MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

OR

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number: 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MICHIGAN	**38-2062816**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
130 SOUTH CEDAR STREET, MANISTIQUE, MI	**49854**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (888) 343-8147

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

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

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

Large Accelerated Filer ¨	Accelerated Filer ¨
Non-accelerated Filer ¨	Smaller reporting company x

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

As of October 31, 2011, there were outstanding 3,419,736 shares of the registrant s common stock, no par value.

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MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	September 30, 2011 (Unaudited)	December 31, 2010	September 30, 2010 (Unaudited)
ASSETS			
Cash and due from banks	**$ 30,122**	$ 22,719	$ 36,561
Federal funds sold	**12,000**	12,000	12,000
Cash and cash equivalents	**42,122**	34,719	48,561
Interest-bearing deposits in other financial institutions	**10**	713	692
Securities available for sale	**37,022**	33,860	37,450
Federal Home Loan Bank stock	**3,060**	3,423	3,794
Loans:			
Commercial	**299,135**	297,047	295,262
Mortgage	**86,500**	80,756	82,312
Consumer	**6,268**	5,283	5,153
Total Loans	**391,903**	383,086	382,727
Allowance for loan losses	**(5,838)**	(6,613)	(5,437)
Net loans	**386,065**	376,473	377,290
Premises and equipment	**9,507**	9,660	9,843
Other real estate held for sale	**5,212**	5,562	5,758
Other assets	**15,600**	14,286	15,618
TOTAL ASSETS	**$ 498,598**	$ 478,696	$ 499,006
LIABILITIES AND SHAREHOLDERS EQUITY			
LIABILITIES:			
Deposits:			
Noninterest bearing deposits	**$ 53,736**	$ 41,264	$ 44,402
NOW, money market, checking	**157,596**	134,703	127,828
Savings	**15,618**	17,670	20,265
CDs<$100,000	**119,893**	96,977	94,560
CDs>$100,000	**24,138**	22,698	22,809
Brokered	**34,077**	73,467	94,660

Total deposits	**405,058**	386,779	404,524
Borrowings:			
Federal Home Loan Bank	**35,000**	35,000	35,000
Other	**997**	1,069	1,069
Total borrowings	**35,997**	36,069	36,069
Other liabilities	**2,064**	1,966	2,426
Total liabilities	**443,119**	424,814	443,019
SHAREHOLDERS EQUITY:			
Preferred stock - No par value:			
Authorized 500,000 shares, 11,000 shares issued and outstanding	**10,866**	10,706	10,658
Common stock and additional paid in capital - No par value			
Authorized - 18,000,000 shares			
Issued and outstanding - **3,419,736 shares**	**43,525**	43,525	43,517
Retained earnings (accumulated deficit)	**607**	(961)	1,131
Accumulated other comprehensive income	**481**	612	681
Total shareholders equity	**55,479**	53,882	55,987
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 498,598**	$ 478,696	$ 499,006

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	**2011**	2010
	(Unaudited)		**(Unaudited)**	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	**$ 5,584**	$ 5,300	**$ 15,918**	$ 15,718
Tax-exempt	**35**	46	**114**	145
Interest on securities:				
Taxable	**304**	324	**878**	1,077
Tax-exempt	**7**	7	**21**	21
Other interest income	**26**	23	**89**	100
Total interest income	**5,956**	5,700	**17,020**	17,061
INTEREST EXPENSE:				
Deposits	**1,091**	1,414	**3,540**	4,309
Borrowings	**156**	222	**452**	643
Total interest expense	**1,247**	1,636	**3,992**	4,952
Net interest income	**4,709**	4,064	**13,028**	12,109
Provision for loan losses	**400**	1,000	**1,000**	4,700
Net interest income after provision for loan losses	**4,309**	3,064	**12,028**	7,409
OTHER INCOME:				
Service fees	**180**	264	**616**	737
Net security gains (losses)		(1)		215
Income from loans sold	**478**	334	**1,863**	958
Mortgage servicing rights	**300**		**300**	
Other	**48**	51	**152**	138
Total other income	**1,006**	648	**2,931**	2,048
OTHER EXPENSES:				
Salaries and employee benefits	**1,811**	1,779	**5,441**	5,281
Occupancy	**334**	358	**1,048**	1,048
Furniture and equipment	**197**	202	**612**	593
Data processing	**177**	193	**532**	587
Professional service fees	**165**	168	**550**	502

Loan and deposit	**288**	212	**719**	665
ORE Writedowns and losses on sale	**296**	7	**728**	2,000
FDIC Insurance Assessment	**215**	222	**755**	665
Telephone	**51**	53	**160**	145
Advertising	**93**	77	**292**	220
Other	**333**	330	**912**	854
Total other expenses	**3,960**	3,601	**11,749**	12,560
Income (Loss) before provision for income taxes	**1,355**	111	**3,210**	(3,103)
Provision for (benefit of) income taxes	**455**	30	**1,071**	(4,593)
NET INCOME	**900**	81	**2,139**	1,490
Preferred dividend expense	**193**	185	**573**	556
NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	**$ 707**	$ (104)	**$ 1,566**	$ 934
INCOME (LOSS) PER COMMON SHARE:				
Basic	**$ .21**	$ (.03)	**$ .46**	$ .27
Diluted	**$ .20**	$ (.03)	**$ .45**	$ .27

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(Dollars in Thousands)

(Unaudited)

	Three Months Ended September 30, 2011			2010		
	Preferred Stock	**Common Shareholders Equity**	**Total Shareholders Equity**	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity
Balance, beginning of period	**$ 10,811**	**$ 43,973**	**$ 54,784**	$ 10,610	$ 45,621	$ 56,231
Net income for period		**900**	**900**		81	81
Net unrealized gain (loss) on securities available for sale		**(68)**	**(68)**		(195)	(195)
Total comprehensive income (loss)		**832**	**832**		(114)	(114)
Dividend on preferred stock		**(138)**	**(138)**		(137)	(137)
Stock option compensation					7	7
Accretion of preferred stock discount	**55**	**(55)**		48	(48)	
Rounding		**1**	**1**			
Balance, end of period	**$ 10,866**	**$ 44,613**	**$ 55,479**	$ 10,658	$ 45,329	$ 55,987

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Nine Months Ended September 30, 2011			2010		
	Preferred Stock	**Common Shareholders Equity**	**Total Shareholders Equity**	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity
Balance, beginning of period	**$ 10,706**	**$ 43,176**	**$ 53,882**	$ 10,514	$ 44,785	$ 55,299
Net income for period		**2,139**	**2,139**		1,490	1,490
Net unrealized gain (loss) on securities available for sale		**(130)**	**(130)**		(412)	(412)
Total comprehensive income		**2,009**	**2,009**		1,078	1,078
Dividend on preferred stock		**(413)**	**(413)**		(412)	(412)
Stock option compensation					22	22
Accretion of preferred stock discount	**160**	**(160)**		144	(144)	
Rounding		**1**	**1**			
Balance, end of period	**$ 10,866**	**$ 44,613**	**$ 55,479**	$ 10,658	$ 45,329	$ 55,987

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30, 2011	2010
Cash Flows From Operating Activities:		
Net income	**$ 2,139**	$ 1,490
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	**1,094**	1,238
Provision for (benefit of) deferred taxes	**1,071**	(4,593)
Provision for loan losses	**1,000**	4,700
(Gain) on sales/calls of securities available for sale		(215)
(Gain) on sale of secondary market loans held for sale	**(260)**	(250)
Origination of secondary market loans held for sale	**(21,619)**	(20,571)
Proceeds from secondary market loans held for sale	**22,013**	20,882
Loss on sales of other real estate	**178**	52
Writedown of other real estate	**550**	1,948
Stock option compensation		22
Change in other assets	**(2,315)**	12,948
Change in other liabilities	**98**	(123)
Net cash provided by operating activities	**3,949**	17,528
Cash Flows From Investing Activities:		
Net (increase) in loans	**(14,855)**	(7,571)
Net (increase) decrease in interest-bearing deposits in other financial institutions	**703**	(14)
Purchase of securities available for sale	**(15,206)**	(5,000)
Proceeds from sales, maturities or calls of securities available for sale	**11,567**	13,372
Capital expenditures	**(663)**	(502)
Redemption of FHLB stock	**363**	
Proceeds from sale of premises, equipment, and other real estate	**3,751**	2,663
Net cash provided by (used in) investing activities	**(14,340)**	2,948
Cash Flows From Financing Activities:		
Net increase (decrease) in deposits	**18,279**	(16,865)
Dividend on preferred stock	**(413)**	(412)
Principal payments on borrowings	**(72)**	(71)
Net cash provided by (used in) financing activities	**17,794**	(17,348)

Net increase in cash and cash equivalents	**7,403**	3,128
Cash and cash equivalents at beginning of period	**34,719**	45,433
Cash and cash equivalents at end of period	**$ 42,122**	$ 48,561
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Interest	**$ 3,525**	$ 4,988
Income taxes	**75**	25
Noncash Investing and Financing Activities:		
Transfers of foreclosures from loans to other real estate held for sale (net of adjustments made through the allowance for loan losses)	**4,129**	4,604

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the Corporation) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2010.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The net other income and other expenses was not changed due to these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period, and actual results could differ. The allowance for loan losses, foreclosed properties, mortgage servicing rights, income tax expense and fair values of financial instruments are particularly subject to change.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to commercial loans which have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan s initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The Corporation also has a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for probable loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation s past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management s opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Stock Option Plans

The Corporation sponsors three stock option plans. One plan was approved during 2000 and applies to officers, employees, and nonemployee directors. This plan was amended as a part of the December 2004 stock offering and recapitalization. The amendment, approved by shareholders, increased the shares available under this plan by 428,587 shares from the original 25,000 (adjusted for the 1:20 reverse stock split), to a total authorized share balance of 453,587. The other two plans, one for officers and employees and the other for nonemployee directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 reverse stock split), were made available for grant under these plans. All three option plans have expired, and therefore no new shares may be granted. Options to purchase shares of the Corporation s stock were granted at a price equal to the market price of the stock at the date of grant. The committee determined the vesting of the options when they were granted as established under the plan.

2. **RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2011, the FASB issued ASU No. 2011-03, Transfers and Servicing (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements.* The ASU is intended to improve financial reporting of repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments to the Codification in this ASU are intended to improve the accounting for these transactions by removing them from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets. The guidance in the ASU is effective for the first interim or annual period beginning on or after December 15, 2011. The provisions of this guidance are not expected to have a significant impact on the Corporation s consolidated financial condition, results of operation or liquidity.

The FASB has issued ASU 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* This ASU represents the converged guidance of the FASB and the IASB (the Boards) on fair value measurement. The collective efforts of the Boards and their staffs, reflected in ASU 2011-04, have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term fair value. The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and IFRSs. The amendments to the Codification in this ASU are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The impact of adoption of this ASU is not expected to be material.

FASB ASU 2011-05, *Presentation of Comprehensive Income.* In June 2011, the FASB issued ASU 2011-05, which provides entities with the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income, along with a total for other comprehensive income, and a total amount for comprehensive income. Regardless of whether an entity chooses to present comprehensive income in a single continuous statement or in two separate but consecutive statements, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. This update should be applied retrospectively effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Corporation currently reports comprehensive income in its detail of changes in Shareholders equity. The additional disclosure of the components required by ASU 2011-05 will be included in our financial statements beginning in the first quarter of 2012 but will not have a financial impact.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. EARNINGS PER SHARE

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our earnings, is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, after giving effect for dilutive shares issued.

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2011 and 2010 (dollars in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	**2011**	2010
(Numerator):				
Net income	**$ 900**	$ 81	**$ 2,139**	$ 1,490
Preferred stock dividends and accretion of discount	**193**	185	**573**	556
Net income (loss) available to common shareholders	**$ 707**	$ (104)	**$ 1,566**	$ 934
(Denominator):				
Weighted average shares outstanding - basic	**3,419,736**	3,419,736	**3,419,736**	3,419,736
Dilutive effect of stock options				
Dilutive effect of common stock warrants	**89,845**		**83,611**	68,734
Weighted average shares outstanding - diluted	**3,509,581**	3,419,736	**3,503,347**	3,488,470
Income (loss) per common share:				
Basic	**$ .21**	$ (.03)	**$ .46**	$ .27
Diluted	**$ .20**	$ (.03)	**$ .45**	$ .27

4. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2011, December 31, 2010 and September 30, 2010 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 30, 2011				
US Agencies	**$ 10,443**	**$ 190**	**$**	**$ 10,633**

US Agencies - MBS	**15,087**	**523**		**15,610**
Corporate	**5,256**		**(99)**	**5,157**
Obligations of states and political subdivisions	**5,507**	**118**	**(3)**	**5,622**
Total securities available for sale	**$ 36,293**	**$ 831**	**$ (102)**	**$ 37,022**
December 31, 2010				
US Agencies	$ 5,000	$	$ (27)	$ 4,973
US Agencies - MBS	26,787	923		27,710
Obligations of states and political subdivisions	1,146	35	(4)	1,177
Total securities available for sale	$ 32,933	$ 958	$ (31)	$ 33,860
September 30, 2010				
US Agencies	$ 5,000	$ 5	$	$ 5,005
US Agencies - MBS	30,272	982		31,254
Obligations of states and political subdivisions	1,147	48	(4)	1,191
Total securities available for sale	$ 36,419	$ 1,035	$ (4)	$ 37,450

When gross unrealized losses exist within the portfolio, we evaluate whether the loss should be considered other-than-temporary. As of each of the dates reported above, the Corporation considers them temporary in nature and related to interest rate fluctuations. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. INVESTMENT SECURITIES (Continued)

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $10.522 million and $10.991 million, respectively, at September 30, 2011, compared to $13.688 million and $14.286 million, respectively, at September 30, 2010.

5. LOANS

The composition of loans at September 30, 2011, December 31, 2010 and September 30, 2010 is as follows (dollars in thousands):

	$195,079 **September 30, 2011**	$195,079 December 31, 2010	$195,079 September 30, 2010
Commercial real estate	**$ 195,079**	$ 194,859	$ 199,892
Commercial, financial, and agricultural	**84,285**	68,858	69,652
One to four family residential real estate	**78,759**	75,074	74,829
Construction:			
Commercial	**19,771**	33,330	25,718
Consumer	**7,741**	5,682	7,483
Consumer	**6,268**	5,283	5,153
Total loans	**$ 391,903**	$ 383,086	$ 382,727

An analysis of the allowance for loan losses for the nine months ended September 30, 2011, the year ended December 31, 2010, and the nine months ended September 30, 2010 is as follows (dollars in thousands):

	$195,079 **September 30, 2011**	$195,079 December 31, 2010	$195,079 September 30, 2010
Balance at beginning of period	**$ 6,613**	$ 5,225	$ 5,225
Recoveries on loans previously charged off	**43**	374	89
Loans charged off	**(1,818)**	(5,486)	(4,577)
Provision for loan losses	**1,000**	6,500	4,700

Balance at end of period	**$**	**5,838**	$	6,613	$	5,437

In the first nine months of 2011, net charge off activity was $1.775 million, or .46% of average loans outstanding compared to net charge offs of $4.488 million, or 1.17% of average loans, in the same period in 2010. In the first nine months of 2011, the Corporation recorded a $1.000 million provision for loan loss compared to $4.700 million in the first nine months of 2010. The Corporation s allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

A breakdown of the allowance for loan losses, the activity for the period, and recorded balances in loans for the nine month period ended September 30, 2011 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Charge-offs	(883)	(562)	(62)	(266)		(45)		(1,818)
Recoveries	21	14				8		43
Provision	861	366	(127)	(13)		37	(124)	1,000
Ending balance ALLR	$ 3,459	$ 836	$ 200	$ 1,343	$	$	$	$ 5,838
Loans:								
Ending balance	$ 195,079	$ 84,285	$ 19,771	$ 78,759	$ 7,741	$ 6,268	$	$ 391,903
Ending balance ALLR	(3,459)	(836)	(200)	(1,343)				(5,838)
Net loans	$ 191,620	$ 83,449	$ 19,571	$ 77,416	$ 7,741	$ 6,268	$	$ 386,065
Ending balance ALLR:								
Individually evaluated	$ 1,583	$ 26	$ 16	$ 367	$	$	$	$ 1,992
Collectively evaluated	1,876	810	184	976				3,846
Total	$ 3,459	$ 836	$ 200	$ 1,343	$	$	$	$ 5,838
Ending balance Loans:								
Individually evaluated	$ 15,090	$ 1,730	$ 1,236	$ 2,285	$	$	$	$ 20,341
Collectively evaluated	179,989	82,555	18,535	76,474	7,741	6,268		371,562
Total	$ 195,079	$ 84,285	$ 19,771	$ 78,759	$ 7,741	$ 6,268	$	$ 391,903

Impaired loans, by definition, are individually evaluated.

A breakdown of the allowance for loan losses, the activity for the period, and recorded balances in loans for the year ended December 31, 2010 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 3,284	$ 1,135	$ 386	$ 23	$	$ 13	$ 384	$ 5,225
Charge-offs	(2,426)	(1,804)	(720)	(416)		(9)	(111)	(5,486)
Recoveries	18	260	67			15	14	374
Provision	2,584	1,427	656	2,015		(19)	(163)	6,500
Unallocated assignment								
Ending balance ALLR	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Loans:								
Ending balance	$ 194,859	$ 68,858	$ 33,330	$ 75,074	$ 5,682	$ 5,283	$	$ 383,086
Ending balance ALLR	(3,460)	(1,018)	(389)	(1,622)			(124)	(6,613)
Net loans	$ 191,399	$ 67,840	$ 32,941	$ 73,452	$ 5,682	$ 5,283	$ (124)	$ 376,473
Ending balance ALLR:								
Individually evaluated	$ 1,601	$ 330	$ 39	$ 696	$	$	$	$ 2,666
Collectively evaluated	1,859	688	350	926			124	3,947
Total	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Ending balance Loans:								
Individually evaluated	$ 18,610	$ 2,696	$ 2,437	$ 5,238	$	$	$	$ 28,981
Collectively evaluated	176,249	66,162	30,893	69,836	5,682	5,283		354,105
Total	$ 194,859	$ 68,858	$ 33,330	$ 75,074	$ 5,682	$ 5,283	$	$ 383,086

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan s credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

Excellent (1)

Borrower is not vulnerable to sudden economic or technological changes and is in a non-seasonal business or industry. These loans generally would be characterized by having good experienced management and a strong liquidity position with minimal leverage.

Good (2)

Borrower shows limited vulnerability to sudden economic change with modest seasonal effect. Borrower has above average financial statements and an acceptable repayment history with minimal leverage and a profitability that exceeds peers.

Average (3)

Generally, a borrower rated as average may be susceptible to unfavorable changes in the economy and somewhat affected by seasonal factors. Some product lines may be affected by technological change. Borrowers in this category exhibit stable earnings, with a satisfactory payment history.

Acceptable (4)

The loan is an otherwise acceptable credit that warrants a higher level of administration due to various underlying weaknesses. These weaknesses, however, have not and may never deteriorate to the point of a Special Mention rating or Classified status. This rating category may include new businesses not yet having established a firm performance record.

Special Mention (5)

The loan is not considered as a Classified status, however may exhibit material weaknesses that, if not corrected, may cause future problems. Borrowers in this category warrant special attention but have not yet reached the point of concern for loss. The borrower may have deteriorated to the point that they would have difficulty refinancing elsewhere. Similarly, purchasers of these businesses would not be eligible for bank financing unless they represent a significantly lessened credit risk.

Substandard (6)

The loan is Classified and exhibits a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans within this category clearly represent troubled and deteriorating credit situations requiring constant supervision and an action plan must be developed and approved by the appropriate officers to mitigate the risk.

Doubtful (7)

Loans in this category exhibit the same weaknesses used to describe the substandard credit; however, the traits are more pronounced. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

Charge-off/Loss (8)

Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

General Reserves:

For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. Within the commercial loan portfolio, the historical loss rates are used for specific industries such as hospitality, gaming, petroleum, and forestry. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Below is a breakdown of loans by risk category as of September 30, 2011 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	(8) Loss	Rating Unassigned	Total
Commercial real estate	$ 3,555	$ 16,988	$ 46,123	$ 113,406	$ 5,032	$ 7,971	$ 2,239	$	$ (235)	$ 195,079
Commercial, financial and agricultural	2,927	9,242	18,403	51,559	206	1,556			392	84,285
Commercial construction	212	556	5,968	11,482	1,553					19,771
One to four family residential real estate		3,330	3,163	5,992		2,289			63,985	78,759
Consumer construction						20			7,721	7,741
Consumer			113	583					5,572	6,268
Total loans	$ 6,694	$ 30,116	$ 73,770	$ 183,022	$ 6,791	$ 11,836	$ 2,239	$	$ 77,435	$ 391,903

Below is a breakdown of loans by risk category as of December 31, 2010 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	(8) Loss	Rating Unassigned	Total
Commercial real estate	$ 4,745	$ 16,975	$ 44,408	$ 109,911	$ 3,789	$ 10,997	$ 3,956	$	$ 78	$ 194,859
Commercial, financial and agricultural	3,726	5,275	16,466	39,844	259	2,636			652	68,858
Commercial construction		579	4,416	22,280	1,921	568			3,566	33,330
One-to-four family residential real estate	33	3,589	3,146	4,271	1,464	3,941			58,630	75,074
Consumer construction									5,682	5,682

Consumer			34	368					4,881	5,283
Total loans	$ 8,504	$ 26,418	$ 68,470	$ 176,674	$ 7,433	$ 18,142	$ 3,956	$	$ 73,489	$ 383,086

The breakdown of loans by risk category for the period ended September 30, 2010 is not available. This disclosure was not required on September 30, 2010, and the Corporation no longer has this detail available for historical periods.

Impaired Loans

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal.

The accrual of interest on loans is discontinued when, in management s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, 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. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

For the nine months ended:	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
September 30, 2011						
With no valuation reserve:						
Commercial real estate	$ 438	$	$ 438	$	$ 24	$ 16
Commercial, financial and agricultural						
Commercial construction						11
One to four family residential real estate	109		79			3
Consumer construction	20		6			
Consumer						
With a valuation reserve:						
Commercial real estate	$ 3,195	$ 2,531	$ 4,856	$ 1,414	$ 43	$ 187
Commercial, financial and agricultural	36	1,084	1,357	41	29	35
Commercial construction			229			
One to four family residential real estate	2,156	104	3,103	342	2	118
Consumer construction			5			
Consumer			3			
Total:						
Commercial real estate	$ 3,633	$ 2,531	$ 5,294	$ 1,414	$ 67	$ 203
Commercial, financial and agricultural	36	1,084	1,357	41	29	35
Commercial construction			229			11
One to four family residential real estate	2,265	104	3,182	342	2	121

Consumer construction	**20**		**11**			
Consumer			**3**			
Total	**$ 5,954**	**$ 3,719**	**$ 10,076**	**$ 1,797**	**$ 98**	**$ 370**
For the year ended:						
December 31, 2010						
With no valuation reserve:						
Commercial real estate	$ 960	$	$ 987	$	$	$ 71
Commercial, financial and agricultural	51		13			1
Commercial construction	458		1,186		11	33
One to four family residential real estate	362	105	237		1	13
Consumer construction						
Consumer						
With a valuation reserve:						
Commercial real estate	$ 2,562	$ 4,537	$ 6,531	$ 1,258	$ 117	$ 306
Commercial, financial and agricultural	709		1,660	279		95
Commercial construction						21
One to four family residential real estate	767		730	230	12	39
Consumer construction	52		52	1		4
Consumer						
Total:						
Commercial real estate	$ 3,522	$ 4,537	$ 7,518	$ 1,258	$ 117	$ 377
Commercial, financial and agricultural	760		1,673	279		96
Commercial construction	458		1,186		11	54
One to four family residential real estate	1,129	105	967	230	13	52
Consumer construction	52		52	1		4
Consumer						
Total	$ 5,921	$ 4,642	$ 11,396	$ 1,768	$ 141	$ 583

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(Unaudited)

5. LOANS (Continued)

For the nine months ended	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
September 30, 2010						
With no valuation reserve:						
Commercial real estate	$ 1,874	$ 1,565	$ 6,544	$	$	$ 275
Commercial, financial and agricultural	111		2,218			73
Commercial construction	813		871			42
One to four family residential real estate	740	106	484			24
Consumer construction						
Consumer						
With a valuation reserve:						
Commercial real estate	$ 273	$ 3,991	$ 862	$ 397	$ 7	$ 32
Commercial, financial and agricultural	570		319	50		17
Commercial construction		634	63			
One to four family residential real estate	14	504	66	808		1
Consumer construction	52		52			3
Consumer				1		
Total:						
Commercial real estate	$ 2,147	$ 5,556	$ 7,406	$ 397	$ 7	$ 307
Commercial, financial and agricultural	681		2,537	50		90
Commercial construction	813	634	934			42
One to four family residential real estate	754	610	550	808		25
Consumer construction	52		52			3
Consumer				1		
Total	$ 4,447	$ 6,800	$ 11,479	$ 1,256	$ 7	$ 467

A summary of past due loans at September 30, 2011, December 31, 2010 and September 30, 2010 is as follows (dollars in thousands):

	September 30, 2011			December 31, 2010			September 30, 2010	
30-89 days Past Due	**90+ days Past Due/ Nonaccrual**	**Total**	30-89 days Past Due	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total

	(accruing)			(accruing)					
Commercial real estate	**$ 338**	**$ 3,633**	**$ 3,971**	$ 19	$ 3,522	$ 3,541	$ 1,157	$ 2,147	$ 3,304
Commercial, financial and agricultural		**36**	**36**	382	760	1,142	100	681	781
Commercial construction	**30**	**20**	**50**		458	458	656	813	1,469
One to four family residential real estate	**124**	**2,265**	**2,389**	923	1,129	2,052	109	754	863
Consumer construction					52	52		52	52
Consumer	**6**		**6**	20		20	5		5
Total past due loans	**$ 498**	**$ 5,954**	**$ 6,452**	$ 1,344	$ 5,921	$ 7,265	$ 2,027	$ 4,447	$ 6,474

A roll-forward of nonaccrual activity for the first nine months ended September 30, 2011 (dollars in thousands):

	For the Nine Months Ended September 30, 2011						
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
NONACCRUAL							
Beginning balance	$ 3,522	$ 760	$ 458	$ 1,129	$ 52	$	$ 5,921
Principal payments	(1,283)	(766)	(14)	(43)			(2,106)
Charge-offs	(566)	(551)	(62)	(382)		(27)	(1,588)
Advances							
Class transfers							
Transfers to OREO	(1,184)	(609)	(382)	(1,901)	(53)		(4,129)
Transfers to accruing	(892)						(892)
Transfers from accruing	4,001	856		3,273	20	27	8,177
Other	35	346		189	1		571
Ending balance	$ 3,633	$ 36	$	$ 2,265	$ 20	$	$ 5,954

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

A roll-forward of nonaccrual activity for the first nine months ended September 30, 2010 (dollars in thousands):

	For the Nine Months Ended September 30, 2010						
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
NONACCRUAL							
Beginning balance	$ 8,290	$ 2,644	$ 1,919	$ 1,461	$ 52	$ 2	$ 14,368
Principal payments	(5,349)	(1,025)	(86)	(27)		(2)	(6,489)
Charge-offs	(2,193)	(1,499)	(27)	(1,281)			(5,000)
Advances							
Class transfers							
Transfers to OREO	(2,057)	(102)	(1,003)	(237)			(3,399)
Transfers to accruing	(54)						(54)
Transfers from accruing	5,347	661		830			6,838
Other	(1,837)	2	10	8			(1,817)
Ending balance	$ 2,147	$ 681	$ 813	$ 754	$ 52	$	$ 4,447

Troubled Debt Restructuring

Troubled debt restructurings (TDR) are determined on a loan-by-loan basis. Generally restructurings are related to interest rate reductions, loan term extensions and short term payment forbearance as means to maximize collectability of troubled credits. The Corporation has not forgiven principal to date, although this would be considered if necessary to ensure the long term collectability of the loan. In general, a borrower must make at least six consecutive timely payments before the Corporation would consider a return of a restructured loan to accruing status in accordance with FDIC guidelines regarding restoration of credits to accrual status. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring.

The Corporation, at September 30, 2011, had loans totaling $3.719 million for which repayment terms were modified to the extent that they were deemed to be restructured loans. The $3.719 million is comprised of 3 loans, the largest of which had a September 30, 2011 balance of $2.401 million. This loan was modified to allow the suspension of principal payments for over a 12-month period . This suspension of principal payments on this loan with a 30-year amortization does not result in a significant change to the net present value of total principal and interest payments over the term of the note. The Corporation has, in accordance with generally accepted accounting principles and per recently enacted accounting standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. As of September 30, 2011, this evaluation showed no material impact related to the current balances of restructured loans.

Insider Loans

The Bank, in the ordinary course of business, grants loans to the Corporation s executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

	September 30, 2011	December 31, 2010	September 30, 2010
Loans outstanding beginning of period	**$ 9,532**	$ 8,552	$ 8,552
New loans	**933**	5,243	2,665
Net activity on revolving lines of credit	**27**	2,065	2,055
Repayment	**(1,630)**	(6,328)	(3,857)
Loans outstanding, end of period	**$ 8,862**	$ 9,532	$ 9,415

There were no loans to related parties classified substandard at September 30, 2011, December 31, 2010 or September 30, 2010. In addition to the outstanding balances above, there were unused commitments of $.318 million to related parties at September 30, 2011.

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6. MORTGAGE SERVICING RIGHTS

As of September 30, 2011, the Corporation had obligations to service approximately $40 million of residential first mortgage loans. Mortgage servicing rights (MSRs) are recorded when loans are sold in the secondary market with servicing retained. At September 30, 2011, the Corporation calculated the value of these MSRs and recorded $300,000 as the initial valuation. The valuation was based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans.

7. BORROWINGS

Borrowings consist of the following at September 30, 2011, December 31, 2010 and September 30, 2010 (dollars in thousands):

	September 30, 2011	December 31, 2010	September 30, 2010
Federal Home Loan Bank fixed rate advances at a weighted average rate of 1.73% maturing from December 2011 to January 2016	**$ 35,000**	$ 35,000	$ 35,000
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024, interest payable at 1%	**997**	1,069	1,069
	$ 35,997	$ 36,069	$ 36,069

The Federal Home Loan Bank borrowings are collateralized at September 30, 2011 by the following: a collateral agreement on the Corporation s one to four family residential real estate loans with a book value of approximately $38.188 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $10.219 million and $10.691 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.060 million. Prepayment of the remaining advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of September 30, 2011.

The USDA Rural Development borrowing is collateralized by loans totaling $.162 million originated and held by the Corporation s wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of $.934 million, and guaranteed by the Corporation.

8. STOCK OPTION PLANS

A summary of stock option transactions for the nine months ended September 30, 2011 and 2010, and the year ended December 31, 2010, is as follows:

	September 30, 2011	December 31, 2010	September 30, 2010
Outstanding shares at beginning of year	**394,072**	411,057	411,057
Granted during the period			
Expired during the period		(16,985)	(16,985)
Outstanding shares at end of period	**394,072**	394,072	394,072
Exercisable shares at end of period	**150,781**	150,781	150,781
Weighted average exercise price per share at end of period	**$ 10.98**	$ 10.98	$ 10.98
Shares available for grant at end of period	**0**	0	0

There were no options granted in the first nine months of 2011 and 2010.

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(Unaudited)

8. STOCK OPTION PLANS (Continued)

Following is a summary of the options outstanding and exercisable at September 30, 2011:

Exercise Price	Number Outstanding	Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years
$9.16	5,000	2,000	3,000	4.21
$9.75	257,152	120,861	126,291	3.21
$10.65	50,000	10,000	40,000	4.00
$11.50	40,000	8,000	32,000	3.71
$12.00	40,000	8,000	32,000	3.71
$156.00 - $185.00	1,920	1,920		0.08
	394,072	150,781	243,291	3.59

9. INCOME TAXES

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. At March 31, 2010 management evaluated the valuation allowance. An analysis of the deferred tax asset was made to determine the utilization of those tax benefits based upon projected future taxable income. At that time, based upon management s determination and in accordance with the generally accepted accounting principles, that it was more likely than not that a portion of these benefits would be utilized, a $3.500 million valuation adjustment was made as a credit to income tax expense. Among the criteria that management considered in evaluating the deferred tax asset was taxable income for the three most recent taxable years ending December 31, 2009 which totaled $8.2 million. This taxable income allowed the Corporation to utilize NOL carryforwards.

Management assessed the valuation allowance for the second and third quarters of 2010 and determined that no additional adjustment was deemed appropriate. At December 31, 2010, based upon further analysis, and in recognition of the current period operating loss before taxes, management determined that an adjustment to the valuation was appropriate and increased the valuation allowance by $1.364 million with an increase to current tax expense.

Management evaluated the deferred tax valuation allowance as of September 30, 2011 and determined that no adjustment to the valuation was warranted. The Corporation, as of September 30, 2011 had a net operating loss and tax credit carryforwards for tax purposes of approximately $27.0 million, and $2.1 million, respectively.

The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it becomes more likely than not that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $17.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.477 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUE MEASUREMENTS
Fair value estimates, methods, and assumptions are set forth below for the Corporation s financial instruments:

Cash, cash equivalents, and interest-bearing deposits - The carrying values approximate the fair values for these assets.

Securities - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Federal Home Loan Bank stock - Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

Loans - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan s effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

Borrowings - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

Accrued interest - The carrying amount of accrued interest approximates fair value.

Off-balance-sheet instruments - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUE MEASUREMENTS (Continued)

The following table presents information for financial instruments at September 30, 2011 and December 31, 2010 (dollars in thousands):

	September 30, 2011		December 31, 2010	
	Carrying Amount	**Estimated Fair Value**	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	**$ 42,122**	**$ 42,122**	$ 34,719	$ 34,719
Interest bearing deposits	**10**	**10**	713	713
Securities available for sale	**37,022**	**37,022**	33,860	33,860
Federal Home Loan Bank stock	**3,060**	**3,060**	3,423	3,423
Net loans	**386,065**	**385,242**	376,473	376,713
Accrued interest receivable	**1,266**	**1,266**	1,155	1,155
Total financial assets	**$ 469,545**	**$ 468,722**	$ 450,343	$ 450,583
Financial liabilities:				
Deposits	**$ 405,058**	**$ 407,120**	$ 386,779	$ 387,885
Borrowings	**35,997**	**35,591**	36,069	36,234
Accrued interest payable	**209**	**209**	232	232
Total financial liabilities	**$ 441,264**	**$ 442,920**	$ 423,080	$ 424,351

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 judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, 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. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include other real estate and loans. The Corporation has estimated the fair values of these assets using the valuation methods below.

Level 1: In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

Level 2: Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3: Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

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10. FAIR VALUE MEASUREMENTS (Continued)

The fair value of all investment securities at September 30, 2011 and September 30, 2010 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 4 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of September 30, 2011, December 31, 2010 or September 30, 2010.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation s assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2011

(dollars in thousands)

	Balance at September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended September 30, 2011	Total Losses for Nine Months Ended September 30, 2011
Assets						
Impaired loans	$ 9,673	$	$	$ 9,673	$ 712	$ 1,587
Other real estate owned	5,212			5,212	296	728
					$ 1,008	$ 2,315

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2011

(dollars in thousands)

	Balance at December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Year Ended December 31, 2010
Assets					
Impaired loans	$ 10,563	$	$	$ 10,563	$ 1,666
Other real estate owned	5,562			5,562	2,753

$	4,419

The Corporation had no investments subject to fair value measurement on a nonrecurring basis.

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management s best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals). This evaluation may require the establishment of a specific loan loss reserve. The current accounting for troubled debt restructurings (TDRs) also requires that if the measurement or evaluation is less than the recorded impairment is recognized and recorded as an increase in the allowance for loan loss and a corresponding increased charge to the provision. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring.

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11. SHAREHOLDERS EQUITY

Participation in the TARP Capital Purchase Program

On April 24, 2009, the Corporation entered into and closed a Letter Agreement, including the Securities Purchase Agreement-Standard Terms (collectively, the Securities Purchase Agreement), related to the CP. Pursuant to the Securities Purchase Agreement, the Corporation issued and sold to the Treasury (i) 11,000 shares of the Corporation s Series A Preferred Shares, and (ii) the Warrant to purchase 379,310 shares of the Corporation s Common Shares, at an exercise price of $4.35 per share (subject to certain anti-dilution and other adjustments), for an aggregate purchase price of $11.000 million in cash. The Warrant has a ten-year term.

As a result of the CPP transaction, the Corporation is required to take certain actions, for so long as the Treasury holds any securities acquired from the Corporation pursuant to the CPP (excluding any period in which the Treasury holds only the Warrant to purchase Common Shares of the Corporation) (the CPP Period), to ensure that its executive compensation and benefit plans with respect to Senior Executive Officers (as defined in the relevant agreements) comply with Section 111(b) of Emergency Economic Stabilization Act of 2008 (EESA), as implemented by any guidance or regulations issued under Section 111(b) of EESA, and not adopt any benefit plans with respect to, or which cover, the Corporation s Senior Executive Officers that do not comply with EESA, as amended by the American Recovery and Reinvestment Act of 2009 (the ARRA), which was passed by Congress and signed by the President on February 17, 2009. The applicable executive compensation standards generally remain in effect during the CPP Period and apply to the Corporation s Senior Executive Officers (which for purposes of the ARRA and the CPP agreements, includes the Corporation s Chief Executive Officer, its Chief Financial Officer, and the next three most highly-compensated executive officers, even though the Corporation s senior executive officers consist of a smaller group of executives for purposes of the other compensation disclosures in the Corporation s annual proxy statement).

Amounts recorded for Preferred Stock and Warrant Common Stock were estimated based on an allocation of the total proceeds from the issuance on the relative fair values of both instruments. Fair value of the Preferred Stock was determined based on assumptions regarding the discount rate (market rate) on the Preferred Stock (estimated 12%). Fair value of the Warrant Common Stock is based on the value of the underlying Preferred Stock based on an estimate for a three year term. The allocation of the proceeds received resulted in the recording of a discount on the Preferred Stock and a premium on the Warrant Common Stock. The discount on the preferred will be accreted on an effective yield basis over a three-year term. The allocated carrying value of the Preferred Stock and Warrant Common Stock on the date of issuance (based on their relative fair values) was $10.382 million and $.618 million, respectively. Cumulative dividends on the Preferred Stock are payable at 5% annum for the first five years and at a rate of 9% per annum thereafter on the liquidation preference of $1,000 per share. The Company is prohibited from paying any dividend with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock for all past dividend periods. The Preferred Stock is non-voting, other than class voting rights on matters that could adversely affect the Preferred Stock. The Preferred Stock may be redeemed at any time with regulatory approval. The Treasury may also transfer the Preferred Stock to a third party at any time. The preferred stock qualifies as Tier 1 Capital for regulatory purposes at the holding company.

The Corporation has the right to redeem the Series A Preferred Shares at any time after consulting with its primary regulator, in which case the executive compensation standards would no longer apply to the Corporation. The Corporation is currently exploring an exit strategy for repayment of the TARP preferred and redemption of the common stock warrants.

MACKINAC FINANCIAL CORPORATION

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(Unaudited)

12. COMMITMENTS, CONTINGENCIES AND CREDIT RISK

Financial Instruments With Off-Balance-Sheet Risk

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Corporation s exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

	September 30, 2011	December 31, 2010	September 30, 2010
Commitments to extend credit:			
Variable rate	**$ 16,443**	$ 18,092	$ 24,293
Fixed rate	**29,632**	13,034	16,891
Standby letters of credit - Variable rate	**4,307**	2,192	1,363
Credit card commitments - Fixed rate	**3,119**	2,737	2,801
	$ 53,501	$ 36,055	$ 45,348

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management s credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit. Credit card commitments are commitments on credit cards issued by the Corporation s subsidiary and serviced by other companies. These commitments are unsecured.

Contingencies

In the normal course of business, the Corporation is involved in various legal proceedings. For expanded discussion on the Corporation s legal proceedings, see Part II, Item 1, Legal Proceedings in this report.

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank s most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at September 30, 2011 represents $62.567 million, or 20.92%, of the total commercial loan portfolio, compared to $52.2 million, or 17.68%, of the commercial loan portfolio on September 30, 2010. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank s locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

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FORWARD LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Corporation intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words believe , expect , intend , anticipate , estimate project , or similar expressions. The Corporation s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

- The highly regulated environment in which the Corporation operates could adversely affect its ability to carry out its strategic plan due to restrictions on new products, funding opportunities or new market entrances;
- General economic conditions, either nationally or in the state(s) in which the Corporation does business;
- Legislation or regulatory changes which affect the business in which the Corporation is engaged;
- Changes in the level and volatility of interest rates which may negatively affect the Corporation s interest margin;
- Changes in securities markets with respect to the market value of financial assets and the level of volatility in certain markets such as foreign exchange;
- Significant increases in competition in the banking and financial services industry resulting from industry consolidation, regulatory changes and other factors, as well as action taken by particular competitors;
- The ability of borrowers to repay loans;
- The effects on liquidity of unusual decreases in deposits;
- Changes in consumer spending, borrowing, and saving habits;
- Technological changes;
- Acquisitions and unanticipated occurrences which delay or reduce the expected benefits of acquisitions;

Difficulties in hiring and retaining qualified management and banking personnel;

The Corporation s ability to increase market share and control expenses;

The effect of compliance with legislation or regulatory changes;

The effect of changes in accounting policies and practices;

The costs and effects of existing and future litigation and of adverse outcomes in such litigation; and

An increase in the Corporation s FDIC insurance premiums, or the collection of special assessments by the FDIC.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation s financial results, is included in the Corporation s filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

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

OF OPERATIONS (Continued)

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation s Annual Report and Form 10-K for the year-ended December 31, 2010. Throughout this discussion, the term Bank refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded third quarter 2011 income available to common shareholders of $ .707 million or $.21 per share compared to net loss of $.104 million, or $.03 per share for the third quarter of 2010. Net income available to common shareholders for the first nine months of 2011 totaled $1.566 million, or $.46 per share, compared to $.934 million, or $.27 per share, for the same period in 2010.

Weighted average shares totaled 3,419,736 for all periods. The common stock warrants outstanding of 379,310 shares were slightly dilutive, at approximately $.01 per share, for the 2011 third quarter and nine month period, as the market value of our stock moved above the $4.35 strike price.

The third quarter results include the initial recording value of mortgage servicing rights at $.300 million, a provision for loan losses of $.400 million and $.296 million of losses on OREO properties. Operating results for the same period in 2010 include a $1.000 million provision and negligible OREO losses. Operating results for the nine month period in 2011 include a $1.000 million provision and $.728 million in OREO write-downs, compared with a $4.700 million provision and $2.000 million in OREO losses, and the recognition of a $3.500 million valuation adjustment on deferred tax assets for the nine months ended September 30, 2010.

The net interest margin for the third quarter of 2011 increased to $4.709 million, or 4.14%, compared to $4.064 million, or 3.69% in the third quarter of 2010. The nine month margin in 2011 was $13.028 million, or 3.95% compared to $12.109 million, or 3.59% in the 2010 nine month period.

Total assets of the Corporation at September 30, 2011 were $498.598 million, up by $19.902 million, or 4.16%, from total assets of $478.696 million at December 31, 2010. Asset totals at September 30, 2011 reflect increased balances of investment securities of approximately $3.162 million and increased loan balances of $8.817 million from December 31, 2010 balances. Deposits totaled $405.058 million at September 30, 2011, an increase of $18.279 million, from the $386.779 million at December 31, 2010.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $ 7.403 million during the first nine months of 2011. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $3.162 million, or 9.34%, from December 31, 2010 to September 30, 2011, with the balance on September 30, 2011, totaling $37.022 million. The Corporation purchased $15.206 million of investments in the first nine months of 2011 and had reductions of $12.044 million due primarily from maturities and paydowns. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2011, investment securities with an estimated fair value of $10.991 million were pledged.

Loans

Through the first nine months of 2011, loan balances increased by $ 8.817 million, or 2.30%, from December 31, 2010 balances of $383.086 million. During the first nine months of 2011, the Bank had total loan production of $113.0 million. This loan production, however, was significantly offset by normal loan principal runoff and amortization, and refinancing, which totaled approximately $58 million, along with USDA and SBA loan sales of

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$40 million. Loan balances were also impacted by nonperforming activity with $1.8 million of loan charge-offs and $4.1 million of loans foreclosed and transferred to other real estate owned.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Following is a summary of the loan portfolio at September 30, 2011, December 31, 2010 and September 30, 2010 (dollars in thousands):

	September 30, 2011	**Percent of Total**	December 31, 2010	Percent of Total	September 30, 2010	Percent of Total
Commercial real estate	**$ 195,079**	**49.78%**	$ 194,859	50.87%	$ 199,892	52.23%
Commercial, financial, and agricultural	**84,285**	**21.51**	68,858	17.97	69,652	18.20
One to four family residential real estate	**78,759**	**20.10**	75,074	19.60	74,829	19.55
Consumer	**6,268**	**1.60**	5,283	1.38	5,153	1.35
Construction:						
Commercial	**19,771**	**5.04**	33,330	8.70	25,718	6.72
Consumer	**7,741**	**1.97**	5,682	1.48	7,483	1.95
Total loans	**$ 391,903**	**100.00%**	$ 383,086	100.00%	$ 382,727	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2011, December 31, 2010 and September 30, 2010 (dollars in thousands):

	September 30, 2011			December 31, 2010			September 30, 2010		
	Outstanding Balance	**Percent of Commercial Loans**	**Percent of Shareholders Equity**	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders Equity	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders Equity
Real estate - operators of nonres bldgs	**$ 62,567**	**20.92%**	**112.78%**	$ 58,114	19.56%	107.85%	$ 52,192	17.68%	93.22%
Hospitality and tourism	**33,867**	**11.32**	**61.04**	37,737	12.70	70.04	39,998	13.55	71.44
Commercial construction	**19,771**	**6.61**	**35.64**	33,330	11.22	61.86	25,718	8.71	45.94
Lessors of nonresidential buildings	**16,433**	**5.49**	**29.62**	16,598	5.59	30.80	15,854	5.37	28.32
Real estate agents and managers	**12,781**	**4.27**	**29.62**	15,857	5.34	29.43	19,675	6.66	35.14

Other	**153,716**	**51.39**	**277.07**	135,411	45.59	251.31	141,825	48.03	253.32
Total Commercial Loans	**$ 299,135**	**100.00%**		$ 297,047	100.00%		$ 295,262	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation s highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of September 30, 2011. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one-to-four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of September 30, 2011, our residential loan portfolio totaled $86.500 million, or 22.07% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from $2.471 million at the end of December 31, 2010 to $ 2.126 million at September 30, 2011. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

Due to the seasonal nature of many of the Corporation s commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer s business cycle. The lending staff evaluates the

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collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Credit Quality

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the nine months ended September 30, 2011 amounted to $1.775 million, or .46% of average loans outstanding, compared to $4.488 million, or 1.17% of average loans outstanding, for the same period in 2010. The current reserve balance is representative of the relevant risk inherent within the Corporation s loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

The table below shows period end balances of nonperforming assets (dollars in thousands):

	September 30, 2011	December 31, 2010	September 30, 2010
Nonperforming Assets:			
Nonaccrual Loans	**$ 5,954**	$ 5,921	$ 4,447
Loans past due 90 days or more			
Restructured loans	**3,719**	4,642	6,800
Total nonperforming loans	**9,673**	10,563	11,247
Other real estate owned	**5,212**	5,562	5,758
Total nonperforming assets	**$ 14,885**	$ 16,125	$ 17,005
Nonperforming loans as a % of loans	**2.47%**	2.76%	2.94%
Nonperforming assets as a % of assets	**2.99%**	3.37%	3.41%
Reserve for Loan Losses:			
At period end	**$ 5,838**	$ 6,613	$ 5,437
As a % of loans	**1.49%**	1.73%	1.42%
As a % of nonperforming loans	**60.35%**	62.61%	48.34%
As a % of nonaccrual loans	**98.05%**	111.69%	122.26%
Texas ratio*	**24.28%**	26.66%	27.68%

* ***calculated by taking total nonperforming assets divided by total equity plus reserve for loan losses***

The following ratios provide additional information relative to the Corporation s credit quality:

		At Period End	
	September 30, 2011	December 31, 2010	September 30, 2010
Total loans, at period end	**$ 391,903**	$ 383,086	$ 382,727
Average loans for the year	**385,391**	384,347	384,028

		For the Period Ended	
	Nine Months Ended September 30, 2011	Twelve Months Ended December 31, 2010	Nine Months Ended September 30, 2010
Net charge-offs during the period	**$ 1,775**	$ 5,112	$ 4,488
Net charge-offs to average loans	**.46%**	1.33%	1.17%
Net charge-offs to beginning allowance balance	**26.84%**	97.84%	85.89%

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Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation s senior lending staff and the bank regulatory examinations, management reviews the Corporation s loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation s loan rating system.

As of September 30, 2011, the allowance for loan losses represented 1.49% of total loans. At September 30, 2011, the allowance included specific reserves in the amount of $1.992 million, as compared to $2.666 million at December 31, 2010 and $2.389 million at September 30, 2010. In management s opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate for the periods indicated (dollars in thousands):

	Nine Months Ended September 30, 2011	Year Ended December 31, 2010	Nine Months Ended September 30, 2010
Balance at beginning of period	**$ 5,562**	$ 5,804	$ 5,804
Other real estate transferred from loans due to foreclosure	**4,129**	5,373	4,604
Other real estate sold	**(3,751)**	(2,862)	(2,650)
OREO write downs	**(550)**	(2,703)	(1,948)
Loss on sale of other real estate	**(178)**	(50)	(52)
Balance at end of period	**$ 5,212**	$ 5,562	$ 5,758

During the first nine months of 2011, the Corporation received real estate in lieu of loan payments of $4.129 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits of $18.279 million, or 4.73% in the first nine months of 2011. The increase in deposits for the first nine months of 2011 is comprised of a decrease in noncore deposits of $37.950 million and an increase in core deposits of $56.229 million. In 2011, the Corporation continued to strategically emphasize the growth of core deposits. This strategic initiative was supported with an individual incentive plan, along with the introduction of several new deposit products and competitive deposit pricing. The core deposit balance increases are primarily in transactional account deposits, our lowest cost of funds.

Management continues to monitor existing deposit products in order to stay competitive as to both terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional deposits.

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The following table represents detail of deposits at the end of the periods indicated (dollars in thousands):

	September 30, 2011	**% of Total**	December 31, 2010	% of Total	September 30, 2010	% of Total
Non-interest-bearing	**$ 53,736**	**13.27%**	$ 41,264	10.67%	$ 44,402	10.98%
NOW, money market, checking	**157,596**	**38.91**	134,703	34.83	127,828	31.60
Savings	**15,618**	**3.86**	17,670	4.57	20,265	5.01
Certificates of Deposit <$100,000	**119,893**	**29.59**	96,977	25.07	94,560	23.37
Total core deposits	**346,843**	**85.63**	290,614	75.14	287,055	70.96
Certificates of Deposit >$100,000	**24,138**	**5.96**	22,698	5.87	22,809	5.64
Brokered CDs	**34,077**	**8.41**	73,467	18.99	94,660	23.40
Total non-core deposits	**58,215**	**14.37**	96,165	24.86	117,469	29.04
Total deposits	**$ 405,058**	**100.00%**	$ 386,779	100.00%	$ 404,524	100.00%

Borrowings

The Corporation also uses FHLB borrowings to provide long-term, stable sources of funds. Current FHLB borrowings total $35.000 million with stated maturities ranging through January 2016. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has a fixed interest rate of 1% and matures in August 2024.

Shareholders Equity

Total shareholders equity increased $1.597 million from December 31, 2010 to September 30, 2011. Contributing to the increase in shareholders equity was net income of $1.566 million and a decrease in the market value of securities of $.131 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of $1.566 million, or $.46 per share, in the first nine months of 2011, compared to $.934 million or $.27 per share for the first nine months of 2010. Operating results for the first nine months of 2010 included the recognition of a $3.500 million deferred tax benefit related to NOL carry-forwards. This deferred tax benefit was recognized in accordance with GAAP accounting which requires the benefit to be recognized when it is more likely than not that the NOL will be utilized within the carry-forward period.

Net Interest Income

Net interest income is the Corporation s primary source of core earnings. Net interest income represents the difference between the average yield earned on interest earning assets and the average rate paid on interest bearing obligations. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest margin on a fully taxable equivalent basis amounted to $4.732 million, 4.18% of average earning assets, in the third quarter of 2011, compared to $4.091 million, 3.72% of average earning assets, in the third quarter of 2010. In the first nine months of 2011, net interest margin increased to $13.104 million, 3.78% of average earning assets, compared to $12.195 million, 3.61% of average earning assets, for the same period in 2010. Margin improvement in 2011 was primarily due to a reduction in funding costs between periods.

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The following tables present the amount of interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

	Three Months Ended							2011-2010			
	Average Balances September 30,			**Average Rates** September 30,		**Interest** September 30,		Income/			Rate/
(dollars in thousands)	**2011**	2010	Increase/ (Decrease)	**2011**	2010	**2011**	2010	Expense Variance	Volume Variance	Rate Variance	Volume Variance
Loans (1,2,3)	**$ 397,665**	$ 385,268	$ 12,397	**5.97%**	5.53%	**$ 5,637**	$ 5,369	$ 268	$ 173	$ 75	$ 2
Taxable securities	**38,102**	33,989	4,113	**3.20**	3.78	**304**	324	(20)	40	(53)	(7)
Nontaxable securities (2)	**858**	859	(1)	**3.27**	5.08	**11**	11			(4)	
Federal funds sold	**12,054**	12,000	54	**.17**	.26	**5**	8	(3)		(3)	
Other interest-earning assets	**3,070**	4,472	(1,402)	**2.74**	1.33	**21**	15	6	(5)	16	(5)
Total earning assets	**451,749**	436,588	15,161	**5.29**	5.20	**5,978**	5,727	251	208	31	(10)
Reserve for loan losses	**(6,070)**	(6,094)	24								
Cash and due from banks	**24,525**	49,943	(25,418)								
Fixed Assets	**9,588**	9,995	(407)								
Other Real Estate	**3,945**	5,758	(1,813)								
Other assets	**13,596**	16,145	(2,549)								
Total assets	**$ 497,333**	$ 512,335	$ (15,002)								
NOW and money market deposits	**$ 127,630**	$ 105,634	$ 21,996	**.56%**	.91%	**$ 177**	$ 241	$ (64)	$ 50	$ (95)	$ (19)
Interest checking	**28,820**	20,252	8,568	**.82**	1.39	**59**	71	(12)	30	(30)	(12)
Savings deposits	**15,734**	20,557	(4,823)	**.20**	.44	**8**	23	(15)	(6)	(12)	3
CDs <$100,000	**117,182**	93,265	23,917	**1.83**	2.05	**536**	481	55	123	(54)	(14)
CDs >$100,000	**23,773**	23,376	397	**1.62**	1.68	**96**	99	(3)	2	(5)	
Brokered deposits	**37,890**	107,774	(69,884)	**2.27**	1.84	**214**	499	(285)	(323)	110	(72)
Borrowings	**36,045**	36,115	(70)	**1.74**	2.44	**156**	222	(66)		(66)	
Total interest-bearing liabilities	**387,074**	406,973	(19,899)	**1.29**	1.59	**1,246**	1,636	(390)	(124)	(152)	(114)
Demand deposits	**52,928**	45,989	6,939								
Other liabilities	**2,333**	2,705	(372)								
Shareholders equity	**54,998**	56,668	(1,670)								
	$ 497,333	$ 512,335	$ (15,002)								

Total liabilities and shareholders equity								
Rate spread	**4.00%**	3.61%						
Net interest margin/revenue	**4.18%**	3.72%	**$ 4,732**	$ 4,091	$ 641	$ 332	$ 183	$ 104

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.
(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax equivalent basis, using a 34% tax rate
(3) Interest income on loans includes fees

	Nine Months Ended										
								2011-2010			
	Average Balances September 30,			**Average Rates** September 30,		**Interest** September 30,		Income/			Rate/
			Increase/					Expense	Volume	Rate	Volume
(dollars in thousands)	**2011**	2010	(Decrease)	**2011**	2010	**2011**	2010	Variance	Variance	Variance	Variance
Loans (1,2,3)	**$ 385,391**	$ 384,028	$ 1,363	**5.56%**	5.55%	**$ 16,097**	$ 15,863	$ 234	$ 56	$ 177	$ 1
Taxable securities	**35,897**	35,546	351	**3.27**	4.05	**878**	1,077	(199)	11	(209)	(1)
Nontaxable securities (2)	**852**	849	3	**3.30**	5.04	**32**	21	11		11	
Federal funds sold	**15,319**	26,619	(11,300)	**.17**	.25	**19**	50	(31)	(21)	(17)	7
Other interest-earning assets	**3,651**	4,477	(826)	**2.56**	1.49	**70**	50	20	(9)	36	(7)
Total earning assets	**441,110**	451,519	(10,409)	**5.16**	5.08	**17,096**	17,061	35	37	(2)	
Reserve for loan losses	**(6,295)**	(5,446)	(849)								
Cash and due from banks	**27,119**	30,714	(3,595)								
Fixed Assets	**9,655**	10,073	(418)								
Other Real Estate	**4,525**	6,346	(1,821)								
Other assets	**14,179**	14,732	(553)								
Total assets	**$ 490,293**	**$ 507,938**	$ (17,645)								
NOW and money market deposits	**$ 123,856**	$ 96,866	$ 26,990	**.68%**	1.00%	**$ 627**	$ 722	$ (95)	$ 202	$ (232)	$ (65)
Interest checking	**26,233**	17,880	8,353	**.99**	1.56	**195**	209	(14)	98	(76)	(36)
Savings deposits	**16,859**	19,676	(2,817)	**.24**	.56	**30**	83	(53)	(12)	(48)	7
CDs <$100,000	**108,105**	80,997	27,108	**1.85**	2.11	**1,497**	1,277	220	426	(155)	(51)
CDs >$100,000	**22,827**	27,494	(4,667)	**1.68**	1.69	**286**	348	(61)	(59)	(2)	
Brokered deposits	**54,606**	130,344	(75,738)	**2.22**	1.71	**905**	1,671	(766)	(971)	489	(284)
Borrowings	**36,061**	36,132	(71)	**1.68**	2.38	**452**	642	(190)	(1)	(189)	
Total interest-bearing liabilities	**388,547**	409,389	(20,842)	**1.37**	1.62	**3,992**	4,952	(959)	(317)	(213)	(429)
Demand deposits	**44,994**	38,818	6,176								
Other liabilities	**2,412**	3,170	(758)								
Shareholders equity	**54,340**	56,561	(2,221)								
Total liabilities and shareholders equity	**$ 490,293**	$ 507,938	$ (17,645)								
Rate spread				**3.78%**	3.46%						
Net interest margin/revenue				**3.78%**	3.61%	**$ 13,104**	$ 12,109	$ 994	$ 354	$ 211	$ 429

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.
(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax equivalent basis, using a 34% tax rate
(3) Interest income on loans includes fees

Throughout 2011 and 2010 there have been no changes to the prime rate. The Corporation, during this period, repriced the majority of its term deposits along with lowering rates on interest bearing transactional deposits. This repricing of liabilities is the primary reason for the increased interest margin, on a fully taxable equivalent basis, from 3.61% in the first nine months of 2010 to 3.78% in the first nine months of 2011.

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During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread.

Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first nine months of 2011, the Corporation determined through this analysis that a provision for loan loss of $1.000 million was required, compared to a $4.700 million provision in the first nine months of 2010. Impacting the loan loss provision for both nine month periods were net loans charged off which totaled $1.775 million in 2011 compared to $4.488 million in 2010. The 2011 nine months charge-offs include $.577 million of loans charged off which were specifically reserved for at 2010 year end.

Other Income

Other income increased by $.883 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010. Revenue due to loans produced and sold in the secondary market, along with the sale of SBA guaranteed loans, amounted to $1.729 million compared to $.897 million a year ago. We expect to continue to benefit from secondary market activity in future periods. Service fees on deposit products, primarily overdraft fees, declined by $.121 million, when comparing the 2011 nine month period to 2010.

During the third quarter of 2011, the Corporation recognized $1.006 million in other income, compared to $.648 million for the third quarter of 2010. The increase between periods was attributed entirely to gains on the sale of SBA and secondary market loans. Service fees on deposit products, primarily overdraft fees, decreased for the third quarter of 2011 by $.084 million to $1.800 million when compared to $.264 million in the third quarter of 2010. In the third quarter of 2011, the Corporation also recognized $.300 million for the initial valuation of mortgage servicing rights. Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

The following table details other income for the three and nine months ended September 30, 2011 and 2010 (dollars in thousands):

	Three Months Ended September 30,				**Nine Months Ended September 30,**			
			Increase/(Decrease)				Increase/(Decrease)	
	2011	2010	**Dollars**	**Percentage**	**2011**	2010	**Dollars**	**Percentage**
Service fees	**$ 180**	$ 264	$ (84)	(31.82)	**$ 616**	$ 737	$ (121)	(16.42)
Income from loans sold	**478**	322	156	48.45	**1,863**	897	966	107.69
Mortgage servicing rights	**300**		300	100.00	**300**		300	100.00
Other noninterest income	**48**	63	(15)	(23.81)	**152**	199	(47)	(23.62)
Subtotal	**1,006**	649	357	55.01	**2,931**	1,833	1,098	59.90
Net security gain (loss)		(1)	1	(100.00)		215	(215)	(100.00)
Total noninterest income	**$ 1,006**	$ 648	$ 358	55.25	**$ 2,931**	$ 2,048	$ 883	43.12

Other Expense

Other expenses increased $.811 million for the nine months ended September 30, 2011, compared to the same period in 2010. Salaries and employee benefits increased between periods, largely reflective of annual salary increases along with increased incentive pay related to compensation plans in place for 2011 that incent employees for core deposit growth. The most significant decline in other expense was in the loan and deposit expense category from costs associated with nonperforming assets. During the first nine months of 2011, the Corporation recorded $.728 million in total write-downs of OREO properties compared to $2.000 million for the nine month period in 2010. Management continually reviews all areas of other expense for cost reduction opportunities that will not impact service quality and employee morale.

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The following table details other expense for the three and nine months ended September 30, 2011 and September 30, 2010 (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
			Increase/(Decrease)				Increase/(Decrease)	
	2011	2010	**Dollars**	**Percentage**	**2011**	2010	**Dollars**	**Percentage**
Salaries and employee benefits	**$ 1,811**	$ 1,779	$ 32	1.80%	**$ 5,441**	$ 5,281	$ 160	3.03%
Occupancy	**334**	358	(24)	(6.70)	**1,048**	1,048		
Furniture and equipment	**197**	202	(5)	(2.48)	**612**	593	19	3.20
Data processing	**177**	193	(16)	(8.29)	**532**	587	(55)	(9.37)
Professional service fees	**165**	168	(3)	(1.79)	**550**	502	48	9.56
Loan and deposit:	**288**	139	149	107.19	**719**	665	54	8.12
OREO writedowns and (gains) losses on sale	**296**	80	216	270.00	**728**	2,000	(1,272)	(63.60)
FDIC insurance premiums	**215**	222	(7)	(3.15)	**755**	665	90	13.53
Telephone	**51**	53	(2)	(3.77)	**160**	145	15	10.34
Advertising	**93**	77	16	20.78	**292**	220	72	32.73
Other	**333**	330	3	0.91	**912**	854	58	6.79
Total noninterest expense	**$ 3,960**	$ 3,601	$ 359	9.97%	**$ 11,749**	$ 12,560	$ (811)	(6.46)%

Federal Income Taxes

Current Federal Tax Provision

The Corporation recorded a federal income tax provision of $1.071 million for the first nine months of 2011 compared to a tax benefit of $4.593 million for the same period in 2010. In 2010, federal tax represents the benefit related to the operating loss for the nine month period and an adjustment of $3.500 to the valuation adjustment related to a recognition of deferred tax benefits of NOL and tax credit carryforwards.

Deferred Tax Benefit

In the first nine months of 2010, management evaluated the deferred tax benefits associated with the net operating loss and tax credit carryforwards based upon the Corporation s foreseen ability to utilize the benefits of these carryforwards prior to their expiration. As a part of this analysis, management considered, among other things, current asset levels and projected loan and deposit growth, current interest rate spreads and projected net interest income levels, and other income and expense, along with management s ability to control expenses and the potential for increasing contributions of noninterest income. Management also considered the impact of nonperforming assets and future period charge-off activity relative to projected provisions. Based upon the analysis of projected taxable income and the probability of achieving these projected taxable income levels, a portion, $3.500 million of the remaining deferred tax benefit was recognized. This $3.500 million deferred tax benefit, along with taxes on current net operating results, income before taxes resulted in a total net benefit in the first nine months of $4.593 million.

As of September 30, 2011, the Corporation had an NOL carryforward of approximately $27.0 million along with various credit carryforwards of $2.1 million. This NOL and credit carryforward benefit is dependent upon the future profitability of the Corporation. A portion of the NOL, approximately $18.0 million, and all of the tax credit carryforwards are also subject to the use limitations of Section 382 of the Internal Revenue Code since they originated prior to the December 2004 recapitalization of the Corporation. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized. The determination criteria for recognition of deferred tax benefits will include the assumption of future period taxable income based upon the projected profitability of the Corporation.

In the first nine months of 2011, management evaluated the deferred tax benefits associated with the net operating loss and tax credit carryforwards based upon the Corporation s foreseen ability to utilize the benefits of these carryforwards prior to their expiration. As a part of this analysis, management considered, among other things, current asset levels and projected loan and deposit growth, current interest rate spreads and projected net interest income levels, and other income and expense, along with management s ability to control expenses and the potential for increasing contributions of noninterest income. Management also considered the impact of nonperforming assets and future period charge-off activity relative to projected provisions. Based upon the analysis of projected taxable income and the probability of achieving these projected taxable income levels, no adjustment to the valuation allowance was deemed necessary.

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Subsequent to September 30, 2011, in deference to the loss recorded in the 2011 third quarter, an analysis of the deferred tax asset was performed in order to determine if there was any impairment relative to ultimate utilization during the carryforward period. As a part of this analysis, management reviewed projected levels of taxable income and assessed the probability of attaining these projected levels. Based upon this analysis, it was determined that there was no additional impairment of this deferred tax asset.

LIQUIDITY

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank s principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of $30.122 million in cash and due from balances, $12.000 million in federal funds sold and $26.031 million of unpledged investment securities. The Corporation has experienced significant deposit inflows during the first nine months of 2011. Management anticipates reducing liquidity levels in future periods through payments of maturing brokered deposits and funding loan growth.

Late in 2010 and early in 2011, the $35.000 million of FHLB borrowings matured. These borrowings were refinanced with the FHLB and now carry a weighted average maturity of three years and a weighted average rate of 1.75%.

During the first nine months of 2011, the Corporation decreased cash and cash equivalents by $7.403 million. As shown on the Corporation s condensed consolidated statement of cash flows, liquidity was impacted by cash used by investing activities, with net cash used for investment securities of $3.639 million and net cash used for loans of $14.855 million. Offsetting the decreases for investing activities were sources from financing activities, with a net increase in deposits of $18.279 million. The increase in deposits was composed of a decrease in brokered deposits of $39.390 million combined with an increase in bank deposits of $57.669 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30 to 90 day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

It is anticipated that during the remainder of 2011, the Corporation will fund anticipated loan production by reducing current balances of liquidity.

The Corporation s primary source of liquidity on a stand-alone basis is dividends from the Bank. The Bank is currently prohibited from paying dividends because of a deficit in retained earnings. The Bank, in order to pay dividends in future periods, will need to completely eliminate the negative balance of retained earnings through future profits.

Liquidity is managed by the Corporation through its Asset and Liability Committee (ALCO). The ALCO Committee meets monthly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank s liquidity is best illustrated by the mix in the Bank s core and noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $100,000. Noncore funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At September 30, 2011, the Bank s core deposits in relation to total funding were 85.6% compared to 71.0% at September 30, 2010. These ratios indicated at September 30, 2011, that the Bank has decreased its reliance on noncore deposits and borrowings to fund the Bank s long-term assets, namely loans and investments. The bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of September 30, 2011, the Bank had

$25.875 million of unsecured lines available and another $2.5 million available if secured. The bank believes that its liquidity position remains

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strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank s liquidity.

From a long-term perspective, the Corporation s plan includes strategies to increase core deposits in the Corporation s local markets. New deposit products and strategic advertising is expected to aid in efforts of management in growing core deposits. The Corporation s operating plan for 2011 called for augmenting local deposit growth efforts with wholesale CD funding, to the extent necessary.

CAPITAL AND REGULATORY

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of September 30, 2011, the Corporation and Bank were well capitalized. During the first nine months of 2011, total capitalization increased by $1.595 million.

The following table details sources of capital for the periods indicated (dollars in thousands):

	September 30, 2011	December 31, 2010	September 30, 2010
Capital Structure			
Shareholders equity	**$ 55,477**	$ 53,882	$ 55,987
Total capitalization	**$ 55,477**	$ 53,882	$ 55,987
Tangible capital	**$ 55,477**	$ 53,882	$ 55,987
Intangible Assets			
Core deposit premium	**$**	$	$
Other identifiable intangibles			
Total intangibles	**$**	$	$
Regulatory capital			
Tier 1 capital:			
Shareholders equity	**$ 55,477**	$ 53,882	$ 55,987
Net unrealized (gains) on available for sale securities	**(481)**	(612)	(681)
Less: disallowed deferred tax asset	**(7,400)**	(9,028)	(9,000)
Less: intangibles			
Total Tier 1 capital	**$ 47,596**	$ 44,242	$ 46,306
Tier 2 Capital:			

Allowable reserve for loan losses	**$ 5,114**	$ 4,890	$ 4,941
Qualifying long-term debt			
Total Tier 2 capital	**5,114**	4,890	4,941
Total capital	**$ 52,710**	$ 49,132	$ 51,247
Risk-adjusted assets	**$ 408,400**	$ 389,468	$ 394,780
Capital ratios:			
Tier 1 Capital to average assets	**9.73%**	9.25%	9.22%
Tier 1 Capital to risk weighted assets	**11.65%**	11.36%	11.73%
Total Capital to risk weighted assets	**12.97%**	12.62%	12.98%

Regulatory capital is not the same as shareholders equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes, such as acquisition intangibles and noncurrent deferred tax benefits.

Presented below is a summary of the capital position in comparison to generally applicable regulatory requirements:

	Shareholders Equity to Quarter-end Assets	Tangible Equity to Quarter-end Assets	Tier 1 Capital to Average Assets	Tier 1 Capital to Risk-Weighted Assets	Total Capital to Risk-Weighted Assets
Regulatory minimum for capital adequacy purposes	N/A	N/A	4.00%	4.00%	8.00%
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
The Corporation:					
September 30, 2011	**11.17%**	**11.17%**	**9.73%**	**11.65%**	**12.97%**
September 30, 2010	11.22%	11.22%	9.22%	11.73%	12.98%
The Bank:					
September 30, 2011	**10.46%**	**10.46%**	**8.79%**	**10.56%**	**11.81%**
September 30, 2010	10.16%	10.16%	8.10%	10.30%	11.55%

MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation s earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation s safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices such as the prime rate or rates paid on various government issued securities. In addition, the Corporation prices the majority of fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

The Corporation has established interest rate floors on approximately $180 million, or 63% of its variable rate commercial loans. These interest rate floors will result in a lag on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $76 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with substantially all of the remaining balances repricing in the next 100 basis point prime rate increase.

The Corporation also has $37.022 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has $227.0 million of transactional accounts, of which $53.7 million consists of non-interest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation s focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

Other deposit products have a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income. Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

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MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following time frames. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1- to 90-day time frame. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following is the Corporation s opportunities at September 30, 2011 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 279,376	$ 7,059	$ 29,144	$ 76,324	$ 391,903
Securities	5,329	5,103	22,137	4,453	37,022
Other (1)	12,010			3,060	15,070
Total interest-earning assets	296,715	12,162	51,281	83,837	443,995
Interest-bearing obligations:					
NOW, money market, savings, interest checking	173,214				173,214
Time deposits	17,057	53,431	73,280	263	144,031
Brokered CDs	27,686		6,391		34,077
Borrowings	5,000		30,000	997	35,997
Total interest-bearing obligations	222,957	53,431	109,671	1,260	387,319
Gap	$ 73,758	$ (41,269)	$ (58,390)	$ 82,577	$ 56,676
Cumulative gap	$ 73,758	$ 32,489	$ (25,901)	$ 56,676	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at September 30, 2011, the Corporation had a cumulative asset sensitivity gap position of $32.489 million within the one-year time frame. The Corporation s cumulative asset sensitive gap suggests that if market interest rates decline in the next twelve months, the Corporation would have a decrease in net interest income versus experiencing increased net interest income if rates were to increase. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2010, the Corporation had a cumulative liability sensitivity gap position of $1.258 million within the one-year time frame.

The borrowings in the gap analysis include $35.000 million of the FHLB advances that were refinanced in late 2010 and early 2011 to fixed rate advances. These borrowings now have a weighted average maturity of 3.0 years with a weighted average rate of 1.75%.

The Corporation s primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets and therefore has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation s interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking offices in Sault Ste. Marie, Michigan. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation.

OFF-BALANCE-SHEET RISK

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps, or options. However, the Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the condensed consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised.

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation s operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation s performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation s ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation s performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

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ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2011, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective at the reasonable assurance levels as of September 30, 2011.

Changes in Internal Control Over Financial Reporting

There were no changes in the Corporation s internal control over financial reporting that occurred during the quarter ended September 30, 2011 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

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
Exhibit 31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
Exhibit 32.1	Section 1350 Certification of Chief Executive Officer.
Exhibit 32.2	Section 1350 Certification of Chief Financial Officer.

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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.

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date: November 14, 2011

By: /s/ Paul D. Tobias
PAUL D. TOBIAS,
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
(principal executive officer)

By: /s/ Ernie R. Krueger
ERNIE R. KRUEGER
EVP/CHIEF FINANCIAL OFFICER
(principal financial and accounting officer)