

FENTURA FINANCIAL INC
Form 10-Q
November 14, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to

Commission file number 000-23550

Fentura Financial, Inc.

(Exact name of registrant as specified in its charter)

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Michigan **38-2806518**
(State or other jurisdiction of **(IRS Employee**
incorporation or organization) **Identification No.)**
175 N Leroy, P.O. Box 725, Fenton, Michigan 48430
(Address of Principal Executive Offices)
(810) 629-2263
(Registrant's telephone number)

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: September 30, 2012

| Class | Common Stock | Shares Outstanding |
|-------|--------------|--------------------|
| | | 2,444,161 |

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****FENTURA FINANCIAL, INC.****CONSOLIDATED BALANCE SHEETS****(Unaudited)**

(000s omitted except share and per share data)

| | September 30, 2012 | December 31, 2011 |
|-----------------------------------------------|-----------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 42,768 | \$ 18,634 |
| Securities: | | |
| Securities available for sale | 48,459 | 58,687 |
| Securities held to maturity | 2,692 | 2,963 |
| Total securities | 51,151 | 61,650 |
| Loans held for sale | 939 | 123 |
| Loans: | | |
| Commercial | 38,899 | 33,956 |
| Commercial real estate | 105,715 | 118,984 |
| Residential real estate | 28,745 | 26,829 |
| Consumer | 23,303 | 25,998 |
| Total loans | 196,662 | 205,767 |
| Less: Allowance for loan losses | (6,267) | (8,164) |
| Net loans | 190,395 | 197,603 |
| Bank owned life insurance | 6,044 | 5,941 |
| Bank premises and equipment | 10,270 | 10,202 |
| Federal Home Loan Bank stock | 661 | 661 |
| Accrued interest receivable | 1,238 | 1,039 |
| Other real estate owned | 2,704 | 1,949 |
| Other assets | 331 | 1,059 |
| Total assets | \$ 306,501 | \$ 298,861 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Deposits: | | |
| Non-interest bearing | \$ 70,293 | \$ 62,713 |
| Interest bearing | 202,086 | 203,168 |
| Total deposits | 272,379 | 265,881 |
| Federal Home Loan Bank advance | 891 | 923 |
| Subordinated debentures | 14,000 | 14,000 |
| Accrued taxes, interest and other liabilities | 3,376 | 3,397 |
| Total liabilities | 290,646 | 284,201 |

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Stockholders' equity

| | | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Common stock - no par value, 5,000,000 shares authorized 2,444,161 shares issued and outstanding at September 30, 2012 (2,388,225 at December 31, 2011) | 43,310 | 43,191 |
| Accumulated deficit | (27,743) | (28,554) |
| Accumulated other comprehensive income | 288 | 23 |
| Total stockholders' equity | 15,855 | 14,660 |
| Total liabilities and stockholders' equity | \$ 306,501 | \$ 298,861 |

See accompanying notes to consolidated financial statements.

Table of Contents**FENTURA FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

(000s omitted except share and per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------------------------------------|---------------------------------------------|-----------------|--------------------------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income | | | | |
| Loans, including fees | \$ 2,814 | \$ 2,890 | \$ 8,256 | \$ 8,865 |
| Interest and dividends on securities: | | | | |
| Taxable | 251 | 388 | 905 | 1,006 |
| Tax-exempt | 27 | 35 | 86 | 119 |
| Interest on federal funds sold | 3 | 8 | 22 | 30 |
| Total interest income | 3,095 | 3,321 | 9,269 | 10,020 |
| Interest expense | | | | |
| Deposits | 336 | 569 | 1,232 | 1,945 |
| Borrowings | 54 | 126 | 319 | 378 |
| Total interest expense | 390 | 695 | 1,551 | 2,323 |
| Net interest income | 2,705 | 2,626 | 7,718 | 7,697 |
| Provision for loan losses | (850) | 1,017 | 92 | 2,542 |
| Net interest income after provision for loan losses | 3,555 | 1,609 | 7,626 | 5,155 |
| Non-interest income | | | | |
| Service charges on deposit accounts | 264 | 319 | 762 | 904 |
| Trust and investment services income | 346 | 224 | 858 | 742 |
| Gain on sale of mortgage loans | 204 | 97 | 572 | 195 |
| Gain on sale of fixed assets | 0 | 349 | 0 | 349 |
| Gain on sale of securities | 116 | 0 | 134 | 5 |
| Other income and fees | 398 | 601 | 1,316 | 1,907 |
| Total non-interest income | 1,328 | 1,590 | 3,642 | 4,102 |
| Non-interest expense | | | | |
| Salaries and employee benefits | 1,544 | 1,789 | 4,875 | 5,084 |
| Occupancy | 277 | 289 | 811 | 848 |
| Furniture and equipment | 267 | 237 | 794 | 806 |
| Loan and collection | 412 | 393 | 732 | 826 |
| Advertising and promotional | 41 | 36 | 119 | 99 |
| Other operating expenses | 939 | 1,009 | 3,250 | 2,922 |
| Total non-interest expense | 3,480 | 3,753 | 10,581 | 10,585 |
| Income (loss) from continuing operations before income tax | 1,403 | (554) | 687 | (1,328) |
| Federal income tax (expense) benefit | 0 | 145 | (124) | (222) |
| Net income (loss) from continuing operations | \$ 1,403 | \$ (699) | \$ 811 | \$ (1,106) |
| Discontinued operations, net of tax | | | | |

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| | | | | |
|--------------------------------------------------------|----------|-----------|---------|-----------|
| Net income from discontinued operations | 0 | 0 | 0 | 5 |
| Gain from sale of discontinued operations | 0 | 0 | 0 | 469 |
| Net income from discontinued operations | 0 | 0 | 0 | 474 |
| Net income (loss) | \$ 1,403 | \$ (699) | \$ 811 | \$ (632) |
| Net income (loss) per share from continuing operations | | | | |
| Basic and diluted | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.48) |
| Net income per share from discontinued operations | | | | |
| Basic and diluted | \$ 0.00 | \$ 0.00 | \$ 0.00 | \$ 0.21 |
| Net income (loss) per share | | | | |
| Basic and diluted | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.27) |

See accompanying notes to consolidated financial statements.

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FENTURA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(Unaudited)

(000s omitted except share and per share data)

| | Nine Months Ended September 30, | |
|-------------------------------------------------------------------------------------------|--------------------------------------------|------------------|
| | 2012 | 2011 |
| Common Stock | | |
| Balance, beginning of period | \$ 43,191 | \$ 43,036 |
| Issuance of shares under | | |
| Director stock purchase plan and dividend reinvestment program (55,936 and 58,492 shares) | 119 | 110 |
| Balance, end of period | 43,310 | 43,146 |
| Accumulated Deficit | | |
| Balance, beginning of period | (28,554) | (27,042) |
| Net income (loss) | 811 | (632) |
| Balance, end of period | (27,743) | (27,674) |
| Accumulated Other Comprehensive Income | | |
| Balance, beginning of period | 23 | 61 |
| Change in unrealized gain on securities, net of tax | 265 | 147 |
| Balance, end of period | 288 | 208 |
| Total stockholders equity | \$ 15,855 | \$ 15,680 |

See accompanying notes to consolidated financial statements.

Table of Contents**FENTURA FINANCIAL, INC****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

| (000s omitted) | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------------|------------------------------------|-------------|
| | 2012 | 2011 |
| OPERATING ACTIVITIES: | | |
| Net (loss) income | \$ 811 | \$ (632) |
| Adjustments to reconcile net (loss) income to cash Provided by operating activities: | | |
| Depreciation | 498 | 520 |
| Amortization and accretion | (490) | (227) |
| Provision for loan losses | 92 | 2,542 |
| Loans originated for sale | 30,018 | (12,133) |
| Proceeds from the sale of loans | (30,262) | 12,689 |
| Gain on sales of loans | (572) | (195) |
| Loss (gain) on other real estate owned | 25 | (30) |
| Write downs on other real estate owned | 12 | 520 |
| Gain on sale of fixed assets | 0 | (349) |
| Net gain on sale of securities | (134) | (5) |
| Net earnings from bank owned life insurance | (103) | (106) |
| Net decrease in interest receivable & other assets | 530 | 1,173 |
| Net increase (decrease) in interest payable & other liabilities | (22) | 544 |
| Net change in discontinued operations operating activities | 0 | 9,995 |
| Total Adjustments | (408) | 14,938 |
| Net cash provided by operating activities | 403 | 14,306 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturities of securities HTM | 271 | 925 |
| Proceeds from maturities of securities AFS | 9,511 | 4,784 |
| Proceeds from calls of securities AFS | 6,150 | 4,000 |
| Proceeds from sales of securities AFS | 13,991 | 2,024 |
| Purchases of securities AFS | (18,535) | (32,380) |
| Proceeds from sale of bank subsidiary | 0 | 711 |
| Origination of loans, net of principal repayments | 16,066 | 6,172 |
| Repurchase of FHLB stock | 0 | 79 |
| Acquisition of loans | (10,531) | 0 |
| Sales of other real estate owned | 788 | 2,773 |
| Acquisition of premises and equipment, net | (566) | (140) |
| Net change in discontinued operations investing activities | 0 | 93,229 |
| Net cash provided by investing activities | 17,145 | 82,177 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase (decrease) in deposits | 6,498 | (3,712) |
| Net decrease in short term borrowings | 0 | (232) |
| Net proceeds from stock issuance | 120 | 110 |
| Repayment of FHLB advances | (32) | (31) |
| Net change in discontinued operations financing activities | 0 | (103,942) |
| Net cash provided by (used in) financing activities | 6,586 | (107,807) |
| Net change in cash and cash equivalents | \$ 24,134 | \$ (11,324) |

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| | | | |
|-----------------------------------------------|-----------|-----------|-----------|
| Cash and cash equivalents | Beginning | \$ 18,634 | \$ 33,492 |
| Cash and cash equivalents | Ending | \$ 42,768 | \$ 22,168 |
| Cash paid for: | | | |
| Interest | | \$ 1,299 | \$ 2,024 |
| Income taxes | | \$ 5 | \$ 232 |
| Non-cash Disclosures: | | | |
| Transfers from loans to other real estate | | \$ 1,522 | \$ 1,822 |
| Loans provided for sales of other real estate | | \$ 58 | \$ 0 |

See accompanying notes to consolidated financial statements.

Table of Contents**FENTURA FINANCIAL, INC****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

| (000s omitted) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net (loss) income | \$ 1,403 | \$ (699) | \$ 811 | \$ (632) |
| Other comprehensive income (loss), net of tax: | | | | |
| Reclassification adjustment for net gains included in income | 116 | 0 | 134 | 5 |
| Unrealized holding (losses) gains related to available-for-sale securities arising during period | (53) | (82) | 131 | 139 |
| Other comprehensive income (loss), net of tax | 63 | (82) | 265 | 144 |
| Comprehensive income (loss) | \$ 1,466 | \$ (781) | \$ 1,076 | \$ (488) |

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Notes to Unaudited Consolidated Interim Financial Statements

NOTE 1 BASIS OF PRESENTATION

The interim consolidated financial statements include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries Fentura Holdings LLC (FHLLC) and The State Bank in Fenton (the Bank), Michigan and the other subsidiaries of the Bank. Intercompany transactions and balances are eliminated in consolidation.

As announced at the 2011 Shareholder Meeting, the Corporation had entered into an agreement to sell West Michigan Community Bank to a third-party investor group. The sale closed on January 31, 2011. West Michigan Community Bank is reported as discontinued operations.

Financial statements are presented with discontinued operations sequestered on the balance sheet, statement of operations and statement of cash flows, as applicable. The presentations have been updated for September 30, 2011 to reflect the discontinued operations results to the extent applicable (see Note 8).

During the third quarter of 2011 management decided the Corporation no longer intended to dispose of the residual assets remaining from the sale of West Michigan Community Bank. As a result of the change in intent, amounts and results of operations for the three and nine month periods ended September 30, 2011, as well as balance sheet data as of September 30, 2011 reflect this change in intent.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation s annual report on Form 10-K for the year ended December 31, 2011.

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NOTE 1 BASIS OF PRESENTATION (continued)

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual loss history experienced by the Corporation. Various rolling periods of historical charge off experience are considered when calculating the current required level of the allowance for loan losses. This includes 4, 8, 12 and 16 quarter un-weighted periods as well as a 12 quarter rolling average with

Table of Contents**NOTE 1 BASIS OF PRESENTATION (continued)**

higher weight being placed on the more recent quarters. These analyses are reviewed and a range of values for the reserve is established. This represents a change in assumption from the prior quarter when a simple 8 quarter rolling average loss history was used. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential mortgage, installment loans and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

Troubled debt restructurings: Under certain circumstances, the Corporation will provide borrowers relief through loan restructurings and modifications. A loan restructuring constitutes a troubled debt restructuring (TDR) if for economic or legal reasons related to the borrower's financial difficulties the Corporation grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment as described above.

Other Real Estate Owned and Foreclosed Assets: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

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

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

Dividend Restrictions: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Banks to the Corporation or by the Corporation to shareholders. The State Bank has been restricted from dividend payments due to the signing of a Consent Order with the Federal Deposit Insurance Corporation (FDIC). The Holding Company has been placed under restrictions by the Federal Reserve regarding the declaration or payment of any dividends and the receipt of dividends from the subsidiary Bank.

Table of Contents**NOTE 1 BASIS OF PRESENTATION** (continued)

Stock Option Plans: Compensation cost is recognized for stock options, restricted stock awards issued to employees, and stock appreciation rights based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options and stock appreciation rights, while the market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options were granted in 2012 or 2011.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at a purchase price at or above the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the Plan.

The following table summarizes stock option activity:

| | Number of Options | Weighted Average Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|-----------------------------------------------------------|-------------------------|------------------------------|---------------------------------------------------------|---------------------------------|
| Options outstanding at January 1, 2012 | 13,786 | \$ 29.60 | | |
| Options forfeited during 2012 | (2,670) | 23.23 | | |
| Options outstanding and exercisable at September 30, 2012 | 11,116 | \$ 31.13 | 1.31 | \$ 0 |

| | Number of Options | Weighted Average Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|----------------------------------------------------------|-------------------------|------------------------------|---------------------------------------------------------|---------------------------------|
| Options outstanding at January 1, 2011 | 18,872 | \$ 29.32 | | |
| Options forfeited during 2011 | (5,086) | 28.57 | | |
| Options outstanding and exercisable at December 31, 2011 | 13,786 | \$ 29.60 | 1.73 | \$ 0 |

On February 24, 2011, the Corporation's board of directors granted 25,000 Stock Appreciation Rights (SARs) to five executives. The terms of the Stock Appreciation Rights Agreements (the SAR Agreements) provide that the SARs will be paid in cash on one or two fixed dates, which are determined as certain performance conditions are met. The conditions include the Corporation's wholly owned subsidiary, The State Bank, no longer being subject to terms, conditions and restrictions of the consent

Table of Contents**NOTE 1 BASIS OF PRESENTATION (continued)**

order dated December 31, 2009 (the "Consent Order") and the Corporation no longer being subject to terms, conditions and restrictions of the agreement between the Corporation and the Federal Reserve Board, which was effective November 4, 2010 (the "FRB Agreement"). The first payment date under the agreement is the later of February 24, 2014, the date on which the State Bank is no longer subject to the terms, conditions and restrictions of the Consent Order, and the date on which the Corporation is no longer subject to the terms, conditions and restrictions of the FRB Agreement. On the first SAR payment date a participant shall receive an amount equal to the product of the number of stock appreciation rights granted and the excess of the fair market value of one share of the Corporation's common stock over \$2.00. If the first SAR payment date does not occur prior to February 24, 2016, then the SARs shall be cancelled without any payment to the participant. If the first SAR payment date occurs prior to February 24, 2016, then the second SAR payment date shall be February 24, 2016. On the second payment date a participant shall receive an amount equal to the number of stock appreciation rights granted and the excess of the fair market value of one share of the Corporation's common stock on the second SAR payment date over the value of one share of the Corporation's common stock on the first SAR payment date. If the fair market value of one share of the Corporation's common stock on the second SAR payment date does not exceed the fair market value of one share of the Corporation's common stock on the first SAR payment date, then no payment shall be made to the participant on the second SAR payment date. There were 20,000 SARs outstanding at September 30, 2012 as a result of this issuance as 5,000 SARs were forfeited during the first quarter of 2012 as a result of one of the executive's departure.

On March 13, 2012, the Corporation's board of directors granted 10,000 Stock Appreciation Rights to a new executive officer. The terms of this Stock Appreciation Rights Agreement is the same as those previously discussed except that the first and second payment dates are March 12, 2015 and March 13, 2017, respectively.

On May 14, 2012, the Corporation's board of directors granted 5,000 Stock Appreciation Rights to a new executive officer. The terms of this Stock Appreciation Rights Agreement is the same as those previously discussed except that the first and second payment dates are May 14, 2015 and May 14, 2017, respectively. As a result of all issuances, 35,000 SARs were outstanding at September 30, 2012.

Generally accepted accounting principles require plans settled in cash to be accounted for as liabilities only when the liability is probable and reasonably estimable and to be re-measured at each reporting period. Management has determined that as of September 30, 2012, it is not probable that the performance criteria will be met and as such no liability for the compensatory element of the awards has been recorded in the consolidated financial statements.

Operating Segments: While the Corporation's chief decision-makers monitor the revenue streams of the various Corporation products and services, operations are managed and financial performance is evaluated on a Corporate-wide basis. Accordingly, all of the Corporation's financial service operations are considered by management to be aggregated in one reportable operating segment.

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

Table of Contents**NOTE 2 SECURITIES**

Securities are as follows:

| (000s omitted) Available for Sale | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2012 | | | | |
| U.S. Government and federal agency | \$ 4,993 | \$ 36 | \$ 0 | \$ 5,029 |
| State and municipal | 450 | 0 | 0 | 450 |
| Mortgage-backed residential | 12,428 | 292 | 0 | 12,720 |
| Collateralized mortgage obligations-agencies | 26,487 | 213 | (83) | 26,617 |
| Collateralized mortgage obligations-private label | 1,656 | 0 | (75) | 1,581 |
| Equity securities | 2,155 | 94 | (187) | 2,062 |
| | \$ 48,169 | \$ 635 | \$ (345) | \$ 48,459 |

| | | | | |
|---------------------------------------------------|-----------|--------|----------|-----------|
| December 31, 2011 | | | | |
| U.S. Government and federal agency | \$ 6,144 | \$ 23 | \$ (2) | \$ 6,165 |
| Mortgage-backed residential | 15,625 | 312 | (15) | 15,922 |
| Collateralized mortgage obligations-agencies | 31,002 | 457 | (5) | 31,454 |
| Collateralized mortgage obligations-private label | 3,725 | 0 | (702) | 3,023 |
| Equity securities | 2,155 | 100 | (132) | 2,123 |
| | \$ 58,651 | \$ 892 | \$ (856) | \$ 58,687 |

| (000s omitted) Held to Maturity | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|-------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2012 | | | | |
| State and municipal | \$ 2,692 | \$ 70 | \$ 0 | \$ 2,762 |
| | \$ 2,692 | \$ 70 | \$ 0 | \$ 2,762 |
| December 31, 2011 | | | | |
| State and municipal | \$ 2,963 | \$ 90 | \$ 0 | \$ 3,053 |
| | \$ 2,963 | \$ 90 | \$ 0 | \$ 3,053 |

Contractual maturities of securities at September 30, 2012 were as follows. Securities not due at a single maturity date, mortgage-backed, collateralized mortgage obligations and equity securities are shown separately.

| (000s omitted) | Available for Sale | | Held to Maturity | |
|------------------------------------|--------------------|---------------|-------------------|---------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| U.S. government and federal agency | | | | |
| Due in one year or less | \$ 0 | \$ 0 | \$ 405 | \$ 409 |
| Due from one to five years | 450 | 450 | 1,431 | 1,450 |
| Due from five to ten years | 2,000 | 2,015 | 856 | 903 |
| Due after ten years | 2,993 | 3,014 | 0 | 0 |

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| | | | | |
|---------------------------------------------------|-----------|-----------|----------|----------|
| Mortgage backed residential | 12,428 | 12,720 | 0 | 0 |
| Collateralized mortgage obligations-agencies | 26,487 | 26,617 | 0 | 0 |
| Collateralized mortgage obligations-private label | 1,656 | 1,581 | 0 | 0 |
| Equity securities | 2,155 | 2,062 | 0 | 0 |
| | \$ 48,169 | \$ 48,459 | \$ 2,692 | \$ 2,762 |

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NOTE 2 SECURITIES (continued)

At September 30, 2012, one holding totaling \$1,656,000 in a security issued by Bear Stearns exceeded 10% of stockholders' equity. At December 31, 2011, two holdings totaling \$3,023,000 in securities issued by Wells Fargo and Bear Stearns exceeded 10% of stockholders' equity. The Corporation sold the Wells Fargo security during the first quarter of 2012.

Sales of available for sale securities, for the nine month periods, were as follows:

| (000s omitted) | September 30, 2012 | September 30, 2011 |
|----------------|--------------------|--------------------|
| Proceeds | \$ 13,991 | \$ 2,024 |
| Gross gains | 325 | 5 |
| Gross losses | (191) | 0 |

The cost basis used to determine the unrealized gains or losses of securities sold was the amortized cost of the individual investment security as of the trade date.

Securities with unrealized losses are aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position as follows:

| September 30, 2012 (000s omitted) | Less than 12 months | | 12 months or more | | Total | |
|---------------------------------------------------|---------------------|-----------------|-------------------|-----------------|------------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Description of Securities | | | | | | |
| Collateralized mortgage obligations-agencies | \$ 10,057 | \$ (83) | \$ 0 | \$ 0 | \$ 10,057 | \$ (83) |
| Collateralized mortgage obligations-private label | 0 | 0 | 1,581 | (75) | 1,581 | (75) |
| Equity securities | 0 | 0 | 728 | (187) | 728 | (187) |
| Total temporarily impaired | \$ 10,057 | \$ (83) | \$ 2,309 | \$ (262) | \$ 12,366 | \$ (345) |

| December 31, 2011 (000s omitted) | Less than 12 months | | 12 months or more | | Total | |
|---------------------------------------------------|---------------------|-----------------|-------------------|-----------------|------------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Description of Securities | | | | | | |
| US government and federal agencies | \$ 0 | \$ 0 | \$ 1,498 | \$ (2) | \$ 1,498 | \$ (2) |
| Mortgage-backed residential | 6,766 | (15) | 0 | 0 | 6,766 | (15) |
| Collateralized mortgage obligations-agencies | 0 | 0 | 4,985 | (5) | 4,985 | (5) |
| Collateralized mortgage obligations-private label | 0 | 0 | 3,023 | (702) | 3,023 | (702) |
| Equity securities | 771 | (128) | 1 | (4) | 772 | (132) |
| Total temporarily impaired | \$ 7,537 | \$ (143) | \$ 9,507 | \$ (713) | \$ 17,044 | \$ (856) |

As of September 30, 2012, the Corporation's security portfolio consisted of 75 securities, 7 of which were in an unrealized loss position. The majority of unrealized losses are related to the Corporation's collateralized mortgage obligations (CMOs) and equity securities, as discussed below.

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NOTE 2 SECURITIES (continued)

Collateralized Mortgage Obligations

The decline in fair value of the Corporation's private label collateralized mortgage obligation is primarily attributable to the lack of liquidity and the financial crisis affecting these markets and not necessarily the expected cash flows of the individual security. The Standard and Poors rating held on the private label security is A-. The underlying collateral of this CMO is comprised largely of 1-4 family residences. In this security, the Corporation holds the senior tranche and receives payments before other tranches. For the private label security, management completes an analysis to review the recent performance of the mortgage pools underlying the instruments. At September 30, 2012, the private label security has an amortized cost of \$1,656,000 and an unrealized loss of \$75,000.

The Corporation has been closely monitoring the performance of the CMO and MBS portfolios. Management evaluates items such as payment streams and underlying default rates, and did not recognize a material adverse change in these items. On a quarterly basis, management uses multiple assumptions to project the expected future cash flows of the private label CMO with prepayment speeds, projected default rates and loss severity rates. The cash flows are then discounted using the effective rate on the securities determined at acquisition. Recent historical experience is the base for determining the cash flow assumptions and is adjusted when appropriate after considering characteristics of the underlying loans collateralizing the private label CMO security.

The Corporation has six agency collateralized mortgage obligations with an unrealized loss of \$83,000. The decline in value is primarily due to changes in interest rates and other market conditions.

Equity securities

The Corporation's equity investments with unrealized losses are investments in three non-public bank holding companies in Michigan. These securities receive a multi-faceted review utilizing call report data. Management reviews such performance indicators as earnings, ROE, ROA, non-performing assets, brokered deposits and capital ratios. Management draws conclusions from this information, as well as any published information or trading activity received from the individual institutions, to assist in determining if any unrealized loss is other than temporary impairment.

Additionally management considers the length of time the investments have been at an unrealized loss. At the end of the third quarter, management performed its review and determined that no other-than-temporary impairment was necessary on the equity securities in the portfolio during the third quarter.

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In evaluating OTTI, management considers the factors presented in Note 1. At the end of the third quarter, management performed its review and determined that no other-than-temporary impairment was necessary in the securities portfolio during the third quarter.

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES**

Major categories of loans are as follows:

| (000s omitted) | September 30, 2012 | December 31, 2011 |
|--------------------------------|--------------------|-------------------|
| Commercial | \$ 38,899 | \$ 33,956 |
| Commercial real estate | 105,715 | 118,984 |
| Residential real estate | 28,745 | 26,829 |
| Consumer | 23,303 | 25,998 |
| Total loans | 196,662 | 205,767 |
| Less allowance for loan losses | (6,267) | (8,164) |
| Net loans | \$ 190,395 | \$ 197,603 |

The Corporation originates primarily residential and commercial real estate loans, commercial and installment loans. The Corporation estimates that the majority of their loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan with the remainder of the portfolio distributed throughout Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Activity in the allowance for loan losses, by classification, for the three month periods ended September 30, 2012 and 2011 is as follows:

| (000s omitted) | Commercial | Commercial | Residential | Installment Loans | Home Equity | Unallocated | Total |
|----------------------------|------------|----------------|----------------|----------------------|----------------|-------------|----------|
| | | Real Estate | Real Estate | | | | |
| Allowance for loan losses | | | | | | | |
| Balance July 1, 2012 | \$ 570 | \$ 5,553 | \$ 433 | \$ 151 | \$ 395 | \$ (19) | \$ 7,083 |
| Provision for loan losses | 176 | (1,769) | 211 | (14) | (18) | 564 | (850) |
| Loans charged off | (226) | (318) | (184) | (5) | (97) | 0 | (830) |
| Loan recoveries | 24 | 833 | 1 | 4 | 2 | 0 | 864 |
| Balance September 30, 2012 | \$ 544 | \$ 4,299 | \$ 461 | \$ 136 | \$ 282 | \$ 545 | \$ 6,267 |

| (000s omitted) | Commercial | Commercial | Residential | Installment Loans | Home Equity | Unallocated | Total |
|----------------------------|------------|----------------|----------------|----------------------|----------------|-------------|----------|
| | | Real Estate | Real Estate | | | | |
| Allowance for loan losses | | | | | | | |
| Balance July 1, 2011 | \$ 1,049 | \$ 6,284 | \$ 388 | \$ 231 | \$ 615 | \$ 361 | \$ 8,928 |
| Provision for loan losses | (176) | 1,053 | 206 | 459 | (258) | (267) | 1,017 |
| Loans charged off | (67) | (752) | (8) | (55) | (20) | 0 | (902) |
| Loan recoveries | 6 | 48 | 2 | 18 | 2 | 0 | 76 |
| Balance September 30, 2011 | \$ 812 | \$ 6,633 | \$ 588 | \$ 653 | \$ 339 | \$ 94 | \$ 9,119 |

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

Activity in the allowance for loan losses, by classification, for the nine month period ended September 30, 2012 and 2011 is as follows:

| (000s omitted) | Commercial | | Residential | | Installment Loans | Home Equity | Unallocated | Total |
|----------------------------|------------|----------------|----------------|--------|----------------------|----------------|-------------|-------|
| | Commercial | Real Estate | Real Estate | | | | | |
| Allowance for loan losses | | | | | | | | |
| Balance January 1, 2012 | \$ 892 | \$ 5,993 | \$ 501 | \$ 214 | \$ 475 | \$ 89 | \$ 8,164 | |
| Provision for loan losses | 375 | (1,059) | 351 | (69) | 38 | 456 | 92 | |
| Loans charged off | (777) | (1,547) | (393) | (23) | (249) | 0 | (2,989) | |
| Loan recoveries | 54 | 912 | 2 | 14 | 18 | 0 | 1,000 | |
| Balance September 30, 2012 | \$ 544 | \$ 4,299 | \$ 461 | \$ 136 | \$ 282 | \$ 545 | \$ 6,267 | |

| (000s omitted) | Commercial | | Residential | | Installment Loans | Home Equity | Unallocated | Total |
|----------------------------|------------|----------------|----------------|--------|----------------------|----------------|-------------|-------|
| | Commercial | Real Estate | Real Estate | | | | | |
| Allowance for loan losses | | | | | | | | |
| Balance January 1, 2011 | \$ 871 | \$ 9,155 | \$ 411 | \$ 233 | \$ 508 | \$ 46 | \$ 11,224 | |
| Provision for loan losses | 117 | 1,769 | 193 | 502 | (69) | 30 | 2,542 | |
| Loans charged off | (203) | (4,517) | (19) | (112) | (118) | 0 | (4,969) | |
| Loan recoveries | 27 | 244 | 3 | 30 | 18 | 0 | 322 | |
| Balance September 30, 2011 | \$ 812 | \$ 6,651 | \$ 588 | \$ 653 | \$ 339 | \$ 76 | \$ 9,119 | |

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

| (000s omitted) | Commercial | | Residential | | Installment Loans | Home Equity | Unallocated | Total |
|-------------------------------------------------|------------|----------------|----------------|--------|----------------------|----------------|-------------|-------|
| | Commercial | Real Estate | Real Estate | | | | | |
| September 30, 2012 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | | |
| Individually evaluated for impairment | \$ 131 | \$ 2,250 | \$ 130 | \$ 39 | \$ 70 | \$ 0 | \$ 2,620 | |
| Collectively evaluated for impairment | 414 | 2,055 | 330 | 96 | 212 | 540 | 3,647 | |
| Total ending allowance balance | \$ 545 | \$ 4,305 | \$ 460 | \$ 135 | \$ 282 | \$ 540 | \$ 6,267 | |
| Loans: | | | | | | | | |
| Loans individually evaluated for impairment | \$ 1,467 | \$ 17,217 | \$ 1,141 | \$ 57 | \$ 345 | \$ 0 | \$ 20,227 | |
| Loans collectively evaluated for impairment | 37,432 | 88,498 | 27,604 | 5,091 | 17,810 | 0 | 176,435 | |
| Total ending loans balance | 38,899 | 105,715 | 28,745 | 5,148 | 18,155 | 0 | 196,662 | |
| Accrued interest receivable | 138 | 296 | 88 | 17 | 72 | 0 | 611 | |

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| | | | | | | | |
|------------------------------------|-----------|------------|-----------|----------|-----------|------|------------|
| Total recorded investment in loans | \$ 39,037 | \$ 106,011 | \$ 28,833 | \$ 5,165 | \$ 18,227 | \$ 0 | \$ 197,273 |
|------------------------------------|-----------|------------|-----------|----------|-----------|------|------------|

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NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

(000s omitted)

| | Commercial | | Residential | | | | | |
|-------------------------------------------------|------------------|-------------------|------------------|-------------------|------------------|---------------|-------------------|--|
| December 31, 2011 | Commercial | Real Estate | Real Estate | Installment Loans | Home Equity | Unallocated | Total | |
| Allowance for loan losses: | | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | | |
| Individually evaluated for impairment | \$ 714 | \$ 2,907 | \$ 201 | \$ 60 | \$ 275 | \$ 0 | \$ 4,157 | |
| Collectively evaluated for impairment | 177 | 2,852 | 275 | 155 | 207 | 341 | 4,007 | |
| Total ending allowance balance | \$ 891 | \$ 5,759 | \$ 476 | \$ 215 | \$ 482 | \$ 341 | \$ 8,164 | |
| Loans: | | | | | | | | |
| Loans individually evaluated for impairment | \$ 3,823 | \$ 24,797 | \$ 844 | \$ 133 | \$ 494 | \$ 0 | \$ 30,091 | |
| Loans collectively evaluated for impairment | 30,133 | 94,187 | 25,985 | 6,270 | 19,101 | 0 | 175,676 | |
| Total ending loans balance | \$ 33,956 | \$ 118,984 | \$ 26,829 | \$ 6,403 | \$ 19,595 | \$ 0 | \$ 205,767 | |
| Accrued interest receivable | 143 | 341 | 75 | 47 | 61 | 0 | 667 | |
| Total recorded investment in loans | \$ 34,099 | \$ 119,325 | \$ 26,904 | \$ 6,450 | \$ 19,656 | \$ 0 | \$ 206,434 | |

The following tables present loans individually evaluated for impairment by class of loans as of:

(000s omitted)

| | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
|--------------------------------------|--------------------------|---------------------|-------------------------------------|
| September 30, 2012 | | | |
| With no related allowances recorded: | | | |
| Commercial | \$ 1,849 | \$ 1,023 | \$ 0 |
| Commercial real estate | 12,609 | 8,548 | 0 |
| Residential real estate | 144 | 115 | 0 |
| Consumer | | | |
| Installment Loans | 79 | 6 | 0 |
| Home Equity | 384 | 257 | 0 |
| With an allowance recorded: | | | |
| Commercial | 519 | 521 | 131 |
| Commercial real estate | 9,027 | 8,933 | 2,250 |
| Residential real estate | 1,404 | 1,028 | 130 |
| Consumer | | | |
| Installment loans | 51 | 51 | 39 |
| Home equity | 90 | 91 | 70 |
| Total | \$ 26,156 | \$ 20,573 | \$ 2,620 |

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

| (000s omitted) | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
|--------------------------------------|--------------------------------|------------------------|----------------------------------------------|
| December 31, 2011 | | | |
| With no related allowances recorded: | | | |
| Commercial | \$ 2,280 | \$ 2,116 | \$ 0 |
| Commercial real estate | 16,275 | 11,302 | 0 |
| Residential real estate | 279 | 168 | 0 |
| Consumer | | | |
| Installment Loans | 13 | 13 | 0 |
| Home Equity | 119 | 119 | 0 |
| With an allowance recorded: | | | |
| Commercial | 1,903 | 1,715 | 714 |
| Commercial real estate | 15,814 | 13,532 | 2,907 |
| Residential real estate | 894 | 675 | 201 |
| Consumer | | | |
| Installment loans | 121 | 121 | 60 |
| Home equity | 377 | 379 | 275 |
| Total | \$ 38,075 | \$ 30,140 | \$ 4,157 |

The following table presents the average recorded investment and interest income recognized on loans individually evaluated for impairment by class of loans for the nine month periods ended:

| (000s omitted) | September 30, 2012 | | September 30, 2011 | |
|--------------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowances recorded: | | | | |
| Commercial | \$ 1,325 | \$ 29 | \$ 2,009 | \$ 71 |
| Commercial real estate | 10,111 | 327 | 12,773 | 109 |
| Residential real estate | 143 | 15 | 233 | 2 |
| Consumer | | | | |
| Installment Loans | 51 | 2 | 92 | 8 |
| Home Equity | 169 | 19 | 86 | 5 |
| With an allowance recorded: | | | | |
| Commercial | 1,302 | 21 | 947 | 36 |
| Commercial real estate | 10,470 | 272 | 18,340 | 560 |
| Residential real estate | 283 | 32 | 756 | 32 |
| Consumer | | | | |
| Installment loans | 76 | 3 | 213 | 6 |
| Home equity | 210 | 3 | 562 | 20 |
| Total | \$ 24,140 | \$ 723 | \$ 36,011 | \$ 849 |

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NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The following table presents the average recorded investment and interest income recognized on loans individually evaluated for impairment by class of loans for the three month periods ended:

| | September 30, 2012 | | September 30, 2011 | |
|--------------------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| (000s omitted) | | | | |
| With no related allowances recorded: | | | | |
| Commercial | \$ 980 | \$ 9 | \$ 1,987 | \$ 37 |
| Commercial real estate | 11,844 | 280 | 12,462 | 45 |
| Residential real estate | 168 | 4 | 233 | 0 |
| Consumer | | | | |
| Installment Loans | 22 | 1 | 33 | 1 |
| Home Equity | 309 | 8 | 88 | 2 |
| With an allowance recorded: | | | | |
| Commercial | 527 | 17 | 832 | 11 |
| Commercial real estate | 8,284 | 182 | 18,955 | 209 |
| Residential real estate | 776 | 22 | 753 | 10 |
| Consumer | | | | |
| Installment loans | 53 | 2 | 210 | 2 |
| Home equity | 91 | 2 | 487 | 6 |
| Total | \$ 23,054 | \$ 527 | \$ 36,040 | \$ 323 |

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans at:

September 30, 2012

| (000s omitted) | Nonaccrual | Loans Past Due Over 90 Days Still Accruing |
|-------------------------|-----------------|--------------------------------------------|
| Commercial | \$ 1,828 | \$ 0 |
| Commercial real estate | 4,551 | 0 |
| Residential real estate | 637 | 0 |
| Home Equity | 0 | 0 |
| Installment loans | 5 | 0 |
| Total | \$ 7,021 | \$ 0 |

December 31, 2011

Nonaccrual Loans Past Due Over 90 Days

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| | | Still Accruing (1) |
|-------------------------|---------------|-----------------------|
| (000s omitted) | | |
| Commercial | \$ 2,837 | \$ 449 |
| Commercial real estate | 13,918 | 0 |
| Residential real estate | 241 | 0 |
| Home Equity | 88 | 39 |
| Installment loans | 13 | 0 |
| Total | \$ 17,097 | \$ 488 |

(1)-Includes accrued interest receivable of \$6

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

The following table presents the aging of the recorded investment in past due loans by class of loans at:

(000s omitted)

| September 30, 2012 | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due |
|-------------------------|---------------------|---------------------|-------------------------------|----------------|
| Commercial | \$ 260 | \$ 11 | \$ 1,103 | \$ 1,374 |
| Commercial real estate | 0 | 2 | 1,925 | 1,927 |
| Residential real estate | 0 | 0 | 248 | 248 |
| Installment loans | 0 | 0 | 5 | 5 |
| Home Equity | 43 | 0 | 0 | 43 |
| Total | \$ 303 | \$ 13 | \$ 3,281 | \$ 3,597 |

(000s omitted)

| December 31, 2011 | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due (1) | Total Past Due |
|-------------------------|---------------------|---------------------|-----------------------------------|----------------|
| Commercial | \$ 431 | \$ 14 | \$ 2,741 | \$ 3,186 |
| Commercial real estate: | 2,796 | 0 | 10,750 | 13,546 |
| Residential real estate | 0 | 0 | 198 | 198 |
| Installment loans | 3 | 1 | 51 | 55 |
| Home Equity | 73 | 0 | 85 | 158 |
| Total | \$ 3,303 | \$ 15 | \$ 13,825 | \$ 17,143 |

(1) Includes interest receivable of \$15.

Modifications:

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of concessions when modifying a loan or lease, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Residential real estate loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs through a reduction of interest rate and/or extension of the maturity date. Installment loans modified in a TDR are primarily comprised of loans where the Corporation has lowered monthly payments by extending the term.

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Corporation may have the financial effect of increasing the specific allowance associated with the loan.

The Corporation has identified as TDRs certain loans for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology. Upon identifying these loans as TDRs, the Corporation classified them as impaired. The Corporation's recorded investment in TDRs at September 30, 2012 is \$14,790,000, with a specific valuation allowance of \$2,392,000. This is compared to \$9,367,000, with a specific valuation allowance of \$1,310,000, at September 30, 2011. This specific valuation allowance is an allocated portion of the total allowance for loan losses. The Corporation has no additional amounts committed to these customers.

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

The following presents by class, information related to loans modified in a TDR during the three month period ended:

| (000s omitted) | Number of Loans | September 30, 2012 | | Number of Loans | September 30, 2011 | |
|-------------------------|--------------------|--------------------------------------------|---------------------------------------------|--------------------|--------------------------------------------|---------------------------------------------|
| | | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial real estate | 2 | \$ 1,570 | \$ 1,570 | 1 | \$ 808 | \$ 808 |
| Residential real estate | 0 | 0 | 0 | 1 | 204 | 204 |
| Consumer loans | 0 | 0 | 0 | 2 | 135 | 135 |
| Total | 2 | \$ 1,570 | \$ 1,570 | 4 | \$ 1,147 | \$ 1,147 |

The following presents by class, information related to loans modified in a TDR during the nine month period ended:

| (000s omitted) | Number of Loans | September 30, 2012 | | Number of Loans | September 30, 2011 | |
|-------------------------|--------------------|--------------------------------------------|---------------------------------------------|--------------------|--------------------------------------------|---------------------------------------------|
| | | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial | 0 | \$ 0 | \$ 0 | 4 | \$ 1,016 | \$ 1,016 |
| Commercial real estate | 10 | 5,321 | 5,321 | 9 | 3,025 | 3,025 |
| Residential real estate | 2 | 189 | 189 | 1 | 204 | 204 |
| Consumer loans | 2 | 95 | 95 | 4 | 779 | 779 |
| Total | 14 | \$ 5,605 | \$ 5,605 | 18 | \$ 5,024 | \$ 5,024 |

The following presents information on TDRs for which there was a payment default during the three month period ended September 30, 2012 (i.e. 30 days or more past due following a modification) that had been modified during the 12-month period prior to the default.

| (000s omitted) | Number of Contracts | September 30, 2012 | | Number of Contracts | September 30, 2011 | |
|------------------------|------------------------|--------------------|-------------------------------------------------------------------|------------------------|--------------------|-------------------------------------------------------------------|
| | | | Recorded Investment (as of period end) ⁽¹⁾ | | | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial real estate | 0 | \$ 0 | | 2 | \$ 219 | |
| Total | 0 | \$ 0 | | 2 | \$ 219 | |

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

The following presents information on TDRs for which there was a payment default during the nine month period ended September 30, 2012 and 2011 (i.e. 30 days or more past due following a modification) that had been modified during the 12-month period prior to the default.

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

| (000s omitted) | September 30, 2012 | | September 30, 2011 | |
|------------------------|------------------------|-------------------------------------------------------------------|------------------------|-------------------------------------------------------------------|
| | Number of Contracts | Recorded Investment (as of period end) ⁽¹⁾ | Number of Contracts | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial | 3 | \$ 747 | 0 | \$ 0 |
| Commercial real estate | 10 | 3,162 | 2 | 219 |
| Installment loan | 1 | 5 | 0 | 0 |
| Total | 14 | \$ 3,914 | 2 | \$ 219 |

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs are analyzed in the same manner as other impaired loans within their respective loan segment.

The following presents by portfolio loan class, the type of modification made in a TDR from July 1 through September 30, 2012 and 2011:

| (000s omitted) | Loans modified through reduction of interest rate | | | |
|-------------------------|---------------------------------------------------|----------------------------------------------------------------|--------------------|----------------------------------------------------------------|
| | September 30, 2012 | | September 30, 2011 | |
| | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial real estate | 1 | \$ 1,345 | 0 | \$ 0 |
| Residential real estate | 0 | 0 | 1 | 204 |
| Installment loan | 0 | 0 | 1 | 128 |
| Total | 1 | \$ 1,345 | 2 | \$ 332 |

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

| (000s omitted) | Loans modified through extension of term | | | |
|-------------------------|------------------------------------------|----------------------------------------------------------------|--------------------|----------------------------------------------------------------|
| | September 30, 2012 | | September 30, 2011 | |
| | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial real estate | 1 | \$ 224 | 1 | \$ 808 |
| Residential real estate | 0 | 0 | 0 | 0 |
| Installment loan | 0 | 0 | 1 | 7 |
| Total | 1 | \$ 224 | 2 | \$ 815 |

- (1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

The following presents by portfolio loan class, the type of modification made in a TDR from January 1, through September 30, 2012 and 2011:

| | Loans modified through reduction of interest rate | | | |
|-------------------------|---------------------------------------------------|----------------------------------------------------------------|--------------------|----------------------------------------------------------------|
| | September 30, 2012 | | September 30, 2011 | |
| (000s omitted) | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial real estate | 5 | \$ 2,962 | 1 | \$ 238 |
| Residential real estate | 1 | 102 | 1 | 204 |
| Installment loan | 1 | 37 | 3 | 773 |
| Total | 7 | \$ 3,101 | 5 | \$ 1,215 |

- (1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

| | Loans modified through extension of term | | | |
|-------------------------|------------------------------------------|----------------------------------------------------------------|--------------------|----------------------------------------------------------------|
| | September 30, 2012 | | September 30, 2011 | |
| (000s omitted) | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial | 0 | \$ 0 | 3 | \$ 970 |
| Commercial real estate | 5 | 2,360 | 7 | 2,781 |
| Residential real estate | 1 | 87 | 0 | 0 |
| Installment loan | 1 | 58 | 1 | 7 |
| Total | 7 | \$ 2,505 | 11 | \$ 3,758 |

- (1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

| | Loans modified through change in payment terms | | | |
|------------------------|------------------------------------------------|----------------------------------------------------------------|--------------------|----------------------------------------------------------------|
| | September 30, 2012 | | September 30, 2011 | |
| (000s omitted) | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ | Number of Loans | Recorded Investment (as of period end) ⁽¹⁾ |
| Commercial | 0 | \$ 0 | 1 | \$ 45 |
| Commercial real estate | 0 | 0 | 1 | 6 |
| Total | 0 | \$ 0 | 2 | \$ 51 |

- (2) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

Credit Quality Indicators:

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Corporation uses the following definitions for classified risk ratings:

Prime. Loans classified as prime are well seasoned borrowers displaying strong financial condition, consistently superior earning performance, and access to a range of financing alternatives. The borrower's trends and outlook, as well as those of its industry are positive.

Table of Contents**NOTE 3 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

Pass. Loans classified as pass have a moderate to average risk to established borrowers that display sound financial condition and operating results. The capacity to service debt is stable and demonstrated at a level consistent with or above the industry norms. Borrower and industry trends and outlook are considered good.

Watch. Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The Corporation does not classify loans as doubtful. Loans that approach this status are charged-off.

Based on the most recent analysis performed, the recorded investment by risk category of loans by class of loans is as follows:

(000s omitted)

| September 30, 2012 | Prime | Pass | Watch | Substandard | Total |
|------------------------|-----------------|-------------------|------------------|------------------|-------------------|
| Commercial | \$ 6,841 | \$ 28,830 | \$ 1,627 | \$ 1,739 | \$ 39,037 |
| Commercial real estate | 877 | 80,873 | 11,092 | 13,169 | 106,011 |
| Total | \$ 7,718 | \$ 109,703 | \$ 12,719 | \$ 14,908 | \$ 145,048 |

(000s omitted)

| December 31, 2011 | Prime | Pass | Watch | Substandard | Total |
|-------------------------|-----------------|-------------------|------------------|------------------|-------------------|
| Commercial | \$ 3,411 | \$ 25,006 | \$ 1,850 | \$ 3,832 | \$ 34,099 |
| Commercial real estate: | 0 | 79,909 | 14,583 | 24,833 | 119,325 |
| Total | \$ 3,411 | \$ 104,915 | \$ 16,433 | \$ 28,665 | \$ 153,424 |

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

(000s omitted)

| September 30, 2012 | Home Equity | Installment | Residential Real Estate | Total |
|--------------------|------------------|-----------------|-------------------------|------------------|
| Performing | \$ 17,880 | \$ 5,108 | \$ 27,690 | \$ 50,678 |
| Non-performing | 347 | 57 | 1,143 | 1,547 |
| Total | \$ 18,227 | \$ 5,165 | \$ 28,833 | \$ 52,225 |

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(000s omitted)

| December 31, 2011 | Home Equity | Installment | Residential Real Estate | Total |
|-------------------|------------------|-----------------|-------------------------------|------------------|
| Performing | \$ 19,162 | \$ 6,317 | \$ 26,060 | \$ 51,539 |
| Non-performing | 494 | 133 | 844 | 1,471 |
| Total | \$ 19,656 | \$ 6,450 | \$ 26,904 | \$ 53,010 |

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NOTE 4 FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

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

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

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

Securities Available for Sale:

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance. The Corporation reviews the performance of the securities that comprise level 3 on a quarterly basis.

Impaired Loans:

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned:

Non-recurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sale and income data available, which results in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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NOTE 4 FAIR VALUE (continued)

Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

| (000s omitted) | Total | Fair Value Measurements Using | | |
|---------------------------------------------------|-----------|----------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2012 | | | | |
| <u>Available for sale securities</u> | | | | |
| US Government and federal agency | \$ 5,029 | \$ 0 | \$ 5,029 | \$ 0 |
| State and local municipalities | 450 | 0 | 450 | 0 |
| Mortgage-backed residential | 12,720 | 0 | 12,720 | 0 |
| Collateralized mortgage obligations-agencies | 26,617 | 0 | 26,617 | 0 |
| Collateralized mortgage obligations-private label | 1,581 | 0 | 1,581 | 0 |
| Equity securities | 2,062 | 0 | 1,064 | 998 |
| | \$ 48,459 | \$ 0 | \$ 47,461 | \$ 998 |

| (000s omitted) | Total | Fair Value Measurements Using | | |
|---------------------------------------------------|-----------|----------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2011 | | | | |
| <u>Available for sale securities</u> | | | | |
| US Government and federal agency | \$ 6,165 | \$ 0 | \$ 6,165 | \$ 0 |
| Mortgage-backed residential | 15,922 | 0 | 15,922 | 0 |
| Collateralized mortgage obligations-agencies | 31,454 | 0 | 31,454 | 0 |
| Collateralized mortgage obligations-private label | 3,023 | 0 | 3,023 | 0 |
| Equity securities | 2,123 | 0 | 1,051 | 1,072 |
| | \$ 58,687 | \$ 0 | \$ 57,615 | \$ 1,072 |

The table below presents a reconciliation including the respective income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

| (000s omitted) | Equity Securities | |
|-----------------------------------------------|-------------------|----------|
| | 2012 | 2011 |
| Beginning balance, January 1, | \$ 1,072 | \$ 1,147 |
| Included in other comprehensive income (loss) | (74) | (36) |
| Ending balance, September 30, | \$ 998 | \$ 1,111 |

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| (000s omitted) | Equity Securities | |
|-----------------------------------------------|-------------------|----------|
| | 2012 | 2011 |
| Beginning balance, July 1, | \$ 949 | \$ 1,142 |
| Included in other comprehensive income (loss) | 49 | (31) |
| Ending balance, September 30, | \$ 998 | \$ 1,111 |

Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

Table of Contents**NOTE 4 FAIR VALUE (continued)**

| (000s omitted) | | Significant Unobservable Inputs (Level 3) |
|--------------------------------------|-----------------|----------------------------------------------------|
| At September 30, 2012 | Total | |
| Impaired loans | | |
| Commercial | \$ 388 | \$ 388 |
| Commercial real estate | 3,389 | 3,389 |
| Residential real estate | 896 | 896 |
| Installment | 12 | 12 |
| Home equity | 20 | 20 |
| Total impaired loans | \$ 4,705 | \$ 4,705 |
| Other real estate owned | | |
| Commercial real estate | \$ 951 | \$ 951 |
| Total other real estate owned | \$ 951 | \$ 951 |

| (000s omitted) | | Significant Unobservable Inputs (Level 3) |
|--------------------------------------|------------------|----------------------------------------------------|
| At December 31, 2011 | Total | |
| Impaired loans | | |
| Commercial | \$ 997 | \$ 997 |
| Commercial real estate | 8,526 | 8,526 |
| Residential real estate | 474 | 474 |
| Installment | 55 | 55 |
| Home equity | 102 | 102 |
| Total impaired loans | \$ 10,154 | \$ 10,154 |
| Other real estate owned | | |
| Commercial real estate | \$ 301 | \$ 301 |
| Total other real estate owned | \$ 301 | \$ 301 |

Table of Contents**NOTE 4 FAIR VALUE** (continued)

The following represent impairment charges recognized during the period:

At September 30, 2012, impaired loans, which were measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal amount of \$6,317,000 with a valuation allowance of \$1,612,000. This is compared to December 31, 2011 when the principal amount of impaired loans was \$13,868,000 with a valuation allowance of \$3,714,000.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,704,000, of which \$951,000 was at fair value, which resulted from write downs totaling \$85,000 during the third quarter of 2012. At December 31, 2011, other real estate owned had a net carrying amount of \$1,949,000, of which \$301,000 was at fair value, which resulted from write downs totaling \$24,000.

Quantitative information about Level 3 fair value measurements is as follows:

| | Fair Value at September 30, 2012 | Valuation Technique(s) | Unobservable Input | Weighted Average |
|----------------------------------|-------------------------------------|-----------------------------------------|-----------------------------------------|------------------|
| Equity Securities ⁽¹⁾ | \$ 998 | Market Average | Price to book multiple of peer group | 64.94% |
| Impaired Loans | 4,705 | Appraisal Value- | | |
| | | Real estate | Discount applied to appraisal | 6.40% |
| | | Appraisal Value- Accounts receivable | Discount applied to appraisal | 94.78% |
| | | Appraisal Value- Vehicles/equipment | Discount applied to appraisal | 78.42% |
| Other real estate | 951 | Appraisal Value | Discount applied to appraisal | 0% |
| Total level 3 assets | \$ 6,654 | | | |

⁽¹⁾ Reasonable modifications made to the price to book multiple are not expected to have a significant impact on the value of the securities. The estimated fair values of financial instruments that are not reported at fair value in their entirety in the Corporation's consolidated balance sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value were as follows:

| (000s omitted) | September 30, 2012 | | December 31, 2011 | |
|-------------------------------|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Assets: | | | | |
| Level 1 inputs: | | | | |
| Cash and cash equivalents | \$ 42,768 | \$ 42,768 | \$ 18,634 | \$ 18,634 |
| FHLB Stock | 661 | NA | 661 | NA |
| Accrued interest receivable | 1,238 | 1,238 | 1,039 | 1,039 |
| Level 2 inputs: | | | | |
| Securities - held to maturity | 2,692 | 2,762 | 2,963 | 3,053 |

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| | | | | |
|-------------------------------|------------|------------|------------|------------|
| Loans held for sale | 939 | 939 | 123 | 123 |
| Performing loans | 192,016 | 201,070 | 195,612 | 203,656 |
| Level 3 inputs: | | | | |
| Impaired loans | 4,705 | 4,705 | 10,154 | 10,154 |
| <u>Liabilities:</u> | | | | |
| Level 1 inputs: | | | | |
| Deposits-non-maturing | \$ 201,977 | \$ 201,977 | \$ 180,098 | \$ 180,098 |
| Accrued interest payable | 1,823 | 1,823 | 1,572 | 1,572 |
| Level 2 inputs: | | | | |
| Deposits-with stated maturity | 70,402 | 71,142 | 85,783 | 85,563 |
| FHLB advance | 891 | 1,086 | 923 | 1,142 |
| Subordinated debentures | 14,000 | 13,738 | 14,000 | 13,751 |

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NOTE 4 FAIR VALUE (continued)

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents

The carrying amounts reported in the consolidated balance sheets for cash and short-term instruments approximate their fair values.

Securities - held to maturity

Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

Loans held for sale

The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

Performing loans

For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans is estimated using discounted cash flow analysis.

FHLB Stock

It was not practical to determine the fair value of FHLB stock and therefore the FHLB stock is not included under a specific value methodology.

Accrued interest

The carrying amount of accrued interest approximates its fair value.

Off-balance-sheet instruments

The fair value of off-balance sheet items is not considered material.

Deposits

The fair values disclosed for non-maturing deposits are by definition equal to the amount payable on demand at the reporting date. Fair values for deposits with a stated maturity are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar deposits.

FHLB advance

Rates currently available for FHLB advances with similar terms and remaining maturities are used to estimate the fair value of the existing obligation.

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NOTE 4 FAIR VALUE (continued)

Subordinated debentures

The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on management's judgments regarding future expected loss experience, current economic conditions, risk characteristics and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

NOTE 5 INCOME TAXES

The provision (benefit) for federal income taxes is computed by applying the statutory federal income tax rate to income (loss) before income taxes as reported in the consolidated financial statements after deducting non-taxable items, principally income on bank-owned life insurance, and deducting credits related to certain investments.

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. Management has reviewed the deferred tax position for the Corporation at September 30, 2012 and December 31, 2011. The Corporation's evaluation of taxable events, losses in recent years and the continuing struggles of the Michigan economy led management to conclude that it was more likely than not that the benefit would not be realized. As a result, the Corporation maintained a full valuation allowance at September 30, 2012 and December 31, 2011.

An income tax benefit associated with continuing operations in the amount of \$124,000 and \$222,000 was recorded for the nine month periods ending September 30, 2012 and 2011, respectively. In 2011, the benefit recorded considered the results of current period adjustments to other comprehensive income and discontinued operations. Generally, the calculation for income tax expense (benefit) does not consider the tax effects of changes in other comprehensive income or loss, which is a component of shareholders' equity on the balance sheet. However, an exception is provided in certain circumstances when there is a pre-tax loss from continuing operations and income from other categories such as other comprehensive income or discontinued operations. In such case, pre-tax income from other categories is included in the tax expense (benefit) calculation for the current period. For the year to date period the income tax benefit was related to the reversal of excess taxes accrued during the fourth quarter of 2011 in relation to estimates of a tax audit.

There were no unrecognized tax benefits at September 30, 2012 or December 31, 2011, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months. The Corporation and its subsidiaries are subject to U.S federal income taxes as well as income tax of the state of Michigan. The Corporation is no longer subject to examination by taxing authorities for years before 2009.

Table of Contents**NOTE 6 EARNINGS PER COMMON SHARE**

The factors in the earnings per share computation follow:

| (000s omitted except share and per share data) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Basic | | | | |
| Net (loss) income | \$ 1,403 | \$ (699) | \$ 811 | \$ (632) |
| Weighted average common shares outstanding | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Basic (loss) income per common share | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.27) |
| Diluted | | | | |
| Net (loss) income | \$ 1,403 | \$ (699) | \$ 811 | \$ (632) |
| Weighted average common shares outstanding for basic earnings per common share | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Add: Dilutive effects of assumed exercises of stock options | 0 | 0 | 0 | 0 |
| Average shares and dilutive potential common shares | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Diluted income per common share | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.27) |

The factors in the earnings per share of continuing operations follow:

| (000s omitted except share and per share data) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Basic | | | | |
| Net loss of continuing operations | \$ 1,403 | \$ (699) | \$ 811 | \$ (1,106) |
| Weighted average common shares outstanding | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Basic loss per common share from continuing operations | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.48) |
| Diluted | | | | |
| Net loss of continuing operations | \$ 1,403 | \$ (699) | \$ 811 | \$ (1,106) |
| Weighted average common shares outstanding for basic earnings per common share | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Add: Dilutive effects of assumed exercises of stock options | 0 | 0 | 0 | 0 |
| Average shares and dilutive potential common shares | 2,425,280 | 2,349,252 | 2,406,118 | 2,326,674 |
| Diluted loss per common share from continuing operations | \$ 0.58 | \$ (0.30) | \$ 0.34 | \$ (0.48) |

Stock options of 11,116 and 13,907 shares of common stock outstanding at September 30, 2012 and September 30, 2011, respectively were not considered in computing diluted earnings per common share for 2012 and 2011, because they were anti-dilutive.

NOTE 7 COMMITMENTS AND CONTINGENCIES

There are various contingent liabilities that are not reflected in the financial statements including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, there are no matters which are expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

Table of Contents**NOTE 8 DISCONTINUED OPERATIONS**

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank (WMCB). The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium to book). As a condition of the sale, the Corporation assumed certain non-performing assets of West Michigan Community Bank which totaled \$9,900,000. The assets were housed in a newly formed real estate holding company subsidiary of the Corporation, FHLLC. In addition, The State Bank assumed \$2,900,000 of watch rated credits.

As of July 1, 2011, due to a change in management s intent, the remaining balances of the assets described above and previously classified as discontinued operations were reclassified to continuing operations; therefore there are no assets or liabilities presented at December 31, 2011 or September 30, 2012. Corresponding amounts also were reclassified for all periods presented.

A condensed statement of income of discontinued operations is presented for the nine months ended September 30, 2011. Due to the sale of West Michigan Community Bank at January 31, 2011, only one month of income and expense is presented for West Michigan Community Bank.

CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS

(000s omitted)

| | Three Months | | Nine Months Ended | | |
|------------------------------------------------------------|----------------------------------------------|----------|----------------------------------------------|--------|--------|
| | Ended | | September 30, 2011 | | |
| | September 30, 2011 | | September 30, 2011 | | |
| | Assumed Loans and Other Real Estate | Total | Assumed Loans and Other Real Estate | WMCB | Total |
| Interest income | \$ (00) | \$ (00) | \$ (00) | \$ 515 | \$ 515 |
| Interest expense | 0 | 0 | 0 | 129 | 129 |
| Net interest income | (00) | (00) | (00) | 386 | 386 |
| Provision for loan losses | 0 | 0 | 0 | (50) | (50) |
| Net interest income (loss) after provision for loan losses | (00) | (00) | (00) | 436 | 436 |
| Non-interest income | 00 | 00 | 00 | 121 | 121 |
| Non-interest expense | 000 | 000 | 82 | 415 | 497 |
| Income (loss) before federal income tax | (000) | (000) | (82) | 142 | 60 |
| Federal income tax (benefit) expense | 0 | 0 | 0 | 57 | 57 |
| Gain on sale of subsidiary | 0 | 0 | 0 | 469 | 469 |
| Net income (loss) | \$ (000) | \$ (000) | \$ (82) | \$ 554 | \$ 472 |

In connection with the sale of West Michigan Community Bank, the Corporation recognized a gross gain of \$711,000. Net of tax the net gain amounted to \$469,000.

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NOTE 9 REGULATORY MATTERS

The Corporation (on a consolidated basis) and its Bank subsidiaries are subject to various regulatory capital requirements administered by the federal and state regulatory agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items that are calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of September 30, 2012 and December 31, 2011, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action.

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators containing provisions to foster improvement in The State Bank's earnings, reduce nonperforming loan levels, increase capital, and require revisions to various policies. The Consent Order requires The State Bank to maintain a Tier 1 capital to average asset ratio of a minimum of 8.0%. It also requires The State Bank to maintain a total capital to risk weighted asset ratio of 12.0%. At September 30, 2012, The State Bank had a Tier 1 capital to average assets ratio of 8.5% and a total capital to risk-weighted assets ratio of 13.2%.

The Consent Orders restrict the Bank from issuing or renewing brokered deposits. The Consent Orders also restrict dividend payments from The State Bank to the Corporation. The Corporation, the Board of Directors and management continue to work on plans to come into compliance with the Consent Orders. At March 31, 2012 actions included the injection of \$250,000 of capital into The State Bank resulting from the sale of non-performing assets from the subsidiary of the Corporation. The Bank maintains capital levels that would be considered well capitalized by regular prompt corrective action regulatory standards. Non-compliance with Consent Order requirements may cause bank to be subject to further enforcement actions by the FDIC.

Effective in November 2010, the Corporation received a notice from The Federal Reserve which defined restrictions being placed upon the Corporation. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an expectation that the Corporation maintain sufficient capital levels.

The Corporation continues to be required to obtain written approval prior to payments of any dividends or for any increase or decrease to outstanding debt.

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NOTE 9 REGULATORY MATTERS (continued)

The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies.

| | Actual | | Purposes | | Requirements | |
|---------------------------------------------------------------|-----------|-------|-----------|-------|--------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (000s omitted) | | | | | | |
| As of September 30, 2012 | | | | | | |
| Total Capital (to Risk Weighted Assets) The State Bank | 28,233 | 13.0% | 17,321 | 8.0% | 25,981 | 12.0% |
| Tier 1 Capital (to Risk Weighted Assets) The State Bank | 25,483 | 11.8 | 8,660 | 4.0 | NA | NA |
| Tier 1 Capital (to Average Assets) The State Bank | 25,483 | 8.5 | 11,949 | 4.0 | 23,899 | 8.0 |
| | | | | | | |
| | | | | | | |
| (000s omitted) | | | | | | |
| As of December 31, 2011 | | | | | | |
| Total Capital (to Risk Weighted Assets) The State Bank | \$ 26,448 | 12.3 | \$ 17,166 | 8.0 | \$ 25,749 | 12.0% |
| Tier 1 Capital (to Risk Weighted Assets) The State Bank | 23,700 | 11.0 | 8,583 | 4.0 | NA | NA |
| Tier 1 Capital (to Average Assets) The State Bank | 23,700 | 8.1 | 11,654 | 4.0 | 23,307 | 8.0 |

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

Certain of the Corporation's accounting policies are important to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances, which could affect these judgments, include, but are not limited to, changes in interest rates, in the performance of the economy or in the financial condition of borrowers.

Results of Operations

As indicated in the statement of operations, results from continuing operations for the first nine months ended September 30, 2012 was net income of \$811,000 compared to a loss of \$1,106,000 for the same period in 2011. Net interest income in the third quarter of 2012 was \$79,000 above net interest income for the same quarter in 2011. The third quarter of 2012 provision for loan losses decreased \$1,867,000 compared to the third quarter of 2011. Management feels the allowance for loan losses is appropriate and such allowance has decreased \$1,897,000 when comparing the balance as of September 30, 2012 to the balance as of December 31, 2011. Non interest income for the third quarter of 2012 was \$262,000 below non interest income for the same quarter in 2011. Non interest expense for the third quarter of 2012 was \$273,000 lower than for the same quarter in 2011. These variances from period to period are detailed over the next several pages.

The banking industry uses standard performance indicators to help evaluate a banking institution's performance. Return on average assets is one of these indicators. For the nine months ended September 30, 2012, the Corporation's return on average assets from continuing operations (annualized) was 0.36% compared to (0.40%) for the same period in 2011. For the nine months ended September 30, 2012, the Corporation's return on average equity from continuing operations (annualized) was 7.04% compared to (9.29%) for the same period in 2011. The year to date net income per share from continuing operations, basic and diluted, was \$0.34 in the third quarter of 2012 compared to a (\$0.48) net loss per share, basic and diluted, for the same period in 2011.

Net Interest Income

Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the nine months ended September 30, 2012 and 2011 are summarized in Table 2.

Table 1 below displays the effects of changing rates and volumes on our net interest income for the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011. The information displayed is with respect to the effects on interest income and interest expense attributable to changes in volume and rate.

As indicated in Table 1, during the nine months ended September 30, 2012, net interest income increased slightly compared to the same period in 2011. Both the loan rates and volumes decreased relative to the same period last year. The rate decrease is due primarily to the repricing of fixed rate loans to current market rates as they renew along with new volume of loans being booked at current rates which are lower than rates for the same periods in prior years. These changes resulted in a decrease in loan yield when comparing September 30, 2012 to September 30, 2011. Mitigating the decrease in interest income, deposit rates and volumes decreased year over year. The deposit interest rate reduction was achieved by a reduction of offering rates on time deposits, which assisted in discouraging high rate instruments from renewing, with some funds exiting, thus reducing interest bearing liability costs. In addition, a shift of deposits from interest bearing to non-interest bearing assisted in improving the net interest margin.

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| (000s omitted) | NINE MONTHS ENDED | | |
|-------------------------------------------|---------------------------------------------------------------|-----------------|--------------|
| | SEPTEMBER 30, 2012 COMPARED TO 2011 INCREASE (DECREASE) | | |
| | VOLUME | YIELD/ RATE | TOTAL |
| Short term investment | \$ (4) | \$ (4) | \$ (8) |
| Taxable securities | 61 | (162) | (101) |
| Tax-exempt securities (1) | (36) | 3 | (33) |
| Total loans (1) | (480) | (129) | (609) |
| Total earning assets | (459) | (292) | (751) |
| Money market savings | (2) | (5) | (7) |
| Savings | 1 | (2) | (1) |
| Retail time deposits | (111) | (98) | (209) |
| Brokered time deposits | (439) | (57) | (496) |
| Advance from FHLB | (48) | 34 | (14) |
| Trust preferred securities | 0 | (45) | (45) |
| Total interest bearing liabilities | (599) | (173) | (772) |
| Net Interest Income | \$ 140 | \$ (119) | \$ 21 |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

As indicated in Table 2, for the nine months ended September 30, 2012, the Corporation's net interest margin as a percentage of average assets (with consideration of full tax equivalency) was 3.98% compared with 3.83% for the same period in 2011. The increase in net interest margin is the result of the downward re-pricing on interest bearing assets which was offset by the decreases in rates paid on interest bearing liabilities when comparing the nine month period ended September 30, 2012 to the nine month period ended September 30, 2011.

Average earning assets decreased 7.7% or \$21,731,000 comparing the first nine months of 2012 to the same time period in 2011. Loans, the highest yielding component of earning assets, represented 77.4% of earning assets in 2012 compared to 75.4% in 2011. Average interest bearing liabilities decreased 10.5% or \$24,966,000 comparing the first nine months of 2012 to the same time period in 2011.

Management reviews economic forecasts and statistics on a monthly basis. Accordingly, the Corporation will continue to strategically manage the balance sheet structure in an effort to optimize net interest income. The Corporation expects to continue to selectively seek out new loan opportunities while continuing to maintain sound credit quality.

Management continually monitors the Corporation's balance sheet in an effort to insulate net interest income from significant swings caused by interest rate volatility. If market rates change, corresponding changes in funding costs will be considered to avoid the potential negative impact on net interest income. The Corporation's policies in this regard are further discussed in the section titled Interest Rate Sensitivity Management.

Table of Contents**Table 2 Average Balance and Rates**

| (000s omitted)(Annualized) | NINE MONTHS ENDED SEPTEMBER 30, | | | | | |
|-----------------------------------------------|---------------------------------|----------------------------|----------------|--------------------|----------------------------|----------------|
| | AVERAGE BALANCE | 2012 INCOME/ EXPENSE | YIELD/ RATE | AVERAGE BALANCE | 2011 INCOME/ EXPENSE | YIELD/ RATE |
| ASSETS | | | | | | |
| Short term investment | \$ 0 | \$ 22 | 0.00% | \$ 12,364 | \$ 30 | 0.32% |
| Securities: | | | | | | |
| U.S. Treasury and government Agencies | 55,881 | 905 | 2.16% | 52,918 | \$ 1,006 | 2.53% |
| State and Political ⁽¹⁾ | 2,828 | 86 | 6.24% | 3,997 | 119 | 6.11% |
| Total Securities | 58,709 | 991 | 2.36% | 56,915 | 1,125 | 2.79% |
| Loans: | | | | | | |
| Commercial | 148,000 | 6,223 | 5.62% | 162,782 | 6,769 | 5.59% |
| Consumer | 24,800 | 1,034 | 5.55% | 28,642 | 1,206 | 5.63% |
| Mortgage | 28,441 | 999 | 4.68% | 20,978 | 890 | 5.67% |
| Total loans | 201,241 | 8,256 | 5.48% | 212,402 | 8,865 | 5.60% |
| TOTAL EARNING ASSETS | 259,950 | 9,269 | 4.77% | 281,681 | 10,020 | 4.99% |
| Cash and cash equivalents | 27,526 | | | 22,540 | | |
| Investment security fair value adjustment | 249 | | | 60 | | |
| Bank premises and equipment | 10,235 | | | 10,748 | | |
| Bank owned life insurance | 5,979 | | | 5,998 | | |
| Other real estate | 2,711 | | | 4,401 | | |
| Allowance for loan loss | (7,606) | | | (9,797) | | |
| Other non-earning assets | 2,194 | | | 4,529 | | |
| TOTAL ASSETS | 301,238 | | | 320,160 | | |
| LIABILITIES & STOCKHOLDERS EQUITY: | | | | | | |
| Deposits: | | | | | | |
| Interest Bearing DDA | \$ 2,735 | \$ 2 | 0.10% | \$ 2,606 | \$ 2 | 0.10% |
| Money market savings | 46,462 | 40 | 0.11% | 48,059 | 47 | 0.13% |
| Savings | 71,162 | 48 | 0.09% | 69,903 | 49 | 0.09% |
| Retail time deposits | 65,803 | 791 | 1.60% | 74,671 | 1000 | 1.79% |
| Brokered time deposits | 11,933 | 351 | 3.92% | 26,826 | 847 | 4.22% |
| Total interest bearing deposits | 198,095 | 1,232 | 0.83% | 222,065 | 1,945 | 1.17% |
| Borrowings | | | | | | |
| Advances from FHLB of Indianapolis | 907 | 50 | 7.34% | 1,467 | 64 | 5.83% |
| Trust preferred securities | 14,000 | 269 | 2.56% | 14,000 | 314 | 3.00% |
| Other borrowings | 0 | 0 | 0.00% | 437 | 0 | 0.00% |
| Total Borrowings | 14,907 | 319 | 2.85% | 15,904 | 378 | 3.18% |
| INTEREST BEARING LIABILITIES | \$ 213,002 | 1,551 | 0.97% | \$ 237,969 | 2,323 | 1.37% |
| Non-interest bearing deposits | 70,038 | | | 62,453 | | |
| Other non-rate bearing liabilities | 3,367 | | | 3,292 | | |
| Stockholders equity | 14,831 | | | 16,446 | | |

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| | | | | |
|-------------------------------------------|------------|-------|------------|-------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 301,238 | | \$ 320,160 | |
| Net Interest Rate Spread | \$ 7,718 | 3.80% | \$ 7,697 | 3.61% |
| Net Interest Income /Margin | | 3.98% | | 3.83% |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

Table of Contents**Table 3 Average Balance and Rates**

| (000s omitted)(Annualized) | THREE MONTHS ENDED SEPTEMBER 30, | | | | | |
|-----------------------------------------------|----------------------------------|----------------------------|----------------|--------------------|----------------------------|----------------|
| | AVERAGE BALANCE | 2012 INCOME/ EXPENSE | YIELD/ RATE | AVERAGE BALANCE | 2011 INCOME/ EXPENSE | YIELD/ RATE |
| ASSETS | | | | | | |
| Short term investment | \$ 0 | \$ 3 | 0.00% | \$ 5,000 | \$ 8 | 0.63% |
| Securities: | | | | | | |
| U.S. Treasury and government Agencies | 52,602 | 251 | 1.91% | 58,627 | \$ 354 | 2.42% |
| State and Political ⁽¹⁾ | 2,719 | 27 | 6.11% | 3,459 | 32 | 5.69% |
| Total Securities | 55,321 | 278 | 2.12% | 62,086 | 386 | 2.60% |
| Loans: | | | | | | |
| Commercial | 149,848 | 2,153 | 5.72% | 154,641 | 1,845 | 4.76% |
| Consumer | 23,786 | 331 | 5.52% | 26,693 | 344 | 5.11% |
| Mortgage | 29,539 | 328 | 4.41% | 21,844 | 282 | 5.12% |
| Total loans | 203,173 | 2,812 | 5.51% | 203,178 | 2,471 | 4.84% |
| TOTAL EARNING ASSETS | \$ 258,494 | \$ 3,093 | 4.77% | \$ 270,264 | \$ 2,865 | 4.88% |
| Cash and cash equivalents | 29,704 | | | 22,901 | | |
| Investment security fair value adjustment | 312 | | | 419 | | |
| Bank premises and equipment | 10,338 | | | 10,290 | | |
| Bank owned life insurance | 6,021 | | | 5,883 | | |
| Other real estate | 2,848 | | | 2,420 | | |
| Allowance for loan loss | (7,422) | | | (9,011) | | |
| Other non-earning assets | 2,114 | | | 3,022 | | |
| TOTAL ASSETS | \$ 302,409 | | | \$ 306,188 | | |
| LIABILITIES & STOCKHOLDERS EQUITY: | | | | | | |
| Deposits: | | | | | | |
| Interest Bearing DDA | \$ 2,803 | \$ 1 | 0.14% | \$ 2,428 | \$ 1 | 0.16% |
| Money market savings | 49,427 | 14 | 0.11% | 45,201 | 13 | 0.11% |
| Savings | 73,562 | 17 | 0.09% | 70,206 | 17 | 0.10% |
| Retail time deposits | 62,614 | 227 | 1.44% | 67,218 | 251 | 1.48% |
| Brokered time deposits | 8,055 | 78 | 3.84% | 21,084 | 178 | 3.35% |
| Total interest bearing deposits | 196,461 | 337 | 0.68% | 206,137 | 460 | 0.89% |
| Borrowings | | | | | | |
| Advances from FHLB of Indianapolis | 891 | 17 | 7.57% | 923 | 17 | 7.31% |
| Trust preferred securities | 14,000 | 37 | 1.05% | 14,000 | 96 | 2.72% |
| Other borrowings | 0 | 0 | 0.00% | 382 | 0 | 0.00% |
| Total Borrowings | 14,891 | 54 | 1.44% | 15,305 | 113 | 2.93% |
| INTEREST BEARING LIABILITIES | \$ 211,352 | 391 | 0.73% | \$ 221,442 | 573 | 1.25% |
| Non-interest bearing deposits | 72,747 | | | 64,927 | | |
| Other non-rate bearing liabilities | 3,382 | | | 3,190 | | |
| Stockholders equity | 14,928 | | | 16,629 | | |

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| | | | | |
|-------------------------------------------|------------|-------|------------|-------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 302,409 | | \$ 306,188 | |
| Net Interest Rate Spread | \$ 2,702 | 4.04% | \$ 2,292 | 3.64% |
| Net Interest Income /Margin | | 4.17% | | 3.86% |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

Table of Contents**Allowance and Provision For Loan Losses**

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is appropriate to provide for probable incurred losses in the loan portfolio. While the Corporation's loan portfolio has no significant concentrations in any one industry or any exposure in foreign loans, the loan portfolio has a concentration connected with commercial real estate loans. Specific strategies have been implemented to reduce the concentration levels and limit exposure to this type of lending in the future. The Michigan economy, employment levels and other economic conditions in the Corporation's local markets may have a significant impact on the level of credit losses. Management continues to identify and devote attention to credits that are not performing as agreed. Of course, deterioration of economic conditions could have an impact on the Corporation's credit quality, which could impact the need for greater provision for loan losses and the level of the allowance for loan losses as a percentage of gross loans. Non-performing loans are discussed further in the section titled "Non-Performing Assets."

The allowance for loan losses reflects management's judgment as to the level considered appropriate to absorb probable losses in the loan portfolio. The Corporation's methodology in determining the appropriateness of the allowance is based on ongoing quarterly assessments and relies on several key elements, which include specific allowances for identified problem loans and a formula-based risk-allocated allowance for the remainder of the portfolio. This includes a review of individual loans, size, and composition of the loan portfolio, historical loss experience, current economic conditions, financial condition of borrowers, the level and composition of non-performing loans, portfolio trends, estimated net charge-offs and other pertinent factors. While management considers the allowance for loan losses to be appropriate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, delinquencies, or loss rates. Although portions of the allowance have been allocated to various portfolio segments, the allowance is general in nature and is available for the portfolio in its entirety.

Various rolling periods of historical charge off experience are considered when calculating the current required level of the allowance for loan losses. This includes 4, 8, 12 and 16 quarter un-weighted periods as well as a 12 quarter rolling average with higher weight being placed on the more recent quarters. These analyses are reviewed and a range of values for the reserve is established. The amount of the allowance for loan losses specifically allocated to impaired loans decreased by \$594,000 during the quarter primarily as a result of upgrades of loans and new valuations of collateral, charge offs incurred on loans for which specific allocations were previously recorded and offset by declines in certain collateral valuations.

At September 30, 2012, the allowance was \$6,267,000, or 3.19% of total loans compared to \$8,164,000 or 3.97%, at December 31, 2011, a decrease of \$1,897,000 during the first nine months of 2012. Non-performing loan levels, discussed below, decreased during the period while net charge-offs decreased to \$1,989,000 during the first nine months of 2012 compared to \$4,647,000 during the first nine months of 2011. A majority of the charge-offs relate to loans for which specific allocations were recorded at December 31, 2011.

Table 4 below summarizes loan losses and recoveries for the first nine months of 2012 and 2011. During the first nine months of 2012, the Corporation experienced net charge-offs of \$1,989,000 or 1.01% of gross loans compared with net charge-offs of \$4,647,000 or 2.26% of gross loans in the first nine months of 2011. The provision for loan loss was \$92,000 in the first nine months of 2012 and \$2,542,000 for the same time period in 2011. The large decline in the required reserve and resulting provision for loan loss can primarily be traced to two factors arising during the quarter. The first would be influenced by the satisfactory resolution of an individual impaired credit during the quarter. The Corporation received all of its principal (including \$500,000 that had previously been charged-off) as well as a portion of the lost interest. This individual transaction (along with a small number of other meaningful recoveries) helped to create a net recovery quarter. These recoveries bolstered the amount held in the loan loss reserve as well as decreasing the historical loss rate for those types of loans. The second factor allowing for a decrease in the loan loss reserve would be a shifting mix of loans, primarily in the commercial real estate portfolio.

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There are six subcategories within the commercial real estate portfolio for which the historical losses are evaluated. The current historical loss rates range from a low of 0% to a high of 21%. During the quarter there was a large unimpaired credit that moved out of the portfolio with the 21% reserve as a result of a payoff, thereby significantly decreasing the required reserve in the commercial real estate portfolio. We are also beginning to see real estate values in our primary markets stabilize, which should provide a more stable basis for our collateral based loan valuations. Likewise, the economy in our primary markets also seems to be stabilizing, albeit at lower levels than historically experienced.

Table 4 Analysis of the Allowance for Loan Losses

| (000s omitted) | Commercial | | Residential | | Installment Loans | Home Equity | Unallocated | Total |
|--------------------------------|------------|----------------|----------------|--------|----------------------|----------------|-------------|-------|
| | Commercial | Real Estate | Real Estate | | | | | |
| Balance January 1, 2012 | | | | | | | | |
| Allowance for loan losses | \$ 892 | \$ 5,993 | \$ 501 | \$ 214 | \$ 475 | \$ 89 | \$ 8,164 | |
| Provision for loan losses | 375 | (1,059) | 351 | (69) | 38 | 456 | 92 | |
| Loans charged off | (777) | (1,547) | (393) | (23) | (249) | 0 | (2,989) | |
| Loan recoveries | 54 | 912 | 2 | 14 | 18 | 0 | 1,000 | |
| Balance September 30, 2012 | \$ 544 | \$ 4,299 | \$ 461 | \$ 136 | \$ 282 | \$ 545 | \$ 6,267 | |
| Net charge offs to gross loans | 1.86% | 0.60% | 1.36% | 0.17% | 1.27% | | 1.01% | |
| | | | | | | | | |
| (000s omitted) | Commercial | | Residential | | Installment Loans | Home Equity | Unallocated | Total |
| | Commercial | Real Estate | Real Estate | | | | | |
| Balance January 1, 2011 | | | | | | | | |
| Allowance for loan losses | \$ 871 | \$ 9,155 | \$ 411 | \$ 233 | \$ 508 | \$ 46 | \$ 11,224 | |
| Provision for loan losses | 117 | 1,769 | 193 | 502 | (69) | 30 | 2,542 | |
| Loans charged off | (203) | (4,517) | (19) | (112) | (118) | 0 | (4,969) | |
| Loan recoveries | 27 | 244 | 3 | 30 | 18 | 0 | 322 | |
| Balance September 30, 2011 | \$ 812 | \$ 6,651 | \$ 588 | \$ 653 | \$ 339 | \$ 76 | \$ 9,119 | |
| Net charge offs to gross loans | 0.33% | 4.13% | 0.07% | 0.68% | 0.69% | | 2.26% | |

Non-Interest Income

Non-interest income decreased during the three months ended September 30, 2012 as compared to the same period in 2011. Overall non-interest income was \$1,328,000 for the three months ended September 30, 2012 compared to \$1,590,000 for the same period in 2011. This represents a decrease of 16.5%. On a year to date basis, non-interest income at September 30, 2012 was \$3,642,000 compared with \$4,102,000 at September 30, 2011; a decrease of 11.2%.

Service charges on deposit accounts are approximately 19.9% of non-interest income for the three months ended September 30, 2012, compared to 20.1% during the same period last year. These fees were \$264,000 in the third quarter of 2012, compared to \$319,000 for the same period of 2011. This represents a decrease of 17.2% from year to year in NSF charges collected. On a year to date basis, service charges on deposit accounts, decreased 15.7% to \$762,000 at September 30, 2012.

Trust, investment and financial planning services income increased \$122,000 or 54.5% in the third quarter of 2012 compared to the same period in the prior year. The increase is attributable to a large increase in annuities due to the liquidation of General Motors pensions. On a year to date basis, trust and wealth management income has increased 15.6% compared to 2011.

Gain on the sale of mortgage loans originated by the Banks and sold into the secondary market increased by \$107,000 or 110.3% to \$204,000 in the third quarter of 2012 compared to \$97,000 for the same period in 2011. This was due to continued low market rates, which resulted in an increase in loans sold into the secondary market. Management believes for the remainder of 2012, mortgage income will be relatively

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flat with the same period in the prior year as the rate environment remains static. On a year to date basis, the gain on the sale of mortgage loans has increased 193.3% when compared to the first nine months of 2011. The Corporation sells the majority of the mortgage loans originated in the secondary market on a servicing released basis.

Other operating income decreased by \$203,000 or 33.8% in the third quarter of 2012 compared to the same time period in 2011. The decreases consist of decreased interchange income from debit cards, a decrease in gain on sale of real estate owned, and decreases in charges related to providing support services to other banks. On a year to date basis, other operating income decreased \$591,000 or 31.0%. The reduction was mainly due to decreases in charges related to providing support services to other banks. This was partially offset by increases in debit card income.

Non-Interest Expense

Total non-interest expense decreased 7.3% to \$3,480,000 in the three months ended September 30, 2012, compared with \$3,753,000 in the same period of 2011. The majority of the decrease related to salaries and benefits. Non-loan related legal fees also declined relative to the third quarter of 2011. These decreases were partially offset by modest increases in furniture and equipment, and loans and collection expenses. For the nine month period ended September 30, 2012, total non-interest expense decreased \$4,000. The decrease was composed mainly of decreases in salaries and benefit and loan collection expenses offset by increases in other operating expenses.

Salary and benefit costs, the Corporation's largest non-interest expense category, were \$1,544,000 in the third quarter of 2012, compared with \$1,789,000, for a decrease of \$245,000 or 13.7%, over the same time period in 2011. For the nine months ended September 30, 2012, salary and benefit costs were \$4,875,000, compared with \$5,084,000 for the same time period in 2011, a decrease of 4.1% or \$209,000. The majority of this decrease was due to accruals for the early retirement of an executive in the prior year period.

Occupancy expenses, at \$277,000, were reduced in the three months ended September 30, 2012 compared to the same period in 2011 with a decrease of \$12,000 or 4.2%. Decreases of occupancy expenses were in property insurance, depreciation, utility costs and reductions in building repairs and maintenance, mostly associated with the sale of a bank facility and consolidation of operations offset by a slight increase in property taxes. For the nine month period ended September 30, 2012, occupancy expenses were \$811,000, compared to \$848,000 for the same time period in 2011. This represents a decrease of 4.4%. For the nine month period ended September 30, 2012, the decrease in occupancy expenses is related to reductions in all areas with the exception of property tax expenses which have increased approximately 24.8% over the same period last year.

During the three months ended September 30, 2012, furniture and equipment expenses were \$267,000 compared to \$237,000 for the same period in 2011, an increase of 12.7%. The increase was due primarily to increases in maintenance contracts related to computer hardware and software. For the nine month period ended September 30, 2012, furniture and equipment expenses were \$794,000 compared to \$806,000 for the same period in 2011. This represents a decrease of 14.9% for the nine month period comparison and is mainly related to decreases in rental expenses, partially offset by increases in maintenance contract costs.

Loan and collection expenses, at \$412,000, were up \$19,000 or 4.8% during the three months ended September 30, 2012 compared to the same time period in 2011. The increase was largely related to aggressive management of problem assets and other real estate, partially offset by reduced writedowns on other real estate owned. For the nine month period ended September 30, 2012, loan and collection expenses totaled \$732,000 compared to \$826,000 for the same period in 2011. This represents a decrease of 11.4%. The decrease during the nine month period was related to decreases in other real estate owned expenses.

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Advertising expenses increased \$5,000 for the three months ended September 30, 2012 compared to the same period in 2011. For the three months ended September 30, 2012, advertising expenses were \$41,000 compared to \$36,000 for the same period in 2011. The Corporation has resumed advertising campaigns with the goal of attracting new customers for lending and deposit products, while also strengthening our presence in local communities through sponsorship of community events. For the nine month period ended September 30, 2012, advertising expenses totaled \$119,000, compared to \$99,000 for the same time in 2011. This is an increase of 20.2%.

Other operating expenses were \$939,000 in the three months ended September 30, 2012 compared to \$1,009,000 in the same time period in 2011, a decrease of \$70,000 or 6.9%. The largest declines were seen in FDIC assessment accruals, non-loan related legal costs, though these decreases were offset partially by costs related to robberies occurring during the quarter. In the nine months ended September 30, 2012, other operating expenses, from continued operations, were \$3,250,000 compared to \$2,922,000 in the same time period in 2011, an increase of \$328,000 or 11.2%. Increases year over year include increases in FDIC assessments, a single cashier's check loss of \$271,000 and costs related to robberies occurring during the third quarter. These increases were partially offset by a decrease in legal expenses year over year.

Financial Condition

Proper management of the volume and composition of the Corporation's earning assets and funding sources is essential for ensuring strong and consistent earnings performance, maintaining adequate liquidity and limiting exposure to risks caused by changing market conditions. The Corporation's securities portfolio is structured to provide a source of liquidity through maturities and to generate an income stream with relatively low levels of credit risk. The Corporation does not engage in securities trading. Loans comprise the largest component of earning assets and are the Corporation's highest yielding assets. Customer deposits are the primary source of funding for earning assets while short-term debt and other sources of funds could be further utilized if market conditions and liquidity needs change.

The Corporation's total assets were \$306,501,000 at September 30, 2012 compared to total assets of \$298,861,000 at December 31, 2011. Loans comprised 64.2% of total assets at September 30, 2012 compared to 68.9% at December 31, 2011. Loans decreased \$9,105,000 during the first nine months of 2012. During the second quarter of 2012, the Bank purchased \$10,500,000 of loans secured by ground leases with national tenants from an outside institution. The purchase is anticipated to enhance interest income in the loan portfolio.

Bank premises and equipment increased \$68,000 to \$10,270,000 at September 30, 2012 compared to \$10,202,000 at December 31, 2011. The increase was the result of the purchase of a new mainframe and of software licenses to support technological initiatives.

Other assets decreased \$728,000 when comparing September 30, 2012 to December 31, 2011. The decrease is mainly attributable to a decrease in repossessed assets, interest receivable and prepaid expenses.

On the liability side of the balance sheet, the ratio of non-interest bearing deposits to total deposits was 25.8% at September 30, 2012 and 23.6% at December 31, 2011. Interest bearing deposit liabilities totaled \$202,086,000 at September 30, 2012 compared to \$203,168,000 at December 31, 2011. Total deposits increased \$6,498,000 with non-interest bearing demand deposits increasing \$7,580,000 and interest bearing deposits decreasing \$1,082,000. FHLB advances decreased \$32,000 when comparing the two periods. Other liabilities decreased \$22,000 from December 31, 2011 to September 30, 2012.

Non-Performing Assets

Non-performing assets include loans on which interest accruals have ceased, loans past due 90 days or more and still accruing, loans that have been renegotiated, and real estate acquired through foreclosure or deed-in-lieu of foreclosure. Table 5 reflects the levels of these assets at September 30, 2012 and December 31, 2011.

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Total non-performing assets decreased \$5,571,000 at September 30, 2012 as compared to December 31, 2011. Total non-performing loans decreased by \$10,564,000 at September 30, 2012 as compared to December 31, 2011. Loans past due over 90 days and still accruing interest decreased \$488,000 during the first nine months of 2012. Non-accrual loans decreased \$10,076,000 when comparing September 30, 2012 to December 31, 2011. Included in non-accrual loans are \$4,097,000 and \$8,128,000 of modified loans which have not been returned to accrual status at September 30, 2012 and December 31, 2011, respectively.

Modified loans presented in Table 5 are comprised of loans which have performed since modification and have been returned to accrual status. Modified loans increased \$3,789,000 to \$10,666,000 at September 30, 2011 compared to \$6,877,000 at December 31, 2011. Modified loans are loans for which concessions have been granted to the borrower based on their individual financial situation. These concessions may include modifications to the interest rate, term of the loan or forgiveness of principal or interest.

Other non-performing assets increased \$1,204,000 in the third quarter of 2012. Other Real Estate owned totaled \$2,704,000 at September 30, 2012 compared to \$1,949,000 at December 31, 2011. Other Real Estate in Redemption increased to \$672,000 from \$223,000 at December 31, 2011. The Other Real Estate Owned in Redemption balance is comprised of two commercial and one residential property.

The level and composition of non-performing assets is affected by economic conditions in the Corporation's local markets. Non-performing assets, charge-offs, and provisions for loan losses tend to decline in a strong economy and increase in a weak economy, potentially impacting the Corporation's operating results. In addition to non-performing loans, management carefully monitors other credits that are current in terms of principal and interest payments but, in management's opinion, may deteriorate in quality if economic conditions change.

Table 5 - Non-Performing Assets and Past Due Loans

| (000s omitted) | September 30, 2012 | December 31, 2011 |
|-------------------------------------------------------------------|-----------------------|----------------------|
| Non-Performing Loans: | | |
| Loans past due 90 days or more & still accruing | \$ 0 | \$ 488 |
| Non-accrual loans | 7,021 | 17,097 |
| Total non-performing loans | 7,021 | 17,585 |
| Modified loans | 10,666 | 6,877 |
| Total modified loans | 10,666 | 6,877 |
| Other non-performing assets: | | |
| Other real estate | 2,704 | 1,949 |
| Other real estate owned in redemption | 672 | 223 |
| Total other non-performing assets | 3,376 | 2,172 |
| Total Non-Performing assets | \$ 21,063 | \$ 26,634 |
| Non-performing loans as a % of total loans | 3.57% | 8.55% |
| Non-performing assets as a % of total loans and other real estate | 10.57% | 12.82% |
| Allowance for loan losses as a % of non-performing loans | 89.26% | 46.43% |
| Accruing loans past due 90 days or more to total loans | 0.00% | 0.24% |
| Non-performing assets as a % of total assets | 6.87% | 8.91% |

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While total non performing assets decreased from December 31, 2011 to September 30, 2012, the ratio of non-performing loans to the allowance for loan losses increased. This is largely due to the improvement in credit quality resulting in a lower required allowance for loan losses and a lag in the time between the higher charge-off historical quarters being replaced with current experience more indicative of the current asset quality in the portfolio. The significant decline in non-performing loans was also a large contributor to the increase in this ratio. The Corporation expects that this ratio will gradually fall back to a level typically seen in past quarters.

Certain portions of the Corporation's non-performing loans included in Table 5 are considered impaired. The Corporation measures impairment on all large balance non-accrual commercial loans. Certain large balance accruing loans rated watch or monitor are also analyzed for possible impairment. Impairment losses are believed to be appropriately covered by the allowance for loan losses.

The Corporation maintains policies and procedures to identify and monitor non-accrual loans. A loan is placed on non-accrual when there is doubt regarding collection of principal or interest, or when principal or interest is past due 90 days or more. Interest accrued but not collected is reversed against income for the current quarter when a loan is placed on non-accrual status. At September 30, 2012, there were no loans past due 90 days or more and still accruing. Management is not aware of any loans that have not been moved to non-accrual or not been reclassified to troubled debt restructures at September 30, 2012. The potential, however, remains that a borrower may become financially distressed in the future and management may place that loan into non-accrual, but this is difficult to predict.

Liquidity and Interest Rate Risk Management

Asset/Liability management is designed to assure liquidity and reduce interest rate risks. The goal in managing interest rate risk is to maintain a strong and relatively stable net interest margin. It is the responsibility of the Asset/Liability Management Committee (ALCO) to set policy guidelines and to establish short-term and long-term strategies with respect to interest rate exposure and balance sheet liquidity. The ALCO, which is comprised of key members of management, meets regularly to review financial performance and soundness, including interest rate risk and liquidity in relation to present and prospective markets and business conditions. Accordingly, the committee adopts funding and balance sheet management strategies that are intended to maximize earnings, maintain liquidity, and achieve balance sheet composition objectives.

Liquidity maintenance together with a solid capital base and strong earnings performance are key objectives of the Corporation. The Corporation's liquidity is derived from a strong deposit base comprised of individual and business deposits. Deposit accounts of customers in the mature market represent a substantial portion of deposits of individuals. The Bank's deposit base plus other funding sources (federal funds purchased, short-term borrowings, FHLB advances, other liabilities and stockholders' equity) provided primarily all funding needs in the first nine months of 2012. While these sources of funds are expected to continue to be available to provide funds in the future, the mix and availability of funds will depend upon future economic conditions. The Corporation does not foresee any difficulty in meeting its funding requirements.

A source of liquidity that is no longer available to the Bank is brokered deposits. Brokered deposits totaled approximately \$2,990,000 at September 30, 2012 and \$11,015,000 at December 31, 2011. As The State Bank is considered adequately capitalized due to being under a consent order at September 30, 2012, it is precluded, under prompt corrective action guidelines, from issuing or renewing brokered deposits. The final brokered deposit matures on October 31, 2012 and is will be repaid using liquidity currently on the balance sheet.

Primary liquidity is provided through short-term investments or borrowings (including federal funds sold and purchased) while the securities portfolio provides secondary liquidity. The securities portfolio has decreased \$10,499,000 since December 31, 2011 due to proceeds from sales of securities available for sale, principal paydowns in the available for sale investment portfolio along with the maturity of held to maturity investments. During the first quarter of 2012, the Corporation sold one private label security at a

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gross loss of \$178,000. Simultaneously four additional securities were sold at a total gain of \$191,000. During the third quarter of 2012, 5 agency CMO s were sold out of the available for sale portfolio at a gain of \$116,000. The Corporation has re-invested some of the funds as well as funds from the call and maturities of these securities back into the securities portfolio to increase yield and manage the asset ratios on the balance sheet. The Corporation regularly monitors liquidity to ensure adequate cash flows to cover unanticipated reductions in the availability of funding sources.

In April 2009, the Corporation, in order to maintain liquidity at the holding company, provided notice to each of The Bank of New York and Wilmington Trust Company, the trustees of the Corporation s junior subordinated debt securities due 2033 (Fentura Trust I), and junior subordinated debt securities due 2035 (Fentura Trust II), respectively, that the Corporation was exercising its right to defer interest payments for each of the interest payment dates of June 15, 2009, as to the Fentura Trust I, and May 23, 2009, as to the Fentura Trust II to June 15, 2014 and May 23, 2014, respectively, unless the Corporation subsequently gives notice that it has elected to shorten such deferral period. The Corporation has the ability under each of the trust indentures to defer interest payments for up to twenty consecutive quarterly periods (five years), so long as the Corporation is not in default, as defined in the respective indentures. The Corporation is not in default under either of the indentures. Interest on the debt securities continues to accrue during the deferral period and interest on the deferred interest also accrues, both of which must be paid at the end of the deferral period. The total estimated interest that will be payable on the debt securities, at the expiration of the allowed deferral period, is approximately \$2,348,000, based on current interest rates. Management believes the Corporation s liquidity position remains stable as the operating expenses of the Corporation are stable.

Interest rate risk is managed by controlling and limiting the level of earnings volatility arising from rate movements. The Corporation regularly performs reviews and analysis of those factors impacting interest rate risk. Factors include maturity and re-pricing frequency of balance sheet components, impact of rate changes on interest margin and prepayment speeds, market value impacts of rate changes, and other issues. Both actual and projected performance are reviewed, analyzed, and compared to policy and objectives to assure present and future financial viability.

The Corporation had cash provided by financing activities resulting primarily from the increase of deposits, which increased \$10,210,000 from December 31, 2011. Cash provided by investing activities was \$17,145,000 in first nine months of 2012 compared to \$82,177,000 in first nine months of 2011. The change in investing activities was due primarily to the sale of a subsidiary bank during 2011, offset somewhat by reduced net purchases of securities. Additionally, increased loan paydowns were offset by the purchase of \$10,531,000 in loans from an outside institution during the third quarter of 2012.

Capital Resources

Management closely monitors bank capital levels to provide for current and future business needs and to comply with regulatory requirements. Regulations prescribed under the Federal Deposit Insurance Corporation Improvement Act of 1991 have defined well capitalized institutions as those having total risk-based ratios, tier 1 risk-based capital ratios and tier 1 leverage ratios of at least 10%, 6%, and 5%, respectively. At September 30, 2012 the subsidiary Bank maintained adequately capitalized leverage requirements as defined by federal law; however the Bank was not in compliance with the capital requirements prescribed by the Consent Order.

Total stockholders equity increased 8.15% to \$15,855,000 at September 30, 2012 compared with \$14,660,000 at December 31, 2011. The increase was due to the net income in the first nine months of 2012, as well as increases in other comprehensive income as noted below. The Corporation s equity to asset ratio was 5.17% at September 30, 2012 and 4.90% at December 31, 2011.

As indicated on the balance sheet at December 31, 2011, the Corporation had accumulated other comprehensive income of \$23,000 compared to accumulated other comprehensive income at September 30, 2012 of \$288,000. The fluctuation in the position is attributable to a combination of the fluctuation of the market price of securities held in the available for sale portfolio along with the sale of the private label CMO during the first quarter.

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The information on the Corporation's capital resources is contained on pages 45 through 48 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011 is incorporated herein by reference.

Regulatory Orders

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators that contain provisions to foster improvement in The State Bank's earnings, lower nonperforming loan levels, increase capital, and require revisions to various policies. The Consent Order requires The State Bank to maintain a Tier 1 capital to average asset ratio of a minimum of 8.0%. It also requires The State Bank to maintain a total capital to risk weighted asset ratio of 12.0%. At September 30, 2012, The State Bank had a Tier 1 capital to average assets ratio of 8.5% and a total capital to risk-weighted assets ratio of 13.2%.

The Consent Order restricts the Bank from issuing or renewing brokered deposits. The Consent Order also restricts dividend payments from The State Bank to the Corporation. The Corporation, the Board of Directors and management continue to execute initiatives to comply with the Consent Order. At March 31, 2012 actions included the injection of \$250,000 capital into The State Bank resulting from the sale of non-performing assets from the subsidiary of the Corporation. While below the compliance level required by the Orders, the Bank maintains capital levels that would be considered well capitalized by regular prompt corrective action regulatory standards. Non-compliance with Consent Order requirements would cause the Bank to be subject to further enforcement actions by the FDIC.

Effective in November 2010, the Corporation received a notice from The Federal Reserve which defined restrictions being placed upon the Corporation. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an expectation that the Corporation maintain sufficient capital levels. The board of directors and management continue to execute and monitor initiatives to comply with Federal Reserve restrictions.

Critical Accounting Policies and Estimates

The Management's Discussion and Analysis of financial condition and results of operations are based on the Corporation's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, ORE, securities valuation and income taxes. Actual results could differ from those estimates.

The allowance for loan losses is maintained at a level we believe is appropriate to absorb probable losses identified and inherent in the loan portfolio. Our evaluation of the appropriateness of the allowance for loan losses is an estimate based on reviews of individual loans, assessments of the impact of current and anticipated economic conditions on the portfolio, and historical loss experience. The allowance for loan losses represents management's best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance for loan losses in the near future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance for loan losses. In either instance unanticipated changes could have a significant impact on operating results.

The allowance for loan losses is increased through a provision charged to operating expense. Uncollectible loans are charged-off through the allowance for loan losses. Recoveries of loans previously

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charged-off are added to the allowance for loan losses. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement.

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. The Corporation's evaluation of taxable events, losses in recent years and the continuing deterioration of the Michigan economy led management to conclude that it was more likely than not that all or part of the benefit would not be realized. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the deferred income tax assets are realized or the valuation allowance is otherwise no longer required. Management will continue to monitor our deferred tax assets quarterly for changes affecting their realizability.

Other Real Estate Owned and Foreclosed Assets are acquired through or instead of loan foreclosure. They are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

The Corporation evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In determining other-than-temporary impairment (OTTI) management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

Off Balance Sheet Arrangements

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at:

| (000s omitted) | September 30, 2012 | December 31, 2011 |
|----------------------------------------------|--------------------|-------------------|
| Commitments to make loans (at market rates) | \$ 22,132 | \$ 5,725 |
| Unused lines of credit and letters of credit | 30,668 | 28,420 |

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosures about market risk contained on page 70 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, is incorporated herein by reference.

Fentura Financial, Inc. faces market risk to the extent that both earnings and the fair value of its financial instruments are affected by changes in interest rates. The Corporation manages this risk with static GAP analysis and has begun simulation modeling. For the first nine months of 2012, the results of these measurement techniques were within the Corporation's policy guidelines. The Corporation does not believe that there has been a material change in the nature of the Corporation's primary market risk.

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exposures, including the categories of market risk to which the Corporation is exposed and the particular markets that present the primary risk of loss to the Corporation, or in how those exposures have been managed in 2012 compared to 2011.

The Corporation's market risk exposure is mainly comprised of its vulnerability to interest rate risk. Prevailing interest rates and interest rate relationships in the future will be primarily determined by market factors, which are outside of the Corporation's control. All information provided in this section consists of forward-looking statements. Reference is made to the section captioned "Forward Looking Statements" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011 for a discussion of the limitations on the Corporation's responsibility for such statements.

Interest Rate Sensitivity Management

Interest rate sensitivity management seeks to maximize net interest income as a result of changing interest rates, within prudent ranges of risk. The Corporation attempts to accomplish this objective by structuring the balance sheet so that re-pricing opportunities exist for both assets and liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these re-pricing opportunities at any point in time constitute a bank's interest rate sensitivity. The Corporation currently does not utilize derivatives in managing interest rate risk.

An indicator of the interest rate sensitivity structure of a financial institution's balance sheet is the difference between rate sensitive assets and rate sensitive liabilities, and is referred to as "GAP". Table 6 sets forth the distribution of re-pricing of the Corporation's earning assets and interest bearing liabilities as of September 30, 2012, the interest rate sensitivity GAP, as defined above, the cumulative interest rate sensitivity GAP, the interest rate sensitivity GAP ratio (i.e. interest rate sensitive assets divided by interest rate sensitive liabilities) and the cumulative sensitivity GAP ratio. The table also sets forth the time periods in which earning assets and liabilities will mature or may re-price in accordance with their contractual terms.

Table 6

| (000s omitted) | GAP Analysis September 30, 2012 | | | | Total |
|-------------------------------------------------------|------------------------------------|--------------------------------|-------------------------|------------------------|-------------------|
| | Within Three Months | Three Months to One Year | One to Five Years | After Five Years | |
| Earning Assets: | | | | | |
| Securities | \$ 6,138 | \$ 11,766 | \$ 18,552 | \$ 14,695 | \$ 51,151 |
| Loans | 29,763 | 34,078 | 90,614 | 42,213 | 196,668 |
| Loans held for sale | 935 | 0 | 0 | 0 | 935 |
| FHLB stock | 661 | 0 | 0 | 0 | 661 |
| Total earning assets | \$ 37,497 | \$ 45,844 | \$ 109,166 | \$ 56,908 | \$ 249,415 |
| Interest bearing liabilities: | | | | | |
| Interest bearing demand deposits | \$ 55,500 | \$ 0 | \$ 0 | \$ 0 | \$ 55,500 |
| Savings deposits | 75,945 | 0 | 0 | 0 | 75,945 |
| Time deposits less than \$100,000 | 9,298 | 16,121 | 20,270 | 67 | 45,756 |
| Time deposits greater than \$100,000 | 5,241 | 8,215 | 11,432 | 0 | 24,888 |
| FHLB Advances | 0 | 35 | 856 | 0 | 891 |
| Subordinated debentures | 14,000 | 0 | 0 | 0 | 14,000 |
| Total interest bearing liabilities | \$ 159,984 | \$ 24,371 | \$ 32,558 | \$ 67 | \$ 216,980 |
| Interest rate sensitivity GAP | (\$ 122,487) | \$ 21,473 | \$ 76,608 | \$ 56,841 | \$ 32,435 |
| Cumulative interest rate sensitivity GAP | (\$ 122,487) | (\$ 101,014) | \$ 24,406 | \$ 32,435 | |
| Interest rate sensitivity GAP ratio | 0.23 | 0.00 | 3.35 | 849.37 | |
| Cumulative interest rate sensitivity GAP ratio | 0.23 | 0.00 | 0.89 | 1.15 | |

As indicated in Table 6, the short-term (one year and less) cumulative interest rate sensitivity gap is negative. Accordingly, if market interest rates increase, this negative gap position could have a short-term

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negative impact on interest margin. Conversely, if market rates decline this should theoretically have a short-term positive impact. However, gap analysis is limited and may not provide an accurate indication of the impact of general interest rate movements on the net interest margin since the re-pricing of various categories of assets and liabilities is subject to the Corporation's needs, competitive pressures, and the needs of the Corporation's customers. In addition, various assets and liabilities indicated as re-pricing within the same period may in fact re-price at different times within such period and at different rate indices. The Prime Rate has remained steady over the past twelve months. This steadiness allowed management to close the gap related to interest rate sensitivity. Management was able to reduce liquid interest bearing liability rates to extremely low rates, while maintaining relatively similar volumes. The Banks were also able to re-price maturing time deposits, usually in a downward fashion as longer term certificates at higher rates matured during the year. On the asset side of the balance sheet, rates on the investment portfolios remained relatively steady and the yields on loans decreased slightly. Management worked to re-price loans favorably as they renewed and were priced accordingly for risk, however overall loan yields decreased. The Corporation expects to continue to make strides in managing interest rate sensitivity, and to move to a more balanced interest rate position.

Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us or our management, are intended to identify forward-looking statements. The presentation and discussion of the provision and allowance for loan losses and statements concerning future profitability or future growth or increases, are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our other filings with the Securities and Exchange Commission.

ITEM 4: CONTROLS AND PROCEDURES

- (a) **Evaluation of Disclosure Controls and Procedures.** The Corporation's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Corporation's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Corporation's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Corporation would be made known to them by others within the Corporation, particularly during the period in which this Form 10-Q was being prepared.
- (b) **Changes in Internal Controls.** During the period covered by this report, there have been no changes in the Corporation's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings. - None

Item 1A. Risk Factors This item is not applicable to smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. None

Item 3. Defaults Upon Senior Securities. - None

Item 4. Mine Safety Disclosures - None

Item 5. Other Information. None

Item 6. Exhibits.

(a) Exhibits

- 10.1 Amended and restated supplemental executive retirement plan with Daniel J. Wollschlager (Incorporated by reference from Form 8-K filed on May 2, 2010)
- 31.1 Certificate of the President and Chief Executive Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Chief Executive Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

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

Fentura Financial, Inc.

Dated: November 13, 2012

/s/ Ronald L. Justice
Ronald L. Justice
President and CEO

Dated: November 13, 2012

/s/ James W. Distelrath
James W. Distelrath
Chief Financial Officer and Principal Accounting Officer

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EXHIBIT INDEX

| Exhibit | Description |
|---------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1 | Amended and restated supplemental executive retirement plan with Daniel J. Wollschlager (Incorporated by reference from Form 8-K filed on May 2, 2010) |
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