22,064	21,690
Proceeds from sale of securities available for sale	41,040	3,477
Purchase of securities available for sale	(103,526)	(59,000)
Purchase of premises and equipment	(7,326)	(251)
Net cash used in investing activities	(59,385)	(49,521)
Financing Activities		
Net increase in deposits	30,471	35,360
Cash dividends	(114)	—
Proceeds from issuance of subordinated debt and related warrants	3,000	—
Repayment of FHLB advances	(17,000)	—
Net cash provided by financing activities	16,357	35,360
Net Increase in Cash and Cash Equivalents	(17,065)	1,224

Cash and Cash Equivalents, Beginning of Period	32,513	34,778
Cash and Cash Equivalents, End of Period	$ 15,448	$ 36,002
Supplemental Disclosures of Cash Flows Information		
Cash paid during the period for interest	$ 3,879	$ 4,329
Cash paid during the period for taxes	723	698
Loans transferred to real estate owned	507	—
Dividends declared, not paid	169	—

See Notes to Condensed Consolidated Financial Statements

First Internet Bancorp

Notes to Condensed Consolidated Financial Statements – Unaudited
(Dollar Amounts in Thousands except shares and per share data)

Note 1: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information or footnotes necessary for a complete presentation of financial condition, results of operations, or cash flows in accordance with U.S. generally accepted accounting principles (“GAAP”). In our opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation have been included. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results expected for the year ending December 31, 2013 or any other period. The June 30, 2013 condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the First Internet Bancorp Annual Report on Form 10-K for the year ended December 31, 2012.

The preparation of the condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, judgments, or assumptions that could have a material effect on the carrying value of certain assets and liabilities. These estimates, judgments, and assumptions affect the amounts reported in the condensed consolidated financial statements and the disclosures provided. The determination of the allowance for loan losses, valuations and impairments of investment securities, and the accounting for income tax expense are highly dependent on management’s estimates, judgments, and assumptions where changes in any of these could have a significant impact on the financial statements.

The condensed consolidated financial statements include the accounts of First Internet Bancorp (“Company”), its wholly-owned subsidiary, First Internet Bank of Indiana (“Bank”), and the Bank’s wholly-owned subsidiary, JKH Realty Services, LLC. All significant intercompany accounts and transactions have been eliminated in consolidation. Share amounts presented have been restated to reflect the three-for-two stock split that occured on June 21, 2013.

The Company is subject to claims and lawsuits that arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial position, results of operations and cash flows of the Company.

Certain reclassifications have been made to the 2012 financial statements to conform to the 2013 financial statement presentation. These reclassifications had no effect on net income.

On June 21, 2013, the Company completed a three-for-two (3:2) split of its common stock by the payment of a stock dividend of one-half of one share on each outstanding share of common stock. Except as otherwise indicated, all of the share and per-share information referenced throughout this report has been adjusted to reflect this stock split.

Note 2: Earnings Per Share

Earnings per share of common stock are based on the weighted-average number of basic shares and dilutive shares outstanding during the period.

The following is a reconciliation of the weighted-average common shares for the basic and diluted earnings per share computations for the three and six months ended June 30, 2013 and 2012:

	Three Months Ended June 30,	
	2013	2012
Basic earnings per share		
Net income available to common shareholders	$ 1,712	$ 1,280
Weighted-average common shares	2,888,260	2,867,763
Basic earnings per common share	$ 0.59	$ 0.45
Diluted earnings per share		
Net income applicable to diluted earnings per share	$ 1,712	$ 1,280
Weighted-average common shares	2,888,260	2,867,763
Dilutive effect of warrants	—	—
Dilutive effect of equity compensation	—	—
Weighted-average common and incremental shares	2,888,260	2,867,763
Diluted earnings per common share	$ 0.59	$ 0.45
Number of shares and warrants excluded from the calculation of diluted earnings per share as the exercise prices were greater than the average market price of the Company's common stock during the period	48,750	90,000

	Six Months Ended June 30,	
	2013	2012
Basic earnings per share		
Net income available to common shareholders	$ 3,200	$ 2,426
Weighted-average common shares	2,887,207	2,866,174
Basic earnings per common share	$ 1.11	$ 0.85
Diluted earnings per share		
Net income applicable to diluted earnings per share	$ 3,200	$ 2,426
Weighted-average common shares	2,887,207	2,866,174
Dilutive effect of warrants	—	—
Dilutive effect of equity compensation	—	—
Weighted-average common and incremental shares	2,887,207	2,866,174
Diluted earnings per common share	$ 1.11	$ 0.85
Number of shares and warrants excluded from the calculation of diluted earnings per share as the exercise prices were greater than the average market price of the Company's common stock during the period	48,750	90,000

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Note 3: Securities

Securities at June 30, 2013 and December 31, 2012 are as follows:

	June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale				
U.S. government-sponsored enterprises	$58,836	$693	$(1,191)	$58,338
Municipals	45,926	1,299	(762)	46,463
Mortgage-backed and asset-backed securities – government-sponsored enterprises	55,433	921	(1,294)	55,060
Mortgage-backed and asset-backed securities – private labeled	1,595	12	(85)	1,522
Other securities	34,585	76	(2,110)	32,551
Total available for sale	$196,375	$3,001	$(5,442)	$193,934

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale				
U.S. government-sponsored enterprises	$18,666	$953	$(1)	$19,618
Municipals	39,999	2,685	(144)	42,540
Mortgage-backed and asset-backed securities – government-sponsored enterprises	75,782	1,884	(177)	77,489
Mortgage-backed and asset-backed securities – private labeled	2,696	17	(260)	2,453
Other securities	16,753	105	(2,265)	14,593
Total available for sale	$153,896	$5,644	$(2,847)	$156,693

The carrying value of securities at June 30, 2013 is shown below by their contractual maturity date. Actual maturities will differ because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale	
	Amortized Cost	Fair Value
Within one year	$1,500	$1,491
One to five years	36,091	35,728

Five to ten years	36,513	36,158
After ten years	65,243	63,975
	139,347	137,352
Mortgage-backed and asset-backed securities – government-sponsored enterprises	55,433	55,060
Mortgage-backed and asset-backed securities – private labeled	1,595	1,522
Totals	$196,375	$193,934

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Gross gains of $24 and $9, and gross losses of $5 and zero resulting from sales of available-for-sale securities were realized for three month period ended June 30, 2013 and 2012, respectively. In the six month period ended June 30, 2013 and 2012, gross gains of $126 and $49 and gross losses of $292 and zero were recognized, respectively.

Certain investments in debt securities are reported in the condensed consolidated financial statements at an amount less than their historical cost. Total fair value of these investments at June 30, 2013 and December 31, 2012 was $112,988 and $41,986, which is approximately 58% and 27%, respectively, of the Company's available-for-sale investment portfolio. These declines primarily resulted from increases in market interest rates after purchase.

Except as discussed below, management believes the declines in fair value for these securities are temporary.

Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period in which the other-than-temporary impairment ("OTTI") is identified.

The following tables show the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2013 and December 31, 2012:

	June 30, 2013					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S.government-sponsored enterprises	$41,911	$ (1,191)	$—	$ —	$41,911	$ (1,191)
Municipals	9,622	(620)	980	(142)	10,602	(762)
Mortgage-backed and asset-backed securities - government-sponsored enterprises	35,179	(1,294)	—	—	35,179	(1,294)
Mortgage-backed and asset-backed securities – private labeled	—	—	1,006	(85)	1,006	(85)
Other securities	20,782	(582)	3,508	(1,528)	24,290	(2,110)
	$107,494	$ (3,687)	$5,494	$ (1,755)	$112,988	$ (5,442)

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	December 31, 2012					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. government-sponsored enterprises	$—	$ —	$ 119	$ (1)	$119	$ (1)
Municipals	470	(4)	2,618	(140)	3,088	(144)
Mortgage-backed and asset-backed securities - government-sponsored enterprises	28,505	(177)	—	—	28,505	(177)
Mortgage-backed and asset-backed securities – private labeled	—	—	1,504	(260)	1,504	(260)
Other securities	5,947	(53)	2,823	(2,212)	8,770	(2,265)
	$34,922	$ (234)	$ 7,064	$ (2,613)	$41,986	$ (2,847)

U.S. Government Sponsored Enterprise and Municipal Securities

The unrealized losses on the Company’s investments in securities issued by U.S. Government sponsored enterprises and municipal securities were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is unlikely the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2013.

Mortgage-Backed Securities

The unrealized losses on the Company’s investment in mortgage-backed securities were caused by interest rate changes. The Company expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments, and it is unlikely the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2013.

Other Securities

The Company’s unrealized loss on investments in other securities is primarily made up of two investments. The first investment is a $2,000 par investment in I-PreTSL I B-2 pooled trust security. The unrealized loss was primarily caused by a sector downgrade by several industry analysts. The Company currently expects to recover the entire amortized cost basis of the investment. The determination of no credit loss was calculated by comparing expected discounted cash flows based on performance indicators of the underlying assets in the security to the carrying value of the investment. Because the Company does not intend to sell the investment and it is unlikely the Company will be required to sell the investment before recovery of its amortized cost basis, which may be maturity, it does not consider the remainder of the investment to be other-than-temporarily impaired at June 30, 2013. The second investment is discussed in the next section.

Other-Than-Temporary Impairment

The Company routinely conducts periodic reviews to identify and evaluate investment securities to determine whether an OTTI has occurred. For certain investments, economic models are used to determine whether an OTTI has occurred on these securities.

An OTTI has been recognized on a $2,000 par investment in ALESCO IV Series B2 pooled trust security. The unrealized loss was primarily caused by (a) a decrease in performance and (b) a sector downgrade by several industry analysts. The Company currently expects ALESCO IV to settle the security at a price less than the contractual amount of the investment (that is, the Company expects to recover less than the entire amortized cost basis of the security). The Company has recognized a loss equal to the credit loss, establishing a new, lower amortized cost basis. The credit loss was calculated by comparing expected discounted cash flows based on performance indicators of the underlying assets in the security to the carrying value of the investment. Because the Company does not intend to sell the investment and it is unlikely the Company will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity, it does not consider the remainder of the investment in ALESCO IV to be other-than-temporarily impaired at June 30, 2013.

For identified mortgage-backed securities in the investment portfolio, an extensive, quarterly review is conducted to determine if an OTTI has occurred. Various inputs to the economic models are used to determine if an unrealized loss is other-than-temporary. The most significant inputs are voluntary prepay rates, default rates, liquidation rates and loss severity.

To determine if the unrealized loss for mortgage-backed securities is other-than-temporary, the Company projects total estimated defaults of the underlying assets (mortgages) and multiplies that calculated amount by an estimate of realizable value upon sale in the marketplace (severity) in order to determine the projected collateral loss. The Company also evaluates the current credit enhancement underlying the bond to determine the impact on cash flows. If the Company determines that a given mortgage-backed security position will be subject to a write-down or loss, the Company records the expected credit loss as a charge to earnings.

The credit losses recognized in earnings during the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,	
	2013	2012
ALESCO IV Series B2	$ —	$ —
I-PreTSL I B-2	—	—

Mortgage-backed and asset-backed securities – private labeled	15	92
	$ 15	$ 92

	Six Months Ended June 30,	
	2013	2012
ALESCO IV Series B2	$ —	$ —
I-PreTSL I B-2	—	—
Mortgage-backed and asset-backed securities – private labeled	49	92
	$ 49	$ 92

Credit Losses Recognized on Investments

Certain debt securities have experienced fair value deterioration due to credit losses, as well as due to other market factors, but are not otherwise other-than-temporarily impaired.

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The following tables provide information about debt securities for which only a credit loss was recognized in income and other losses are recorded in other comprehensive loss.

	Accumulated Credit Losses
Credit losses on debt securities held	
April 1, 2013	$ 1,505
Realized losses related to other-than-temporary impairments	(178)
Additions related to other-than-temporary losses not previously recognized	—
Additions related to increases in previously recognized other-than-temporary losses	15
June 30, 2013	$ 1,342

	Accumulated Credit Losses
Credit losses on debt securities held	
April 1, 2012	$ 1,835
Realized losses related to other-than-temporary impairments	(7)
Additions related to other-than-temporary losses not previously recognized	—
Additions related to increases in previously recognized other-than-temporary losses	92
June 30, 2012	$ 1,920

	Accumulated Credit Losses
Credit losses on debt securities held	
January 1, 2013	$ 1,737
Realized losses related to other-than-temporary impairments	(444)
Additions related to other-than-temporary losses not previously recognized	31
Additions related to increases in previously recognized other-than-temporary losses	18
June 30, 2013	$ 1,342

	Accumulated Credit Losses
Credit losses on debt securities held	
January 1, 2012	$ 1,835
Realized losses related to other-than-temporary impairments	(7)
Additions related to other-than-temporary losses not previously recognized	—
Additions related to increases in previously recognized other-than-temporary losses	92
June 30, 2012	$ 1,920

Amounts reclassified from accumulated other comprehensive income and the affected line items in the statements of income during the three and six months ended June 30, 2013 and 2012, were as follows:

	Amounts Reclassified from Accumulated Other Comprehensive Income for the Three Months Ended June 30,		Affected Line Item in the Statements
	2013	2012	of Income
Securities available for sale			
Gain (loss) realized in earnings	$ 19	$ 9	Gain (loss) on sale of securities
OTTI losses recognized in earnings	(15)	(92)	Other-than-temporary impairment loss recognized in Net Income
Total reclassified amount before tax	4	(83)	Income Before Income Taxes
Tax (expense) benefit	(1)	29	Income Tax Provision
Total reclassifications out of Accumulated Other Comprehensive Income	$ 3	$ (54)	Net Income

	Amounts Reclassified from Accumulated Other Comprehensive Income for the Six Months Ended June 30,		Affected Line Item in the Statements
	2013	2012	of Income
Securities available for sale			
Gain (loss) realized in earnings	$ (166)	$ 49	Gain (loss) on sale of securities
OTTI losses recognized in earnings	(49)	(92)	Other-than-temporary impairment loss recognized in Net Income
Total reclassified amount before tax	(215)	(43)	Income Before Income Taxes
Tax (expense) benefit	75	15	Income Tax Provision
Total reclassifications out of Accumulated Other Comprehensive Income	$ (140)	$ (28)	Net Income

Note 4: Loans Receivable

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balance adjusted for unearned income, charge-offs, the allowance for loan losses, any unamortized deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

For loans recorded at cost, interest income is accrued based on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, as well as premiums and discounts, are deferred and amortized as a level yield adjustment over the respective term of the loan.

Categories of loans include:

	June 30, 2013	December 31, 2012
Real estate loans		
Residential	$ 118,770	$ 128,815
Commercial	108,680	84,918
Total real estate loans	227,450	213,733
Commercial loans	19,128	14,271
Consumer loans	116,405	126,486
Total loans	362,983	354,490
Deferred loan origination costs and premiums and discounts on purchased loans	3,344	3,671
Allowance for loan losses	(5,527)	(5,833)
Total net loans	$ 360,800	$ 352,328

The risk characteristics of each loan portfolio segment are as follows:

Commercial Real Estate: These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of property type and geographic location. Management monitors and evaluates commercial real estate loans based on property financial performance, collateral value and other risk grade criteria. As a general rule, the Company avoids financing special use projects or properties outside of its designated market areas unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate loans versus nonowner-occupied loans.

Commercial: Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected, and the collateral securing these loans may fluctuate in value. Loans are made for working capital, equipment purchases, or other purposes. Most commercial loans are secured by the assets being financed and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis.

Residential Real Estate and Consumer: With respect to residential loans that are secured by 1-4 family residences and are generally owner occupied, the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer loans are secured by consumer assets such as automobiles or recreational vehicles. Some consumer loans are unsecured, such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

Allowance for Loan Losses Methodology

Company policy is designed to ensure that an adequate allowance for loan losses ("ALLL") is maintained. The portfolio is segmented by loan type. The required ALLL for types of performing homogeneous loans which do not have a specific reserve is determined by applying a factor based on historical losses averaged over the past twelve months. Management believes the historical loss experience methodology is appropriate in the current economic environment, as it captures loss rates that are comparable to the current period being analyzed. Management adds qualitative factors for observable trends, changes in internal practices, changes in delinquencies and impairments, and, finally, external factors. Observable factors include changes in the composition and size of portfolios, as well as loan terms or concentration levels. We evaluate the impact of internal changes such as management and staff experience levels or modification to loan review processes. Delinquency trends are scrutinized for both volume and severity of past due, nonaccrual, classified or graded loans as well as any changes in the value of underlying collateral. Finally, we consider the effect of other external factors such as national, regional and local economic and business conditions, as well as competitive, legal and regulatory requirements. All criticized, classified, and impaired loans are evaluated for impairment by applying at least one of three methodologies: present value of future cash flows; fair value of collateral less cost to sell; or the loan's observable market price. All troubled debt restructurings ("TDR") are considered impaired loans. Loans evaluated for impairment are removed from other pools to prevent double-counting.

Provision for Loan Losses

A provision for estimated losses on loans is charged to operations based upon management's evaluation of the potential losses. Such an evaluation, which includes a review of all loans for which full collectability may not be reasonably assured considers, among other matters, the estimated net realizable value of the underlying collateral, as applicable, economic conditions, loan loss experience and other factors that are particularly susceptible to changes that could result in a material adjustment in the near term. While management endeavors to use the best information available in making its evaluations, future allowance adjustments may be necessary if economic conditions change substantially from the assumptions used in making the evaluations.

Accounting Standards Codification ("ASC") Topic 310, *Receivables*, requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loans' effective interest rates or the fair value of the underlying collateral and allows existing methods for recognizing interest income.

Policy for Charging Off Loans

The Company's policy is to charge off a loan at any point in time when it no longer can be considered a bankable asset, meaning collectable within the parameters of policy. A secured loan is generally charged off to the estimated fair value of the collateral no later than when it is 120 days past due as to principal or interest. An unsecured loan generally is charged off no later than when it is 180 days past due as to principal or interest. All charge-offs are approved by the Chief Credit Officer.

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The following tables present changes in the balance of the ALLL during the three and six month periods ended June 30, 2013 and 2012:

	Three Months Ended June 30, 2013				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Allowance for loan losses:					
Balance, beginning of period	$1,022	$ 3,082	$ 466	$ 1,178	$5,748
Provision charged to expense	(49)	74	11	(12)	24
Losses charged off	—	(238)	—	(162)	(400)
Recoveries	11	—	70	74	155
Balance, end of period	$984	$ 2,918	$ 547	$ 1,078	$5,527

	Six Months Ended June 30, 2013				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Allowance for loan losses:					
Balance, beginning of period	$1,149	$ 3,107	$ 371	$ 1,206	$5,833
Provision charged to expense	(130)	49	106	133	158
Losses charged off	(54)	(238)	—	(398)	(690)
Recoveries	19	—	70	137	226
Balance, end of period	$984	$ 2,918	$ 547	$ 1,078	$5,527

	Three Months Ended June 30, 2012				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Allowance for loan losses:					
Balance, beginning of period	$1,160	$ 2,564	$ 430	$ 1,634	$5,788
Provision charged to expense	(114)	382	28	268	564
Losses charged off	(146)	(272)	—	(354)	(772)
Recoveries	16	—	—	131	147
Balance, end of period	$916	$ 2,674	$ 458	$ 1,679	$5,727

	Six Months Ended June 30, 2012				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Allowance for loan losses:					
Balance, beginning of period	$1,099	$ 2,485	$ 333	$ 1,739	$5,656
Provision charged to expense	67	461	125	481	1,134

Losses charged off	(275)	(272)	—	(804)	(1,351)
Recoveries	25	—	—	263	288
Balance, end of period	$916	$ 2,674	$ 458	$ 1,679	$5,727

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The following tables present the recorded investment in loans based on portfolio segment and impairment method as of June 30, 2013, and December 31, 2012:

	June 30, 2013				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Loans:					
Ending balance	$118,770	$ 108,680	$ 19,128	$116,405	$362,983
Ending balance: individually evaluated for impairment	2,052	1,954	—	404	4,410
Ending balance: collectively evaluated for impairment	$116,718	$ 106,726	$ 19,128	$116,001	$358,573
Allowance for loan losses:					
Ending Balance	$984	$ 2,918	$ 547	$1,078	$5,527
Ending balance: individually evaluated for impairment	34	441	—	29	504
Ending balance: collectively evaluated for impairment	$950	$ 2,477	$ 547	$1,049	$5,023

	December 31, 2012				
	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	Total
Loans:					
Ending balance	$128,815	$ 84,918	$ 14,271	$126,486	$354,490
Ending balance: individually evaluated for impairment	2,482	2,467	—	474	5,423
Ending balance: collectively evaluated for impairment	$126,333	$ 82,451	$ 14,271	$126,012	$349,067
Allowance for loan losses:					
Ending Balance	$1,149	$ 3,107	$ 371	$1,206	$5,833
Ending balance: individually evaluated for impairment	206	682	—	54	942
Ending balance: collectively evaluated for impairment	$943	$ 2,425	$ 371	$1,152	$4,891

The Company utilizes a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 to 8. A description of the general characteristics of the 8 risk grades is as follows:

- Grades 1 & 2 - These grades are assigned to loans with very high credit quality borrowers of investment or near investment grade or where the loan is primarily secured by cash or conservatively margined high quality marketable securities. These borrowers are generally publicly traded, have significant capital strength, possess investment grade public debt ratings, demonstrate low leverage, exhibit stable earnings and growth and have ready access to various financing alternatives.

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- Grades 3 & 4 - Loans assigned these grades include loans to borrowers possessing solid credit quality with acceptable risk. Borrowers in these grades are differentiated from higher grades on the basis of size (capital and/or revenue), leverage, asset quality, stability of the industry or specific market area and quality/coverage of collateral. These borrowers generally have a history of consistent earnings and reasonable leverage.

- Grade 5 - This grade includes “pass grade” loans to borrowers which require special monitoring because of deteriorating financial results, declining credit ratings, decreasing cash flow, increasing leverage, marginal collateral coverage or industry stress that has resulted or may result in a changing overall risk profile.

- Grade 6 - This grade is for “Special Mention” loans in accordance with regulatory guidelines. This grade is intended to include loans to borrowers whose credit quality has clearly deteriorated and where risk of further decline is possible unless active measures are taken to correct the situation. Weaknesses are considered potential at this state and are not yet fully defined.

- Grade 7 - This grade includes “Substandard” loans in accordance with regulatory guidelines. Loans categorized in this grade possess a well-defined credit weakness, and the likelihood of repayment from the primary source is uncertain. Significant financial deterioration has occurred, and very close attention is warranted to ensure the full repayment without loss. Collateral coverage may be marginal, and the accrual of interest has been suspended.

- Grade 8 - This grade includes “Doubtful” loans in accordance with regulatory guidelines. Such loans have been placed on nonaccrual status and may be heavily dependent upon collateral possessing a value that is difficult to determine or based upon some near-term event which lacks clear certainty. These loans have all of the weaknesses of those classified as Substandard; however, based on existing conditions, these weaknesses make full collection of the principal balance highly improbable.

Nonaccrual Loans

Any loan which becomes 90 days delinquent or has the full collection of principal and interest in doubt will be considered for nonaccrual status. At the time a loan is placed on nonaccrual, all accrued but unpaid interest will be reversed from interest income. Placing the loan on nonaccrual does not relieve the borrower of the obligation to repay interest. A loan placed on nonaccrual may be restored to accrual status when all delinquent principal and interest has been brought current, and the Company expects full payment of the remaining contractual principal and interest.

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of June 30, 2013 and December 31, 2012:

	June 30, 2013	
	Commercial Real Estate	Commercial
Rating:		
1-5 Pass	$105,112	$ 17,823
6 Special Mention	1,614	1,305
7 Substandard	1,954	—
8 Doubtful	—	—
Total	$108,680	$ 19,128

	June 30, 2013	
	Residential Real Estate	Consumer
Performing	$117,816	$116,282
Nonperforming (nonaccrual)	954	123
Total	$118,770	$116,405

	December 31, 2012	
	Commercial Real Estate	Commercial
Rating:		
1-5 Pass	$80,830	$ 13,860
6 Special Mention	1,621	411
7 Substandard	2,467	—
8 Doubtful	—	—
Total	$84,918	$ 14,271

	December 31, 2012	
	Residential Real Estate	Consumer
Performing	$127,426	$126,331
Nonperforming (nonaccrual)	1,389	155
Total	$128,815	$126,486

The following tables present the Company's loan portfolio aging analysis as of June 30, 2013 and December 31, 2012:

	June 30, 2013							
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non-accrual Loans	Total Loans 90 Days or More Past Due and Accruing
Residential real estate	$188	$ 138	$ 821	$ 1,147	$117,623	$ 118,770	$954	$ —
Commercial real estate	—	—	1,851	1,851	106,829	108,680	1,851	—
Commercial	—	—	—	—	19,128	19,128	—	—
Consumer	453	117	46	616	115,789	116,405	123	10
Total	$641	$ 255	$ 2,718	$ 3,614	$359,369	$ 362,983	$2,928	$ 10

	December 31, 2012							
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non-accrual Loans	Total Loans 90 Days or More Past Due and Accruing
Residential real estate	$130	$ 5	$ 1,555	$ 1,690	$127,125	$ 128,815	$1,389	$ 450
Commercial real estate	—	—	2,362	2,362	82,556	84,918	2,362	—
Commercial	—	—	—	—	14,271	14,271	—	—
Consumer	1,025	148	122	1,295	125,191	126,486	155	21
Total	$1,155	$ 153	$ 4,039	$ 5,347	$349,143	$ 354,490	$3,906	$ 471

Impaired Loans

A loan is designated as impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16) when, based on current information or events, it is probable that the Company will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Payments with insignificant delays not exceeding 90 days outstanding are not considered impaired. Certain nonaccrual and substantially all delinquent loans may be considered to be impaired. Generally, loans are placed on nonaccrual status at 90 days past due and accrued interest is reversed against earnings, unless the loan is well-secured and in the process of collection. The accrual of interest on impaired and nonaccrual loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due.

Impaired loans include nonperforming commercial loans but also include loans modified in TDRs where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.

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The following table presents the Company's impaired loans as of June 30, 2013 and December 31, 2012:

	June 30, 2013			December 31, 2012		
	Recorded Balance	Unpaid Principal Balance	Specific Allowance	Recorded Balance	Unpaid Principal Balance	Specific Allowance
Loans without a specific valuation allowance						
Residential real estate loans	$2,000	$ 2,359	$ —	$2,047	$ 2,357	$ —
Commercial real estate loans	—	—	—	—	—	—
Commercial loans	—	—	—	—	—	—
Consumer loans	340	349	—	380	577	—
Total	2,340	2,708	—	2,427	2,934	—
Loans with a specific valuation allowance						
Residential real estate loans	52	59	34	435	442	206
Commercial real estate loans	1,954	2,412	441	2,467	2,925	682
Commercial loans	—	—	—	—	—	—
Consumer loans	64	90	29	94	206	54
Total	2,070	2,561	504	2,996	3,573	942
Total impaired loans						
Residential real estate loans	2,052	2,418	34	2,482	2,799	206
Commercial real estate loans	1,954	2,412	441	2,467	2,925	682
Commercial loans	—	—	—	—	—	—
Consumer loans	404	439	29	474	783	54
Total	$4,410	$ 5,269	$ 504	$5,423	$ 6,507	$ 942

The table below presents average balances and interest income recognized for impaired loans during both the three month and six month periods ended June 30, 2013 and June 30, 2012:

	June 30, 2013 Three Months Ended		Six Months Ended		June 30, 2012 Three Months Ended		Six Months Ended	
	Average Balance	Interest Income	Average Balance	Interest Income	Average Balance	Interest Income	Average Balance	Interest Income
Loans without a specific valuation allowance								
Residential real estate loans	$2,122	$ 7	$2,097	$ 14	$1,108	$ 5	$1,181	$ 10
Commercial real estate loans	—	—	—	—	423	—	282	—
Commercial loans	—	—	—	—	—	—	—	—
Consumer loans	345	9	357	21	373	13	378	25
Total	2,467	16	2,454	35	1,904	18	1,841	35
Loans with a specific valuation allowance								
Residential real estate loans	40	1	171	1	757	1	627	4
Commercial real estate loans	2,210	2	2,295	3	4,349	2	5,444	2
Commercial loans	—	—	—	—	—	—	—	—
Consumer loans	95	2	95	4	42	1	65	3
Total	2,345	5	2,561	8	5,148	4	6,136	9
Total impaired loans								
Residential real estate loans	2,162	8	2,268	15	1,865	6	1,808	14
Commercial real estate loans	2,210	2	2,295	3	4,772	2	5,726	2
Commercial loans	—	—	—	—	—	—	—	—
Consumer loans	440	11	452	25	415	14	443	28
Total	$4,812	$ 21	$5,015	$ 43	$7,052	$ 22	$7,977	$ 44

Troubled Debt Restructurings ("TDRs")

The loan portfolio includes TDRs which are loans that have been modified to grant economic concessions to borrowers who have experienced financial difficulties. These concessions typically result from loss mitigation efforts and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructuring and typically are returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally not less than six months.

When loans are modified in a TDR, any possible impairment similar to other impaired loans is evaluated based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, or use the current fair value of the collateral, less selling costs for collateral dependent loans. If it is determined that the value of the modified loan is less than the recorded balance of the loan, impairment is recognized through a specific allowance or charge-off to the allowance. In periods subsequent to modification, all TDRs, including those that have payment defaults, are evaluated for possible impairment, and impairment is recognized through the allowance.

In the course of working with troubled borrowers, the Company may choose to restructure the contractual terms of certain loans in an effort to work out an alternative payment schedule with the borrower in order to optimize the collectability of the loan. Any loan modified is reviewed by the Company to identify if a TDR has occurred (when the Company grants a concession to the borrower that it would not otherwise consider based on economic or legal reasons related to a borrower's financial difficulties). Terms may be modified to fit the ability of the borrower to repay in line with its current financial status or the loan may be restructured to secure additional collateral and/or guarantees to support the debt, or a combination of the two.

Loans classified as a TDR during the three and six months ended June 30, 2013 consisted of one consumer loan with a recorded balance of $15 before and after the modification, and three loans with a total recorded balance of $17 before and after the modification, respectively. The 2013 modifications consisted solely of maturity date concessions. Payment extensions have proven to be successful in optimizing the overall collectability of the loan by increasing the period of time that the borrower is able to make required payments to the Company.

There were no TDR loans which had payment defaults during the three and six months ended June 30, 2013 and 2012. Default occurs when a loan is 90 days or more past due or transferred to nonaccrual within 12 months of restructuring.

Note 5: Premises and Equipment

Premises and equipment at June 30, 2013 and December 31, 2012 consisted of the following:

	June 30, 2013	December 31, 2012
Land	$2,500	$ —
Building and improvements	2,751	—
Furniture and equipment	4,350	3,521
Less accumulated depreciation	(2,861)	(2,728)
	$6,740	$ 793

In the first quarter of 2013, the Company acquired an office building with approximately 52,000 square feet of office space and related real estate located in Fishers, Indiana. The Company acquired the property for the current and future operations of the Bank for $4,083. The cost basis of the building is being depreciated on a straight-line basis over 39 years. The remaining increase is primarily related to investments in building and leasehold improvements at both the Fishers location and the Company's corporate office.

Note 6: Goodwill

The change in the carrying amount of goodwill for the periods ended June 30, 2013 and December 31, 2012 were:

Balance as of January 1, 2012	$4,687
Changes in goodwill during the year	—
Balance as of December 31, 2012	4,687
Changes in goodwill during the period	—
Balance as of June 30, 2013	$4,687

Goodwill is tested for impairment on an annual basis as of August 31, or whenever events or changes in circumstances indicate the carrying amount of goodwill exceeds its implied fair value. No events or changes in circumstances have occurred since the August 31, 2012 annual impairment test that would suggest it was more likely than not goodwill impairment existed.

Note 7: Benefit Plans

Employment Agreements

The Company has entered into employment or change in control agreements with certain officers that provide for the continuation of salary and certain benefits for a specified period of time under certain conditions. Under the terms of the agreements, these payments could occur in the event of a change in control of the Company, as defined, along with other specific conditions.

2013 Equity Incentive Plan

The 2013 Equity Incentive Plan (the "2013 Plan") authorizes the issuance of 750,000 shares of our common stock in the form of equity-based awards to employees, directors, and other eligible persons. Upon shareholder approval of the 2013 Plan, no further awards may be made under the 2006 Stock Option Plan, which had 595,500 shares of common stock available for issuance when the 2013 Plan became effective. Under the terms of the 2013 Plan, the pool of shares available for issuance may be used for available types of equity awards under the 2013 Plan, which includes stock options, stock appreciation rights, restricted stock awards, stock unit awards and other stock-based awards. All employees, consultants and advisors of the Company or any subsidiary, as well as all non-employee directors of the Company, are eligible to receive awards under the 2013 Plan.

There are no awards outstanding under the 2013 Plan or the 2006 Stock Option Plan as of June 30, 2013. However, on July 22, 2013, the Compensation Committee of the Board of Directors of the Company awarded 46,232 shares to executive officers and other persons under the 2013 Plan. The shares of restricted stock will vest in three installments on January 1, 2014, January 1, 2015, and January 1, 2016.

Directors Deferred Stock Plan

The Company has adopted a stock compensation plan for members of the Board of Directors ("Directors Deferred Stock Plan"). The Company has reserved 180,000 shares of common stock that may be issued pursuant to the Directors Deferred Stock Plan. The plan provides directors the option to elect to receive up to 100% of their annual retainer in either common stock or deferred stock rights. Monthly meeting fees are paid in cash. The deferred stock right is payable to the director on the basis of one common share for each deferred stock right.

Director compensation totaled $55 and $40 for the three months ended June 30, 2013 and 2012, respectively, of which $34 and $25 for the three months ended June 30, 2013 and 2012, respectively were paid in either common stock or deferred stock rights. Director compensation totaled $101 and $67 for the six months ended June 30, 2013 and 2012, respectively, of which $63 and $40 for the six months ended June 30, 2013 and 2012, respectively, were paid in deferred stock rights. The common stock and deferred stock rights are granted on January 1 at fair value and vest from January 1 until December 31. The Company recognizes compensation expense ratably over the vesting period based upon the fair value of the stock on the grant date.

The following is an analysis of deferred stock rights and common stock related to the Directors Deferred Stock Plan for the six months ended June 30, 2013:

	Six months ended June 30, 2013	
	Deferred Rights	Common Shares
Outstanding, beginning of period	70,315	
Granted	8,472	
Exercised	—	
Outstanding, end of period	78,787	

Note 8: Initial Adoption of Fair Value Option

ASC Topic 825, *Financial Instruments,* permits entities to measure recognized financial assets and financial liabilities using either historical cost or the fair value option at specified election dates. In the 2013 second quarter, we began using derivative financial instruments to manage exposure to interest rate risk in our mortgage banking business. These derivative financial instruments are recorded at fair value with changes in fair value reflected in Noninterest Income on the Condensed Consolidated Statements of Income.

To mitigate the volatility reported in earnings caused by measuring related assets and liabilities differently, the Company has elected the fair value option for the hedged item, mortgage loans held for sale under mandatory pricing agreements, that were originated on or after April 1, 2013. The Company continues to record mortgage loans held for sale under best-efforts pricing agreements at the lower of cost or fair value. Prior to April 1, 2013, all mortgage loans held for sale were carried at the lower of cost or fair value.

The $1,127 loss recognized on mortgage loans held for sale under mandatory pricing agreements in both the three and six month periods ended June 30, 2013 has been included in Gain on loans sold, within Noninterest Income on the Condensed Consolidated Statements of Income. The effect on the financial statements is presented below:

	June 30, 2013		
	Aggregate Value	Loss	Fair Value
Loans held for sale	$28,713	$(1,127)	$27,586

Note 9: Fair Value of Financial Instruments

ASC Topic 820, *Fair Value Measurements*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Topic 820 also specifies 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 Quoted prices in active markets for identical assets or liabilities

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid mutual funds. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows.

Level 2 securities include U.S. government-sponsored enterprises, mortgage and asset-backed securities and obligations of state, municipals and certain corporate securities. Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities' relationship to other benchmark quoted investment securities.

In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy and include certain other securities. Fair values are calculated using discounted cash flows. Discounted cash flows are calculated based off of the anticipated future cash flows updated to incorporate loss severities and volatility. Rating agency and industry research reports as well as default and deferral activity are reviewed and incorporated into the calculation.

Loans Held for Sale

The fair value of loans held for sale is determined using quoted prices for a similar asset, adjusted for specific attributes of that loan (Level 2).

Forward Contracts

The fair values of forward contracts on to-be-announced securities are determined using quoted prices in active markets, or benchmarked thereto (Level 1).

Interest Rate Lock Commitment

The fair value of interest rate lock commitments (“IRLCs”)are determined using the projected sale price of individual loans based on changes in market interest rates, projected pull-through rates (the probability that an IRLC will ultimately result in an originated loan), the reduction in the value of the applicant’s option due to the passage of time, and the remaining origination costs to be incurred based on management’s estimate of market costs (Level 3).

The following tables present the fair value measurements of assets and liabilities recognized in the accompanying condensed consolidated balance sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2013 and December 31, 2012:

		June 30, 2013 Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. government-sponsored enterprises	$58,338	$—	$ 58,338	$ —
Municipals	46,463	—	46,463	—
Mortgage-backed and asset-backed securities - government-sponsored enterprises	55,060	—	55,060	—
Mortgage-backed and asset-backed securities - private labeled	1,522	—	1,522	—
Other securities	32,551	1,491	29,529	1,531
Total available for sale securities	193,934	1,491	190,912	1,531
Loans held for sale	27,586	—	27,586	—
Forward contracts	1,208	1,208	—	—
Interest rate lock commitments	(78)	—	—	(78)

		December 31, 2012 Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. government-sponsored enterprises	$19,618	$—	$ 19,618	$ —
Municipals	42,540	—	42,540	—
Mortgage-backed and asset-backed securities - government-sponsored enterprises	77,489	—	77,489	—
Mortgage-backed and asset-backed securities - private labeled	2,453	—	2,453	—
Other securities	14,593	1,553	12,200	840
	$156,693	$ 1,553	$ 154,300	$ 840

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The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying condensed consolidated balance sheets using significant unobservable (Level 3) inputs:

	Three Months Ended	
	Securities Available for Sale	Interest Rate Lock Commitments
Balance, April 1, 2013	$ 1,168	$ —
Total realized and unrealized gains and losses	—	—
Included in net income	—	(78)
Included in other comprehensive loss	363	—
Balance, June 30, 2013	$ 1,531	$ (78)
Balance, April 1, 2012	$ 525	$ —
Total realized and unrealized gains and losses	—	—
Included in net income	—	—
Included in other comprehensive loss	233	—
Balance, June 30, 2012	$ 758	$ —

	Six Months Ended	
	Securities Available for Sale	Interest Rate Lock Commitments
Balance, January 1, 2013	$ 840	$ —
Total realized and unrealized gains and losses		
Included in net income	—	(78)
Included in other comprehensive loss	691	—
Balance, June 30, 2013	$ 1,531	$ (78)
Balance, January 1, 2012	$ 470	$ —
Total realized and unrealized gains and losses	—	—
Included in net income	—	—
Included in other comprehensive loss	288	—
Balance, June 30, 2012	$ 758	$ —

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Impaired Loans (Collateral Dependent)

Loans for which it is probable that the Company will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans.

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value.

Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

The following tables present the fair value measurements of impaired loans recognized in the accompanying condensed consolidated balance sheets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fell at June 30, 2013 and December 31, 2012:

		June 30, 2013		
		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$1,996	$ —	$ —	$ 1,996

		December 31, 2012		
		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active	Significant Other	Significant Unobservable

		Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Inputs (Level 3)
Impaired loans	$1,481	$ —	$ —	$ 1,481

Unobservable (Level 3) Inputs

The following tables present quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements other than goodwill.

	Fair Value at June 30, 2013	Valuation Technique	Unobservable Inputs	Range
Other securities	$ 1,531	Discounted cash flow	Discount margin Cumulative default % Loss given default % Cumulative prepayment %	10% - 17% 2.2% - 100% 4% - 20% 2% - 100%
Collateral dependent impaired loans	$ 1,996	Market comparable assets	Marketability discount	35%
		Appraisal value	N/A	N/A

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	Fair Value at December 31, 2012	Valuation Technique	Unobservable Inputs	Range
Other securities	$ 840	Discounted cash flow	Discount margin Cumulative default % Loss given default % Cumulative prepayment %	7% - 14.25% 2.2% - 100% 85% – 100% 0% - 100%
Collateral dependent impaired loans	$ 1,481	Market comparable properties	Marketability discount	12%

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying consolidated balance sheets at amounts other than fair value:

Cash and Cash Equivalents

For these instruments, the carrying amount is a reasonable estimate of fair value.

Loans Held for Sale

The fair value of these financial instruments approximates carrying value.

Interest Bearing Time Deposits

The fair value of these financial instruments approximates carrying value.

Loans Receivable

The fair value of loans receivable is estimated by discounting future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and remaining maturities.

Accrued Interest Receivable

The fair value of these financial instruments approximates carrying value.

Federal Home Loan Bank Stock

The carrying amount approximates fair value.

Deposits

The fair value of noninterest-bearing demand deposits and savings and NOW accounts is the amount payable as of the reporting date. The fair value of fixed maturity certificates of deposit is estimated using rates currently offered for deposits of similar remaining maturities.

FHLB Advances

The fair value of fixed rate advances is estimated using rates currently offered for similar remaining maturities.

Accrued Interest Payable

The fair value of these financial instruments approximates carrying value.

Subordinated Debt

The carrying amount approximates fair value as the transaction closed on June 28, 2013 .

Commitments

The fair value of commitments to extend credit are based on fees currently charged to enter into similar agreements with similar maturities and interest rates. The Company determined that the fair value of commitments was zero based on the contractual value of outstanding commitments at each of June 30, 2013 and December 31, 2012.

The following schedule includes the carrying value and estimated fair value of all financial assets and liabilities at June 30, 2013 and December 31, 2012:

	June 30, 2013 Fair Value Measurements Using			
	Carrying Amount	Quoted Prices In Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$15,448	$ 15,448	$ —	$ —
Interest bearing time deposits	2,500	2,500	—	—
Loans held for sale	14,685	—	14,685	—
Loans receivable – net	360,800	—	—	365,157
Accrued interest receivable	2,271	2,271	—	—
FHLB stock	2,943	—	2,943	—
Deposits	561,162	—	321,212	245,419
FHLB advances	23,740	—	25,716	—
Accrued interest payable	100	100	—	—
Subordinated debt	2,745	—	2,745	—

	December 31, 2012 Fair Value Measurements Using			
	Carrying Amount	Quoted Prices In Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$32,513	$ 32,513	$ —	$ —
Interest bearing time deposits	—	—	—	—
Loans held for sale	63,234	—	63,234	—
Loans receivable - net	352,328	—	—	351,194
Accrued interest receivable	2,196	2,196	—	—
FHLB stock	2,943	—	2,943	—
Deposits	530,691	—	300,818	236,375
FHLB advances	40,686	—	42,986	—
Accrued interest payable	120	120	—	—

Note 10: Derivative Financial Instruments

The Company uses derivative financial instruments to help manage exposure to interest rate risk and the effects that changes in interest rates may have on net income and the fair value of assets and liabilities. The Company enters into forward contracts for the future delivery of mortgage loans to third party investors and enters into interest rate lock commitments (“IRLCs”) with potential borrowers to fund specific mortgage loans that will be sold into the secondary market. The forward contracts are entered into in order to economically hedge the effect of changes in interest rates resulting from the Company’s commitment to fund the loans.

Each of these items are considered derivatives, but are not designated as accounting hedges, and therefore, are recorded at fair value with changes in fair value reflected in noninterest income on the Condensed Consolidated Statements of Income. The fair value of derivative instruments with a positive fair value are reported in Other assets in the Condensed Consolidated Balance Sheets while derivative instruments with a negative fair value are reported in Accrued expenses and other liabilities in the Condensed Consolidated Balance Sheets.

We did not use any derivative financial instruments prior to 2013. At June 30, 2013 the notional amount and fair value of IRLCs and forward contracts utilized by the Company were as follows:

	June 30, 2013		December 31, 2012	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Asset Derivatives				
Derivatives not designated as hedging instruments				
Forward contracts	$62,750	$1,208	$ —	$ —
Liability Derivatives				
Derivatives not designated as hedging instruments				
IRLCs	$41,914	$78	$ —	$ —

Fair values of derivative financial instruments were estimated using changes in mortgage interest rates from the date the Company entered into the IRLC and the balance sheet date. Periodic changes in the fair value of the derivative financial insturments on the Condensed Consolidated Statements of Income for the three and six-month periods ended June 30, 2013 and 2012 were as follows:

	Amount of gain / (loss) recognized			
	June 30, 2013		June 30, 2012	
	Three Months Ended	Six Months Ended	Three Months Ended	Six Months Ended
Asset Derivatives				
Derivatives not designated as hedging instruments				
Forward contracts	$ 1,208	$ 1,208	$ —	$ —
Liability Derivatives				
Derivatives not designated as hedging instruments				
IRLCs	$ (78)	$ (78)	$ —	$ —

Note 11: Subordinated Debenture

On June 28, 2013, the Company entered into a subordinated debenture purchase agreement with a third party and issued a subordinated debenture in the principal amount of $3,000 which bears interest at a fixed annual rate of 8.00% and is scheduled to mature on June 28, 2021; however, the Company can repay the debenture without premium or penalty at any time after June 28, 2016. The debenture is expected to qualify for treatment as Tier 2 capital for regulatory capital purposes. The purchase agreement and the debenture contain customary subordination provisions and events of default; however the right of the investor to accelerate the payment of the debenture is limited to bankruptcy or insolvency.

As partial inducement for the third party to purchase the debenture, the Company issued to the third party a warrant to purchase up to 48,750 shares of common stock, at an initial per share exercise price equal to $19.33. The warrant will become exercisable on June 28, 2014, and, unless previously exercised, will expire on June 28, 2021. The Company has the right to force an exercise of the warrant after the debenture has been repaid in full if the 20-day volume-weighted average price of a share of its common stock exceeds $30.00.

The Company used the Black-Scholes option pricing model to assign a fair value of $255 to the warrant. The following assumptions were used to value the warrant: a risk-free interest rate of 0.66% per the U.S. Treasury yield curve in effect at the date of issuance, an expected dividend yield of 1.19% calculated using the dividend rate and stock price at the date of the issuance, and an expected volatility of 34% based on the estimated volatility of the Company’s stock over the expected term of the warrant, which is estimated to be three years.

In addition, on June 28, 2013 the Company entered into a separate arrangement pursuant to which, at the Company’s option, the third party has committed to purchase an additional $3,000 debenture on or before December 31, 2013 under terms and conditions substantially similar to those contained in the purchase agreement.

Note 12: Future Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-02 to improve the transparency of reporting reclassifications out of accumulated other comprehensive income. Other comprehensive income includes gains and losses that are initially excluded from net income for an accounting period. Those gains and losses are later reclassified out of accumulated other comprehensive income into net income. The amendments in the Update do not change the current requirements for reporting net income or other comprehensive income in financial statements. All of the information required within this Update is already required to be disclosed elsewhere in the financial statements under GAAP.

The new amendments will require an organization to:

- Present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income–but only if the item reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period.

- Cross-reference to other disclosures currently required under GAAP for other reclassification items (that are not required under GAAP) to be reclassified directly to net income in their entirety in the same reporting period. This would be the case when a portion of the amount reclassified out of accumulated other comprehensive income is initially transferred to a balance sheet account instead of directly to income or expense.

- The amendments are effective for reporting periods beginning after December 15, 2012. The Company has adopted the methodologies prescribed by this ASU, and the ASU did not have a material effect on its financial position or results of operations.

In January 2013, the FASB issued ASU 2013-01, which clarifies the scope of transactions that are subject to the disclosures about offsetting. The Update clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. Specifically, Update 2011-11 applies only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either off