MACKINAC FINANCIAL CORP /MI/
Form 10-K
March 30, 2017
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2016

OR

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

For the transition period from to

Commission File Number 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MICHIGAN	38-2062816
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 South Cedar Street

Manistique, Michigan 49854

(888) 343-8147

(Address, including Zip Code, and telephone number,

including area code, of registrant's principal executive offices)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, no par value	The NASDAQ Stock Market, LLC

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

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. Yes   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 definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

The aggregate market value of the common stock held by non-affiliates of the Registrant, based on a per share price of $11.01 as of June 30, 2016, was $42.498 million. As of March 28, 2017, there were outstanding, 6,294,930 shares of the Corporation's Common Stock (no par value).

Documents Incorporated by Reference:

Portions of the Corporation's Proxy Statement for the 2017 Annual Meeting of Shareholders are incorporated by reference into Part III of this Report.

Table of Contents

TABLE OF CONTENTS

PART I		2
Item 1.	Business	2
Item 1B.	Unresolved Staff Comments	12
Item 2.	Properties	12
Item 3.	Legal Proceedings	13
Item 4.	Mine Safety Disclosures	13
PART II		14
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities	14
Item 6.	Selected Financial Data	16
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	17
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	36
Item 8.	Financial Statements and Supplementary Data	40
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	80
Item 9A.	Controls and Procedures	80
Item 9B.	Other Information	80
PART III		81
Item 10.	Directors, Executive Officers, and Corporate Governance	81
Item 11.	Executive Compensation	81
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	81
Item 13.	Certain Relationships, Related Transactions and Director Independence	82
Item 14.	Principal Accountant Fees and Services	82
PART IV		83
Item 15.	Exhibits and Financial Statement Schedules	83

Table of Contents

PART I

Item 1.Business

Mackinac Financial Corporation (the "Corporation") was incorporated under the laws of the state of Michigan on December 16, 1974. The Corporation changed its name from "First Manistique Corporation" to "North Country Financial Corporation" on April 14, 1998. On December 16, 2004, the Corporation changed its name from North Country Financial Corporation to Mackinac Financial Corporation. The Corporation is headquartered and located in Manistique, Michigan. The mailing address of the Corporation is 130 South Cedar Street, Manistique, Michigan 49854.

In December of 2004, the Corporation was recapitalized with the net proceeds, approximately $26.2 million, from the issuance of $30 million of common stock in a private placement. Commensurate with this recapitalization, the Corporation changed its name from North Country Financial Corporation to Mackinac Financial Corporation, and its subsidiary bank adopted the "mBank" identity early in 2005.

On December 5, 2014, the Corporation completed its acquisition of Peninsula Financial Corporation ("PFC") and its wholly owned subsidiary, The Peninsula Bank. PFC had six branch offices and $126 million in assets as of the acquisition date. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a combination of cash payments and the issuance of shares of the Corporation's common stock to PFC shareholders. Each share of PFC's 288,000 shares of common stock was converted into the right to receive, at the shareholder's election and subject to certain limitations (i) approximately 3.64 shares of the Corporation's common stock, with cash paid in lieu of fractional shares, or (ii) cash at $46.13 per share of common stock. The conversion of PFC's shares resulted in the issuance of 695,361 shares of the Corporation's common stock and payment of $4.484 million in cash to the former PFC shareholders.

On April 29, 2016, the Corporation completed its acquisition of The First National Bank of Eagle River ("Eagle River.") Eagle River had three branch offices and approximately $125 million in assets as of the acquisition date. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $12.5 million.

On August 31, 2016, the Corporation completed its acquisition of Niagara Bancorporation ("Niagara") and its wholly owned subsidiary, First National Bank of Niagara. Niagara had four branch offices and approximately $67 million in assets. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $7.325 million.

The Corporation owns all of the outstanding stock of its banking subsidiary, mBank (the "Bank"). The Bank currently has 12 branch offices located in the Upper Peninsula of Michigan, 4 branch offices located in Michigan's Lower Peninsula and 7 branches in Wisconsin. The Bank maintains offices in the Michigan counties of: Chippewa, Grand Traverse, Luce, Manistee, Marquette, Menominee, Oakland, Otsego, and Schoolcraft. The Bank maintains offices in the Wisconsin counties of: Florence, Marinette, Oneida and Vilas. The Bank provides drive-in convenience at 17 branch locations and has 25 automated teller machines. The Bank has no foreign offices.

The Corporation also owns three non-bank subsidiaries: First Manistique Agency, presently inactive; First Rural Relending Company, a relending company for nonprofit organizations; and North Country Capital Trust, a statutory business trust which was formed solely for the issuance of trust preferred securities (none of which remain outstanding). The Bank represents the principal asset of the Corporation. The Bank has one wholly owned subsidiary, mBank Title Insurance Agency, LLC, which provided title insurance services until 2014 and is currently inactive. The Corporation and the Bank are engaged in a single industry segment, commercial banking, broadly defined to include commercial and retail banking activities, along with other permitted activities closely related to banking.

Operations

The principal business of the Corporation is the general commercial banking business, conducted through the Bank's provision of a full range of loan and deposit products. These banking services include customary retail and commercial banking services, including checking and savings accounts, time deposits, interest bearing transaction accounts, safe deposit facilities, real estate mortgage lending, commercial lending, commercial and governmental lease financing, and direct and indirect consumer financing. Funds for the Bank's operations are also provided by brokered deposits and

Table of Contents

through borrowings from the Federal Home Loan Bank ("FHLB") system, proceeds from the sale of loans and mortgage-backed and other securities, funds from repayment of outstanding loans and earnings from operations. Earnings depend primarily upon the difference between (i) revenues from loans, investments, and other interest-bearing assets and (ii) expenses incurred in payment of interest on deposit accounts and borrowings, an adequate allowance for loan losses, and general operating expenses.

Competition

Banking is a highly competitive business. The Bank competes for loans and deposits with other banks, savings and loan associations, credit unions, mortgage bankers, and investment firms in the scope and type of services offered, pricing of loans, interest rates paid on deposits, and number and location of branches, among other things. The Bank also faces competition for investors' funds from mutual funds and corporate and government securities.

The Bank competes for loans principally through interest rates and loan fees, the range and quality of the services it provides and the locations of its branches. In addition, the Bank actively solicits deposit-related clients and competes for deposits by offering depositors a variety of savings accounts, checking accounts, and other services.

Employees

As of December 31, 2016, the Corporation and its subsidiaries employed, in the aggregate, 222 employees. The Corporation provides its employees with comprehensive medical and dental benefit plans, a life insurance plan, and a 401(k) plan. None of the Corporation's employees are covered by a collective bargaining agreement with the Corporation. Management believes its relationship with its employees to be good.

Business

The Bank makes mortgage, commercial, and installment loans to customers throughout Michigan and Northeastern Wisconsin. Fees may be charged for these services. The Bank's most prominent concentration in the loan portfolio relates to commercial loans to entities within the real estate — operators of nonresidential buildings industry. This concentration represented $121.861 million or 22.42% of the commercial loan portfolio at December 31, 2016. The Bank also supports the service industry, with its hospitality and related businesses, as well as gaming, forestry, restaurants, farming, fishing, and many other activities important to growth in the regions we service. The economy of the Bank's market areas is affected by summer and winter tourism activities.

The Bank has become a premier SBA/USDA lender in our regions. Many of these SBA/USDA guaranteed loans are sold at a premium on the secondary market, with the Bank retaining the servicing. The Bank does not sell the loan guarantees on every credit, rather only those where acceptable market rates are above par.

The Bank also offers various consumer loan products including installment, mortgages and home equity loans. In addition to making consumer portfolio loans, the Bank engages in the business of making residential mortgage loans for sale to the secondary market.

On December 5, 2014, upon the consummation of the merger of PFC with and into the Corporation, the Corporation consolidated Peninsula Bank with the Bank. The acquisition nearly doubled the bank's presence in the Upper Peninsula to 13 total branches and increased the total number of branches in Michigan from 11 to 17.

On April 29, 2016, the Corporation consummated the merger of Eagle River into the Bank. On August 31, 2016, upon consummation of the purchase of all outstanding stock of Niagara Bancorporation, Inc., the Corporation consolidated First National Bank of Niagara with the Bank. These acquisitions increased the Bank's presence to 23 branches.

The Bank's primary source for lending, investments, and other general business purposes is deposits. The Bank offers a wide range of interest bearing and non-interest bearing accounts, including commercial and retail checking accounts, negotiable order of withdrawal ("NOW") accounts, money market accounts with limited transactions, individual retirement accounts, regular interest-bearing statement savings accounts, certificates of deposit with a range of maturity date options, and accessibility to a customer's deposit relationship through online banking. The sources of deposits are residents, businesses and employees of businesses within the Bank's market areas, obtained through the personal solicitation of the Bank's officers and directors, direct mail solicitation and limited advertisements published in the local

Table of Contents

media. The Bank also utilizes the wholesale deposit market for any shortfalls in loan funding. No material portions of the Bank's deposits have been received from a single person, industry, group, or geographical location.

The Bank is a member of the FHLB. The FHLB provides an additional source of liquidity and long-term funds. Membership in the FHLB has provided access to attractive rate advances, as well as advantageous lending programs. The Community Investment Program makes advances to be used for funding community-oriented mortgage lending, and the Affordable Housing Program grants advances to fund lending for long-term low and moderate income owner occupied and affordable rental housing at subsidized interest rates.

The Bank has secondary borrowing lines of credit available to respond to deposit fluctuations and temporary loan demands. The unsecured lines totaled $48.0 million at December 31, 2016, with additional amounts available if collateralized.

As of December 31, 2016, the Bank had no material risks relative to foreign sources. See the "Interest Rate Risk" and "Foreign Exchange Risk" sections in Management's Discussion and Analysis of Financial Condition and Results of Operations under Item 7 below, for details on the Corporation's foreign account activity.

Compliance with federal, state, and local statutes and/or ordinances relating to the protection of the environment is not expected to have a material effect upon the Bank's capital expenditures, earnings, or competitive position.

Supervision and Regulation

As a registered bank holding company, the Corporation is subject to regulation and examination by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") under the Bank Holding Company Act, as amended (the "BHCA"). The Bank is subject to regulation and examination by the Michigan Department of Insurance and Financial Services (the "DIFS") and the Federal Deposit Insurance Corporation (the "FDIC").

Under the BHCA, the Corporation is subject to periodic examination by the Federal Reserve Board, and is required to file with the Federal Reserve Board periodic reports of its operations and such additional information as the Federal Reserve Board may require. In accordance with Federal Reserve Board policy, the Corporation is expected to act as a source of financial strength to the Bank and to commit resources to support the Bank in circumstances where the Corporation might not do so absent such policy. In addition, there are numerous federal and state laws and regulations which regulate the activities of the Corporation, the Bank and the non-bank subsidiaries, including requirements and limitations relating to capital and reserve requirements, permissible investments and lines of business, transactions with affiliates, loan limits, mergers and acquisitions, issuances of securities, dividend payments, inter-affiliate

liabilities, extensions of credit and branch banking.

Federal banking regulatory agencies have established risk-based capital guidelines for banks and bank holding companies that are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies. The resulting capital ratios represent qualifying capital as a percentage of total risk-weighted assets and off-balance sheet items. The guidelines are minimums, and the federal regulators have noted that banks and bank holding companies contemplating expansion programs should not allow expansion to diminish their capital ratios and should maintain all ratios well in excess of the minimums. The current ratios have recently been significantly adjusted as discussed under "Basel III" below.

The Federal Deposit Insurance Corporation Improvement Act contains "prompt corrective action" provisions pursuant to which banks are to be classified into one of five categories based upon capital adequacy, ranging from "well capitalized" to "critically undercapitalized" and which require (subject to certain exceptions) the appropriate federal banking agency to take prompt corrective action with respect to an institution which becomes "significantly undercapitalized" or "critically undercapitalized". The FDIC also, after an opportunity for a hearing, has authority to downgrade an institution from "well capitalized" to "adequately capitalized" or to subject an "adequately capitalized" or "undercapitalized" institution to the supervisory actions applicable to the next lower category, for supervisory concerns. Information pertaining to the Corporation's and the Bank's capital is contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 below, as well as in Note 16 to the Corporation's Consolidated Financial Statements in Item 8 below.

Table of Contents

Current federal law provides that adequately capitalized and managed bank holding companies from any state may acquire banks and bank holding companies located in any other state, subject to certain conditions.

In 1999, Congress enacted the Gramm-Leach-Bliley Act ("GLBA"), which eliminated certain barriers to and restrictions on affiliations between banks and securities firms, insurance companies and other financial service organizations. Among other things, GLBA repealed certain Glass-Steagall Act restrictions on affiliations between banks and securities firms, and amended the BHCA to permit bank holding companies that qualify as "financial holding companies" to engage in a broad list of "financial activities," and any non-financial activity that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines is "complementary" to a financial activity and poses no substantial risk to the safety and soundness of depository institutions or the financial system. GLBA treats lending, insurance underwriting, insurance company portfolio investment, financial advisory, securities underwriting, dealing and market-making, and merchant banking activities as financial in nature for this purpose.

Under GLBA, a bank holding company may become certified as a financial holding company by filing a notice with the Federal Reserve Board, together with a certification that the bank holding company meets certain criteria, including capital, management, and Community Reinvestment Act requirements. The Corporation is not currently required to qualify as a financial holding company.

Privacy Restrictions

GLBA, in addition to the previously described changes in permissible non-banking activities permitted to banks, bank holding companies and financial holding companies, also requires financial institutions in the U.S. to provide certain privacy disclosures to customers and consumers, to comply with certain restrictions on sharing and usage of personally identifiable information, and to implement and maintain commercially reasonable customer information safeguarding standards. The Corporation believes that it complies with all provisions of GLBA and all implementing regulations, and the Bank has developed appropriate policies and procedures to meet its responsibilities in connection with the privacy provisions of GLBA.

The USA PATRIOT Act

In 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act"). The USA PATRIOT Act is designed to deny terrorists and criminals the ability to obtain access to the United States financial system, and has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The USA PATRIOT Act mandates financial services companies to implement additional policies and procedures with respect to, or additional measures designed to address, any or all of the following matters, among others: money laundering, terrorist financing, identifying and reporting suspicious activities and currency transactions, and currency

crimes.

Sarbanes-Oxley Act

On July 30, 2002, President Bush signed into law The Sarbanes-Oxley Act of 2002. This legislation addresses accounting oversight and corporate governance matters, including:

- The creation of a five-member oversight board that will set standards for accountants and have investigative and disciplinary powers;
- The prohibition of accounting firms from providing various types of consulting services to public clients and requiring accounting firms to rotate partners among public client assignments every five years;
- Increased penalties for financial crimes;
- Expanded disclosure of corporate operations and internal controls and certification of financial statements;
- Enhanced controls on, and reporting of, insider training; and
- Prohibition on lending to officers and directors of public companies, although the Bank may continue to make these loans within the constraints of existing banking regulations.

Among other provisions, Section 302(a) of the Sarbanes-Oxley Act requires that our Chief Executive Officer and Chief Financial Officer certify that our quarterly and annual reports do not contain any untrue statement or omission of a

Table of Contents

material fact. Specific requirements of the certifications include having these officers confirm that they are responsible for establishing, maintaining and regularly evaluating the effectiveness of our disclosure controls and procedures; they have made certain disclosures to our auditors and Audit Committee about our internal controls; and they have included information in our quarterly and annual reports about their evaluation and whether there have been significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to their evaluation.

In addition, Section 404 of the Sarbanes-Oxley Act and the SEC's rules and regulations thereunder require our management to evaluate, with the participation of our principal executive and principal financial officers, the effectiveness, as of the end of each fiscal year, of our internal control over financial reporting. Our management must then provide a report of management on our internal over financial reporting that contains, among other things, a statement of their responsibility for establishing and maintaining adequate internal control over financial reporting, and a statement identifying the framework they used to evaluate the effectiveness of our internal control over financial reporting.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") into law. The Dodd-Frank Act resulted in sweeping changes in the regulation of financial institutions aimed at strengthening safety and soundness for the financial services sector. A summary of certain provisions of the Dodd-Frank Act is set forth below:

· Increased Capital Standards and Enhanced Supervision.

The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. These new standards are described below. The Dodd-Frank Act also increased regulatory oversight, supervision and examination of banks, bank holding companies and their respective subsidiaries by the appropriate regulatory agency.

· Federal Deposit Insurance.

The Dodd-Frank Act made permanent the $250,000 deposit insurance limit for insured deposits and provided unlimited federal deposit insurance on noninterest bearing transaction accounts at all insured depository institutions through December 31, 2012. Subsequent to 2012, these amounts reverted from unlimited insurance to $250,000 coverage per separately insured depositor. The Dodd-Frank Act also changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible equity, eliminated the ceiling on the size of the Deposit Insurance Fund (the "DIF") and increased the floor on the size of the DIF.

· The Consumer Financial Protection Bureau (“CFPB”).

The Dodd-Frank Act centralized responsibility for consumer financial protection by creating a new agency, the CFPB, responsible for implementing, examining and, for large financial institutions of $10 billion or more in total assets, enforcing compliance with federal consumer financial laws. Because we have under $10 billion in total assets, however, the Federal Deposit Insurance Corporation will still continue to examine us at the federal level for compliance with such laws.

· Interest on Demand Deposit Accounts.

The Dodd-Frank Act repealed the prohibition on the payment of interest on demand deposit accounts effective July 21, 2011, thereby permitting depository institutions to now pay interest on business checking and other accounts.

· Mortgage Reform.

The Dodd-Frank Act provided for mortgage reform addressing a customer’s ability to repay, restricted variable-rate lending by requiring the ability to repay to be determined for variable rate loans by using

Table of Contents

the maximum rate that will apply during the first five years of a variable-rate loan term, and made more loans subject to requirements for higher-cost loans, new disclosures and certain other restrictions.

· Interstate Branching.

The Dodd-Frank Act allows banks to engage in de novo interstate branching, a practice that was previously significantly limited.

· Interchange Fee Limitations.

The Dodd-Frank Act gave the Federal Reserve Board the authority to establish rules regarding interchange fees charged for electronic debit transactions by a payment card issuer that, together with its affiliates, has assets of $10 billion or more and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The Federal Reserve Board has rules under this provision that limit the swipe fees that a debit card issuer can charge a merchant for a transaction to the sum of 21 cents and five basis points times the value of the transaction, plus up to one cent for fraud prevention costs. While we are not directly subject to such regulations since our total assets do not exceed $10 billion, these regulations may impact our ability to compete with larger institutions who are subject to the restrictions.

The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States and requires the CFPB and other federal agencies to implement many new and significant rules and regulations in addition to those discussed above. The CFPB has issued significant new regulations that impact consumer mortgage lending and servicing. Those regulations became effective in January 2014. In addition, the CFPB issued new regulations that changed the disclosure requirements and forms used under the Truth in Lending Act and Real Estate Settlement and Procedures Act effective October 3, 2015. Compliance with these new laws and regulations and other regulations under consideration by the CFPB will likely result in additional costs, which could be significant and could adversely impact our results of operations, financial condition or liquidity.

Basel III

On July 2, 2013, the Federal Reserve and OCC approved a final rule to establish a new comprehensive regulatory capital framework for all US banking organizations, with an effective date of January 1, 2015. The Regulatory Capital Framework ("Basel III") implements several changes to the US regulatory capital framework required by the Dodd-Frank Act. The new US capital framework imposes higher minimum capital requirements, additional capital buffers above those minimum requirements, a more restrictive definition of capital, and higher risk weights for various enumerated classifications of assets, the combined impact of which effectively results in substantially more demanding capital standards for US banking organizations.

The Basel III final rule establishes a common equity Tier 1 capital ("CET1") requirement, a Tier 1 capital requirement of 6.0% and an 8.0% total capital requirement. The new CET1 and minimum Tier 1 capital requirements became effective January 1, 2015. In addition to these minimum risk-based capital ratios, the Basel III final rule requires that all banking organizations maintain a "capital conservation buffer" consisting of CET1 in an amount equal to 2.5% of risk-weighted assets in order to avoid restrictions on their ability to make capital distributions and to pay certain discretionary bonus payments to executive officers. In order to avoid those restrictions, the capital conservation buffer effectively increased the minimum CET1 capital, Tier 1 capital and total capital ratios for US banking organizations to 7.0%, 8.5% and 10.5%, respectively. Banking organizations with capital levels that fall within the buffer will be required to limit dividends, shares repurchases or redemptions (unless replaced within the same calendar quarter by capital instruments of

Table of Contents

equal or higher quality), and discretionary bonus payments. The capital conservation buffer is phased in over a 5-year period, beginning January 1, 2016.

	Adequately Capitalized Requirement	Well-Capitalized Requirement	Well-Capitalized with Buffer, fully phased in 2019
Leverage	4.0%	5.0%	5.0%
CET1	4.5%	6.5%	7.0%
Tier 1	6.0%	8.0%	8.5%
Total Capital	8.0%	10.0%	10.5%

As required by Dodd-Frank, the Basel III final rule requires that capital instruments such as trust preferred securities and cumulative preferred shares be phased out of Tier 1 capital by January 1, 2016, for banking organizations that had $15 billion or more in total consolidated assets as of December 31, 2009 and permanently grandfathers as Tier 1 capital such instruments issued by these smaller entities prior to May 19, 2010 (provided they do not exceed 25% of Tier 1 capital).

The Basel III final rule provides banking organizations under $250 billion in total consolidated assets or under $10 billion in foreign exposures with a one-time “opt-out” right to continue excluding Accumulated Other Comprehensive income from CET1 capital. The election to opt-out must be made on the banking organization’s first Call Report filed after January 1, 2015. The Corporation has elected to opt-out and continues to exclude Accumulated Other Comprehensive Income from its regulatory capital.

The Basel III final rule requires that goodwill and other intangible assets (other than mortgage servicing assets), net of associated deferred tax liabilities, be deducted from CET1 capital. Additionally, deferred tax assets that arise from net operating loss and tax credit carryforwards, net of associated deferred tax liabilities and valuation allowances, are fully deducted from CET1 capital. However, deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks, along with mortgage servicing assets and “significant” (defined as greater than 10% of the issued and outstanding common stock of the unconsolidated financial institution) investments in the common stock of unconsolidated “financial institutions” are partially includible in CET1 capital, subject to deductions defined in the final rule.

Information regarding the Corporation and the Bank’s regulatory capital can be found in Note 16 – Regulatory Matters in the financial statements included herein.

Monetary Policy

The earnings and business of the Corporation and the Bank depends on interest rate differentials. In general, the difference between the interest rates paid by the Bank to obtain its deposits and other borrowings, and the interest rates received by the Bank on loans extended to its customers and on securities held in the Bank's portfolio, comprises the major portion of the Bank's earnings. These rates are highly sensitive to many factors that are beyond the control of the Bank, and accordingly, its earnings and growth will be subject to the influence of economic conditions, generally, both domestic and foreign, including inflation, recession, unemployment, and the monetary policies of the Federal Reserve Board. The Federal Reserve Board implements national monetary policies designed to curb inflation, combat recession, and promote growth through, among other means, its open-market dealings in US government securities, by adjusting the required level of reserves for financial institutions subject to reserve requirements, through adjustments to the discount rate applicable to borrowings by banks that are members of the Federal Reserve System, and by adjusting the Federal Funds Rate, the rate charged in the interbank market for purchase of excess reserve balances. In addition, legislative and economic factors can be expected to have an ongoing impact on the competitive environment within the financial services industry. The nature and timing of any future changes in such policies and their impact on the Bank cannot be predicted with certainty.

Table of Contents

Selected Statistical Information

I.Distribution of Assets, Obligations, and Shareholders' Equity; Interest Rates and Interest Differential

The key components of net interest income, the daily average balance sheet for each year — including the components of earning assets and supporting obligations — the related interest income on a fully tax equivalent basis and interest expense, as well as the average rates earned and paid on these assets and obligations is contained under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" under Item 7 below.

An analysis of the changes in net interest income from period-to-period and the relative effect of the changes in interest income and expense due to changes in the average balances of earning assets and interest-bearing obligations and changes in interest rates is contained under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" under Item 7 below.

II.Investment Portfolio

A.Investment Portfolio Composition

The following table presents the carrying value of investment securities available for sale as of December 31 of the years set forth below (dollars in thousands):

	2016	2015	2015
US Treasuries	$ —	$ —	$ 5,280
Corporate	19,910	12,646	12,674
Equity	500	—	—
US Agencies	23,952	27,377	22,717
US Agencies - MBS	16,833	3,759	13,688
State and political subdivisions	25,078	9,946	11,473
Total	$ 86,273	$ 53,728	$ 65,832

B.Relative Maturities and Weighted Average Interest Rates

The following table presents the maturity schedule of securities held and the weighted average yield of those securities, as of December 31, 2016 (fully taxable equivalent, dollars in thousands):

	In one year or less	After one, but within five years	After five, but within ten years	Over ten years	Total	Weighted Average Yield (1)
US Treasuries	$ —	$ —	$ —	$ —	$ —	—%
US Agencies	401	23,051	500	—	23,952	1.62%
US Agencies - MBS	305	12,632	1,996	1,900	16,833	2.03%
Corporate	—	16,365	3,545	—	19,910	2.68%
Equity	—	—	—	500	500	4.61%
State and political subdivisions	265	8,664	10,008	6,141	25,078	3.54%
Total	$ 971	$ 60,712	$ 16,049	$ 8,541	$ 86,273	
Weighted average yield (1)	3.19%	2.04%	3.72%	3.50%	2.51%	

(1) Weighted average yield includes the effect of tax-equivalent adjustments using a 34% tax rate.

Table of Contents

III.Loan Portfolio

A.Type of Loans

The following table sets forth the major categories of loans outstanding for each category at December 31 (dollars in thousands):

	2016	2015	2014	2013	2012
Commercial real estate	$ 389,420	$ 312,805	$ 315,387	$ 268,809	$ 244,966
Commercial, financial and agricultural	142,648	122,140	101,895	79,655	80,646
One to four family residential real estate	205,945	140,502	139,553	103,768	87,948
Construction	23,731	27,100	25,715	17,799	24,694
Consumer	20,113	15,847	18,385	13,801	10,923
Total	$ 781,857	$ 618,394	$ 600,935	$ 483,832	$ 449,177

B.Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table presents the remaining maturity of total loans outstanding for the categories shown at December 31, 2016, based on scheduled principal repayments (dollars in thousands):

	Commercial Real Estate	Commercial, Financial, and Agricultural	1-4 Family Residential Real Estate	Consumer	Construction	Total
In one year or less:						
Variable interest rates	$ 19,601	$ 49,296	$ 2,199	$ 2,446	$ 2,099	$ 75,641
Fixed interest rates	35,675	14,934	10,240	1,464	11,693	74,006
After one year but within five years:						
Variable interest rates	82,883	16,230	3,248	56	2,212	104,629
Fixed interest rates	191,815	43,108	24,842	12,431	4,593	276,789
After five years:						

Variable interest rates	26,647	7,532	144,726	101	2,900	181,906
Fixed interest rates	32,799	11,548	20,690	3,615	234	68,886
Total	$ 389,420	$ 142,648	$ 205,945	$ 20,113	$ 23,731	$ 781,857

C.Risk Elements

The following table presents a summary of nonperforming assets and problem loans as of December 31 (dollars in thousands):

	2016	2015	2014	2013	2012
Nonaccrual loans	$ 4,124	$ 2,353	$ 3,939	$ 1,406	$ 4,687
Interest income recorded during period for nonaccrual loans	437	795	—	—	54
Accruing loans past due 90 days or more	—	32	—	—	—
Restructured loans on nonaccrual not included above	165	154	3,105	614	—

10

Table of Contents

IV.Summary of Loan Loss Experience

A.Analysis of the Allowance for Loan Losses

Changes in the allowance for loan losses arise from loans charged off, recoveries on loans previously charged off by loan category, and additions to the allowance for loan losses through provisions charged to expense. Factors which influence management's judgment in determining the provision for loan losses include establishing specified loss allowances for selected loans (including large loans, nonaccrual loans, and problem and delinquent loans) and consideration of historical loss information and local economic conditions.

The following table presents information relative to the allowance for loan losses for the years ended December 31, (dollars in thousands):

	2016	2015	2014	2013	2012
Balance of allowance for loan losses at beginning of period	$ 5,004	$ 5,140	$ 4,661	$ 5,218	$ 5,251
Loans charged off:					
Commercial	477	1,801	682	2,171	775
One to four family residential real estate	133	142	290	141	399
Consumer	113	87	74	120	82
Total loans charged off	723	2,030	1,046	2,432	1,256
Recoveries of loans previously charged off:					
Commercial	102	662	259	150	253
One to four family residential real estate	5	2	22	26	7
Consumer	32	26	44	24	18
Total recoveries	139	690	325	200	278
Net loans charged off	584	1,340	721	2,232	978
Provisions charged to expense	600	1,204	1,200	1,675	945
Balance at end of period	$ 5,020	$ 5,004	$ 5,140	$ 4,661	$ 5,218
Average loans outstanding	703,047	602,904	509,749	462,500	422,440
Ratio of net charge-offs	.08%	.22%	.14%	.48%	0.23

11

Table of Contents

B.Allocation of Allowance for Loan Losses

The allocation of the allowance for loan losses for the years ended December 31, is shown on the following table. The percentages shown represent the percent of each loan category to total loans (dollars in thousands):

	2016 Amount	%	2015 Amount	%	2014 Amount	%	2013 Amount	%	2012 Amount	%
Commercial real estate	$ 1,345	49.81%	$ 1,611	50.58%	$ 2,813	52.48%	$ 1,849	55.56%	$ 3,267	54.54%
Commercial, financial, and agricultural	614	18.25	645	19.75	1,539	16.96	1,378	16.46	692	17.95
Commercial construction	57	1.47	79	2.48	142	2.71	80	2.25	125	3.84
1-4 family residential real estate	296	26.34	274	22.72	285	23.22	516	21.45	980	19.58
Consumer construction	6	1.56	7	1.91	6	1.57	25	1.43	—	1.66
Consumer	90	2.57	64	2.56	13	3.06	148	2.85	—	2.43
Unallocated general reserves	2,612	—	2,324	—	342	—	665	—	154	—
Total	$ 5,020	100.00%	$ 5,004	100.00%	$ 5,140	100.00%	$ 4,661	100.00%	$ 5,218	100.00%

V.Deposits

Deposit information is contained in Note 7 to the Corporation’s Consolidated Financial Statements in Item 8 of this Form 10-K below.

VI.Return on Equity and Assets

See Item 6 of this Form 10-K, “Selected Financial Data”

VII.Financial Instruments with Off-Balance Sheet Risk

Information relative to commitments, contingencies, and credit risk are discussed in Note 19 to the Corporation’s Consolidated Financial Statements contained in Item 8 of this Form 10-K.

Item 1B.Unresolved Staff Comments

None.

Item 2.Properties

The Corporation’s headquarters are located at 130 South Cedar Street, Manistique, Michigan 49854. The headquarters location is owned by the Corporation and not subject to any mortgage.

All of the branch locations are designed for use and operation as a bank, are well maintained, and are suitable for current operations. Of the 23 branch locations 17 are owned and 6 are leased. The Corporation has additional office space to

Table of Contents

house administrative operational support. The Corporation also leases two offices that support our commercial lending. Below is a comprehensive listing of our branch locations:

Aurora	W563 County Road N	Aurora, WI	Owned
Birmingham	260 E. Brown Street, Suite 300	Birmingham, MI	Leased
Eagle River	400 E. Wall Street	Eagle River, WI	Owned
Escanaba	2224 N. Lincoln Road	Escanaba, MI	Owned
Florence	845 Central Ave	Florence, WI	Owned
Gaylord	1955 S. Otsego Avenue	Gaylord, MI	Owned
Ishpeming - Downtown	100 S. Main Street	Ishpeming, MI	Owned
Ishpeming - Jubilee	900 US 41 West	Ishpeming, MI	Leased
Ishpeming - West	US West & 170 N. Daisy Street	Ishpeming, MI	Leased
Kaleva	14429 Wuoksi Avenue	Kaleva, MI	Owned
Manistique	130 South Cedar Street	Manistique, MI	Owned
Manistique - Jack’s	735 E. Lakeshore Drive	Manistique, MI	Leased
Marquette	857 W. Washington Street	Marquette, MI	Leased
Marquette - McClellan	175 S. McClellan Avenue	Marquette, MI	Owned
Negaunee	440 US 41 East	Negaunee, MI	Leased
Newberry	414 Newberry Avenue	Newberry, MI	Owned
Niagara	900 Roosevelt Road	Niagara, WI	Owned
Sault Ste. Marie	138 Ridge Street	Sault Ste. Marie, MI	Owned
Spread Eagle	493 US Highway 2	Spread Eagle, WI	Owned
Stephenson	S216 Menominee Street	Stephenson, MI	Owned
St. Germain	240 HWY 70 East	St. Germain, WI	Owned
Three Lakes	1811 Superior Street	Three Lakes, WI	Owned
Traverse City	3530 North Country Drive	Traverse City, MI	Owned

Item 3.Legal Proceedings

There are no pending material legal proceedings to which the Corporation is a party or to which any of its property was subject, except for proceedings which arise in the ordinary course of business. In the opinion of management, pending legal proceedings will not have a material effect on the consolidated financial position or results of operations of the Corporation.

Item 4.Mine Safety Disclosures

Not applicable.

13

Table of Contents

PART II

Item 5.Market for Registrant’s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

MARKET INFORMATION

(Unaudited)

The Corporation’s common stock is traded on the NASDAQ Capital Market under the symbol MFNC. The following table sets forth the range of high and low trading prices of the Corporation’s common stock from January 1, 2015 through December 31, 2016, as reported by NASDAQ.

	For the Quarter Ended			
	March 31	June 30	September 30	December 31
2016				
High	$ 11.69	$ 11.97	$ 11.98	$ 14.07
Low	9.90	10.00	10.64	11.00
Close	10.25	11.01	11.49	13.47
Dividends declared per share	0.100	0.100	0.100	0.100
Book value	12.42	12.38	12.50	12.55
2015				
High	$ 12.75	$ 12.25	$ 10.96	$ 12.03
Low	10.18	10.12	9.90	9.91
Close	11.39	10.53	10.10	11.49
Dividends declared per share	0.075	0.075	0.100	0.100

The Corporation had approximately 1,600 shareholders of record as of March 24, 2017. A substantially greater number of holders are beneficial owners whose shares are held of record by banks, brokers and other nominees.

Dividends

The holders of the Corporation's common stock are entitled to dividends when, and if declared by the Board of Directors of the Corporation, out of funds legally available for that purpose. In determining dividends, the Board of Directors considers the earnings, capital requirements and financial condition of the Corporation and its subsidiary bank, along with other relevant factors. The Corporation's principal source of funds for cash dividends is the dividends paid by the Bank. The ability of the Corporation and the Bank to pay dividends is subject to regulatory restrictions and requirements. In 2016, the Bank paid dividends to the Corporation totaling $11.825 million.

Issuer Purchases of Equity Securities

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. Shares repurchased to date are covered by Board authorizations made and publically announced for $600,000 on February 27, 2013, an additional $600,000 on December 17, 2013, and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date. The Corporation purchased 14,000 shares for $.150 million in 2016, 102,455 shares for $1.122 million in 2015, 13,700 shares of its common stock for $.143 million in 2014, and $.509 million in 2013. There were no repurchases made during the 4th quarter of 2016. As of December 31, 2016 the Corporation had $25,000 remaining of the previously authorized buyback amount.

For information regarding securities authorized for issuance under equity compensation plans, see Item 12 of this Form 10-K.

Table of Contents

Performance Graph

Shown below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on the Corporation's common stock with that of the cumulative total return on the NASDAQ Bank Index and the NASDAQ Composite Index for the five-year period ended December 31, 2016. The following information is based on an investment of $100, on December 31, 2011 in the Corporation's common stock, the NASDAQ Bank Index, and the NASDAQ Composite Index, with dividends reinvested.

This graph and other information contained in this section shall not be deemed to be "soliciting" material or to be "filed" with the Securities and Exchange Commission or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended.

Table of Contents

Item 6.Selected Financial Data

SELECTED FINANCIAL DATA

(Unaudited)

(Dollars in Thousands, Except Per Share Data)

	Year Ended December 31,				
	2016	2015	2014	2013	2012
SELECTED FINANCIAL CONDITION DATA:					
Total assets	$ 983,520	$ 739,269	$ 743,785	$ 572,800	$ 545,980
Loans	781,857	618,394	600,935	483,832	449,177
Securities	86,273	53,728	65,832	44,388	43,799
Deposits	823,512	610,323	606,973	466,299	434,557
Borrowings	67,579	45,754	49,846	37,852	35,925
Common shareholders’ equity	78,609	76,602	73,996	65,249	61,448
Total shareholders’ equity	78,609	76,602	73,996	65,249	72,448
SELECTED OPERATIONS DATA:					
Interest income	$ 37,983	$ 33,513	$ 27,669	$ 25,523	$ 24,427
Interest expense	4,885	4,393	4,142	4,124	4,603
Net interest income	33,098	29,120	23,527	21,399	19,824
Provision for loan losses	600	1,204	1,200	1,675	945
Net security gains (losses)	150	455	54	73	—
Other income	4,003	3,434	3,058	3,865	4,043
Other expenses	(29,885)	(23,876)	(22,610)	(18,128)	(16,757)
Income before income taxes	6,766	7,929	2,829	5,534	6,165
Provision (credit) for income taxes	2,283	2,333	1,129	(403)	(922)
Net income	4,483	5,596	1,700	5,937	7,087
Preferred dividend and accretion of discount	—	—	—	308	629
Net income available to common shareholders	$ 4,483	$ 5,596	$ 1,700	$ 5,629	$ 6,458
PER SHARE DATA:					
Earnings — Basic	$ 0.72	$ 0.90	$ 0.30	$ 1.01	$ 1.51
Earnings — Diluted	0.72	0.89	0.30	1.00	1.46
Cash dividends declared	0.40	0.35	0.225	0.17	0.04
Book value	12.55	12.32	11.81	11.77	11.05
Tangible book value	11.29	11.54	11.01	11.77	11.05
Market value - closing price at year end	13.47	11.49	11.85	9.90	7.09

FINANCIAL RATIOS:					
Return on average common equity	5.73%	7.41%	2.57%	9.07%	12.43%
Return on average total equity	5.73	7.41	2.57	8.26	10.26
Return on average assets	0.52	0.76	0.28	1.01	1.23
Dividend payout ratio	55.56	41.67	75.00	16.83	2.65
Average equity to average assets	9.05	10.23	10.94	12.28	11.95
Net interest margin	4.19	4.30	4.19	4.17	4.17
ASSET QUALITY RATIOS:					
Nonperforming loans to total loans	1.14%	.41%	.66%	.42%	1.04%
Nonperforming assets to total assets	0.91	0.66	0.93	0.58	1.45
Allowance for loan losses to total loans	0.64	0.81	0.86	0.96	1.16
Allowance for loan losses to nonperforming loans	121.73	197.09	130.49	230.29	111.33
Net charge-offs to average loans	0.08	0.22	0.14	0.48	0.23
Texas ratio	11.76	6.34	9.37	5.59	10.25

Table of Contents

Item 7.Management's Discussion and Analysis of Financial Condition and Results of Operations

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:

Risk Factors

Risks Related to our Lending and Credit Activities

· Our business may be adversely affected by conditions in the financial markets and economic conditions generally, as our borrowers' ability to repay loans and the value of the collateral securing our loans decline.

· Weakness in the markets for residential or commercial real estate, including the secondary residential mortgage loan markets, could reduce our net income and profitability.

· As a community banking organization, the Corporation's success depends upon local and regional economic conditions and has different lending risks than larger banks.

We manage our credit exposure through careful monitoring of loan applicants and loan concentrations in particular industries and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is an estimate based on experience, judgment and expectations regarding borrowers and economic conditions, as well as regulator judgments. We can make no assurance that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, profitability or financial condition.

- Our allowance for loan losses may be insufficient.

Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of our control, may require an increase in our allowance for loan losses.

Risks Related to Our Operations

- We are subject to interest rate risk.

Our earnings and cash flows are largely dependent upon our net interest income, which is the difference between interest income on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. There are many factors which influence interest rates that are beyond our control, including but not limited to general economic conditions and governmental policy, and in particular, the policies of the FRB.

- Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.

Table of Contents

· We may not realize the expected benefits of our recent acquisition of The First National Bank of Eagle River and the First National Bank of Niagara.

· Our controls and procedures may fail or be circumvented.

· Impairment of deferred income tax assets could require charges to earnings, which could result in an adverse impact on our results of operations.

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some valuation allowance is necessary, which requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carry back and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g. cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2016, net deferred tax assets are approximately $10.035 million. If a valuation allowance becomes necessary with respect to such balance, it could have a material adverse effect on our business, results of operations and financial condition.

· Our information systems may experience an interruption of breach in security.

Risks Related to Legal and Regulatory Compliance

· We operate in a highly regulated environment, which could increase our cost structure or have other negative impacts on our operations.

Strategic Risks

· Maintaining or increasing our market share may depend on lowering prices and market acceptance of new products and services.

· Future growth or operating results may require us to raise additional capital but that capital may not be available.

Reputation Risks

- Unauthorized disclosure of sensitive of confidential client or customer information, whether through a breach of our computer system or otherwise, could severely harm our business.

Liquidity Risks

- We could experience an unexpected inability to obtain needed liquidity.

The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. We seek to ensure our funding needs are met by maintaining an appropriate level of liquidity through asset/liability management.

Risks Related to an Investment in Our Common Stock

- Limited trading activity for shares of our common stock may contribute to price volatility.

- Our securities are not an insured deposit.

Table of Contents

· You may not receive dividends on your investment in common stock.

Our ability to pay dividends is dependent upon our receipt of dividends from the Bank, which is subject to regulatory restrictions. Such restrictions, which govern state-chartered banks, generally limit the payment of dividends on bank stock to the bank's undivided profits after all payments of all necessary expenses, provided that the bank's surplus amounts to at least 20% of its capital after payment of the dividend.

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.

Overview

The following discussion and analysis presents the more significant factors affecting the Corporation's financial condition as of December 31, 2016 and 2015 and the results of operations for 2014 through 2016. This discussion also covers asset quality, liquidity, interest rate sensitivity, and capital resources for the years 2015 and 2016. 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. Throughout this discussion, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

The acquisition of Eagle River in April 2016 added approximately $125 million in assets, $81 million in loan balances and $105 million in deposits to the Corporation. The acquisition of Niagara added $67 million in assets, $32 million in loan balances and $59 million in deposits.

Dollar amounts in tables are stated in thousands, except for per share data.

EXECUTIVE SUMMARY

The purpose of this section is to provide a brief summary of the 2016 results of operations and financial condition. A more detailed analysis of the results of operations and financial condition follows this summary.

The Corporation reported net income of $4.483 million, or $.72 per share, for the year ended December 31, 2015, compared to $5.596 million, or $.90 per share, in 2015, and net income of $1.700 million, or $.30 per share, for 2014. The 2016 results include costs related to the acquisitions of Eagle River and Niagara in the amount of $3.101 million. The 2015 results include one-time charges related to regulatory audit costs incurred in connection with our approval as an SBA preferred lender and the transfer of our asset based lending subsidiary assets to mBank, which included a prepayment penalty on its line of credit. The 2014 results include transaction related expenses of $2.475 million.

Total assets of the Corporation at December 31, 2016, were $983.520 million, an increase of $244.251 million, or 33.04%, from total assets of $739.269 million reported at December 31, 2015, largely a result of the acquisitions of Eagle River and Niagara.

At December 31, 2016, the Corporation's loans stood at $781.857 million, an increase of $163.463 million, or 26.43%, from 2015 year-end balances of $618.394 million. Total loan production in 2016 amounted to $301.893 million, which included $81.694 million of secondary market mortgage loans sold. The Corporation also sold $7.202 million of SBA/USDA guaranteed loans. Loan balances were also impacted by normal amortization and paydowns, some of which related to payoffs on participation loans.

Nonperforming loans totaled $4.124 million, or 1.14%, of total loans at December 31, 2016 compared to $2.539 million, or .41% of total loans at December 31, 2015. Nonperforming assets at December 31, 2016, were $8.906 million, .91% of total assets, compared to $4.863 million or .66% of total assets at December 31, 2015.

Table of Contents

Total deposits increased from $610.323 million at December 31, 2015 to $823.512 million at December 31, 2016, an increase of 34.93%. The increase in deposits in 2016 was comprised of an increase in wholesale deposits of $42.969 million and an increase in core deposits of $170.220 million, the latter of which was largely a result of the acquisitions of Eagle River and Niagara. In 2016, the Corporation utilized wholesale deposits in order to better manage interest rate risk in funding fixed rate loans.

Shareholders' equity totaled $78.609 million at December 31, 2016, compared to $76.602 million at the end of 2015, an increase of $2.007 million. This change reflects the net income available to common shareholders of $4.483 million, other comprehensive loss of $.428 million, an increase related to stock compensation expense of $.600 million, the repurchase of common stock of $.150 million and dividends declared on common stock of $2.498 million. The book value per common share at December 31, 2016, amounted to $12.55 compared to $12.32 at the end of 2015.

For a description of our significant accounting policies, see Note 1 to the financial statements included herein.

RESULTS OF OPERATIONS

(dollars in thousands, except per share data)	2016	2015	2014
Taxable-equivalent net interest income	$ 33,244	$ 29,210	$ 23,575
Taxable-equivalent adjustment	(146)	(90)	(48)
Net interest income, per income statement	33,098	29,120	23,527
Provision for loan losses	600	1,204	1,200
Other income	4,153	3,889	3,112
Other expense	29,885	23,876	22,610
Income before provision for income taxes	6,766	7,929	2,829
Provision for (benefit of) income taxes	2,283	2,333	1,129
Net income	$ 4,483	$ 5,596	$ 1,700
Earnings per common share			
Basic	$ 0.72	$ 0.90	$ 0.30
Diluted	$ 0.72	$ 0.89	$ 0.30
Return on average assets	.52%	.76%	.28%
Return on average equity	5.73	7.41	2.57

Summary

The Corporation reported net income available to common shareholders of $4.483 million in 2016, compared to $5.596 million in 2015 and $1.700 million in 2014. The 2016 results include costs related to the acquisition of Eagle River and Niagara in the amount of $3.101 million. The 2015 results include a provision for loan loss of $1.204 million. The 2014 results include a provision for loan loss of $1.200 million and costs related to the PFC acquisition of $2.475 million.

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 funding sources. Net interest revenue is the Corporation's principal source of revenue, representing 90% of total revenue in 2016. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest income on a taxable equivalent basis increased $4.034 million from $29.210 million in 2015 to $33.244 million in 2016. In 2016, interest rates were stable with the prime rate at 3.25% for nearly the entire year. There was a 25 basis point increase in mid-December 2016. The Corporation experienced a decrease of 14 basis points in the overall rates on earning assets from 4.97% in 2015 to 4.83% in 2016. Interest bearing funding sources declined by four basis

points, from .80% in 2015 to .76% in 2016. The combination of these effective rate changes resulted in a decrease in net interest margin from 4.32% in 2015 to 4.21% in 2016.

The following table details sources of net interest income for the three years ended December 31 (dollars in thousands):

	2016	Mix	2015	Mix	2014	Mix
Interest Income						
Loans	$ 36,142	95.15%	$ 32,047	95.63%	$ 26,491	95.74%
Funds sold	10	0.03	1	—	—	—
Taxable securities	1,322	3.48	1,095	3.27	962	3.48
Nontaxable securities	210	0.55	162	0.48	64	0.23
Other interest-earning assets	299	0.79	208	0.62	152	0.55
Total earning assets	37,983	100.00%	33,513	100.00%	27,669	100.00%
Interest Expense						
NOW, money markets, checking	731	14.96%	583	13.27%	404	9.75%
Savings	41	0.84	31	0.70	15	0.36
Certificates of deposit	1,256	25.71	1,627	37.04	1,984	47.90
Brokered deposits	1,294	26.49	1,010	22.99	815	19.68
Borrowings	1,563	32.00	1,142	26.00	924	22.31
Total interest-bearing funds	4,885	100.00%	4,393	100.00%	4,142	100.00%
Net interest income	$ 33,098		$ 29,120		$ 23,527	
Average Rates						
Earning assets	4.81%		4.95%		4.93%	
Interest-bearing funds	0.76		0.80		0.90	
Interest rate spread	4.05		4.15		4.03	

For purposes of this presentation, non-taxable interest income has not been restated on a tax-equivalent basis.

As shown in the table above, income on loans provides more than 95% of the Corporation's interest revenue. The Corporation's loan portfolio has approximately $362.176 million of variable rate loans that predominantly reprice with changes in the prime rate and $419.681 million of fixed rate loans. A large portion of the variable rate loans, 41%, or $149.588 million, have interest rate floors. These loans will not reprice until the prime rate increases to the extent necessary to surpass the interest rate floor. A prime rate increase of 100 basis points or more will reprice $127.490 million of these loans with floors, while the majority of the remainder will reprice with an additional 100 basis point increase in the prime rate.

The majority of interest bearing liabilities do not reprice automatically with changes in interest rates, which provides flexibility to manage interest income. Management monitors the interest rate sensitivity of earning assets and interest bearing liabilities to minimize the risk of movements in interest rates.

The following table presents the amount of taxable equivalent 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.

Table of Contents

Taxable equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 34% federal tax rate, thus making tax-exempt yields comparable to taxable asset yields.

	Year Ended December 31,								
	2016			2015			2014		
ars in thousands)	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Avera Rate
ETS:									
s (1,2,3)	$ 703,047	$ 36,174	5.15%	$ 608,938	$ 32,053	5.26%	$ 509,749	$ 26,506	5.20%
ble securities	56,058	1,322	2.36	55,057	1,095	1.99	45,172	962	2.13
axable securities	15,606	333	2.13	3,466	245	7.07	2,062	97	4.7
r interest-earning s	14,579	300	2.06	9,255	209	2.26	3,888	152	3.91
earning assets	789,290	38,129	4.83	676,716	33,602	4.97	560,871	27,717	4.94
rve for loan s	(4,971)			(5,265)			(5,187)		
and due from s	36,878			25,985			23,124		
l assets	14,441			12,704			10,174		
r real estate ed	3,360			2,364			2,088		
r assets	26,575			26,183			14,542		
	76,283			61,971			44,741		
AL AVERAGE ETS	$ 865,573			$ 738,687			$ 605,612		
BILITIES AND REHOLDERS' ITY:									
/ and Money kets	$ 195,314	$ 644	0.33%	$ 157,781	$ 489	.31%	$ 114,313	$ 309	.27%
est checking	55,237	87	0.16	51,438	94	0.18	45,158	95	0.21
ngs deposits	47,025	41	0.09	30,020	31	0.1	15,717	15	0.1
ficates of deposit	138,877	1,256	0.90	156,828	1,626	1.04	168,349	1,984	1.18
ered deposits	135,303	1,294	0.96	101,789	1,010	0.99	69,833	815	1.17
owings	68,361	1,563	2.29	53,896	1,142	2.12	45,451	924	2.03
interest-bearing ities	640,117	4,885	0.76	551,752	4,392	.80%	458,821	4,142	0.9
and deposits	144,622			107,958			76,880		
r liabilities	2,534			3,432			3,662		
eholders' equity	78,300			75,545			66,249		
	225,456			186,935			146,791		

AL AVERAGE BILITIES AND REHOLDERS' ITY	$ 865,573			$ 738,687			$ 605,612		
spread			4.07			4.17			4.04%
nterest in/revenue, tax valent basis		$ 33,244	4.21%		$ 29,210	4.32%		$ 23,575	4.20%

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

Table of Contents

The following table presents the dollar amount, in thousands, of changes in taxable equivalent interest income and interest expense for major components of interest-earning assets and interest-bearing obligations. It distinguishes between changes related to higher or lower outstanding balances and changes due to the levels and fluctuations in interest rates. For each category of interest-earning assets and interest-bearing obligations, information is provided for changes attributable to (i) changes in volume (i.e. changes in volume multiplied by prior period rate) and (ii) changes in rate (i.e. changes in rate multiplied by prior period volume). For purposes of this table, changes attributable to both rate and volume are shown as a separate variance.

	Year ended December 31, 2016 vs. 2015 Increase (Decrease) Due to				2015 vs. 2014 Increase (Decrease) Due to			
	Volume	Rate	Volume and Rate	Total Increase (Decrease)	Volume	Rate	volume and Rate	Total Increase (Decrease)
Interest earning assets:								
Loans	$ 4,954	$ (721)	$ (111)	$ 4,122	$ 5,158	$ 326	$ 63	$ 5,547
Taxable securities	20	203	4	227	211	(64)	(14)	133
Nontaxable securities	858	(171)	(600)	87	66	49	33	148
Other interest earning assets	72	11	8	91	160	(50)	(53)	57
Total interest earning assets	$ 5,904	$ (678)	$ (699)	$ 4,527	$ 5,595	$ 261	$ 29	$ 5,885
Interest bearing obligations:								
NOW and money market deposits	$ 116	$ 31	$ 8	$ 155	$ 117	$ 45	$ 17	$ 179
Interest checking	7	(13)	(1)	(7)	13	(12)	(2)	(1)
Savings deposits	18	(5)	(3)	10	14	1	1	16
Certificates of deposit	(186)	(208)	24	(370)	(131)	(240)	13	(358)
Brokered deposits	333	(37)	(12)	284	373	(122)	(55)	196
Borrowings	306	90	25	421	172	39	7	218
Total interest bearing obligations	$ 594	$ (142)	$ 41	$ 493	$ 558	$ (289)	$ (19)	$ 250
Net interest income, tax equivalent basis				$ 4,034				$ 5,635

23

Table of Contents

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 2016, the Corporation recorded a provision for loan loss of $.600 million, compared to a provision of $1.204 million in 2015 and $1.200 million in 2014. There was no provision for loan losses for acquired loans as a result of acquisition fair value adjustments.

Noninterest Income

Noninterest income was $4.153 million, $3.889 million, and $3.112 million in 2016, 2015, and 2014, respectively. The principal recurring sources of noninterest income are the gains on the sale of SBA/USDA guaranteed loans and secondary market loans. In 2016, revenues from these two business lines totaled $2.472 million compared to $1.681 million in 2015 and $1.394 million in 2014. The Corporation, in recent years, expanded its efforts to generate increased income from secondary market loans by adding additional staff and streamlining processing activities.

Deposit related income totaled $.995 million in 2016 compared to $.836 million in 2015 and $.701 million in 2014. During 2016, the Corporation reviewed and made changes to the fee structure for deposit accounts; however the current regulatory environment may limit the Corporation's ability to grow these revenue sources.

The following table details noninterest income for the three years ended December 31 (dollars in thousands):

	2016	2015	2014	2016-2015%	2015-2014
Deposit service charges	$ 348	$ 200	$ 150	74.00%	33.33%
NSF Fees	647	636	551	1.73	15.43
Gain on sale of secondary market loans	1,340	873	493	53.49	77.08
Secondary market fees generated	235	198	144	18.69	37.50
SBA Fees	897	610	757	47.05	(19.42)
Mortgage servicing rights (amortization) income	(40)	547	675	(107.31)	(18.96)
Other	576	370	288	55.68	28.47
Subtotal	4,003	3,434	3,058	16.57	12.30
Net security gains	150	455	54	(67.03)	742.59
Total noninterest income	$ 4,153	$ 3,889	$ 3,112	6.79%	24.97%

Noninterest Expense

Noninterest expense was $29.885 million in 2016, compared to $23.876 million and $22.610 million in 2015 and 2014, respectively. In 2016, the Corporation incurred $3.101 million of costs related to the acquisition of Eagle River and Niagara. Salaries and benefits, at $14.625 million, increased by $2.176 million, or 17.48%, from the 2015 expenses of $12.449 million and compared to $10.303 million in 2014. The increased salaries and benefits expense was largely a result of an increased number of staff as a result of the acquisitions, as well as customary annual increases to legacy employees. In 2015, the increase in noninterest expense totaled $1.266 million, or 5.60%.

Management will continue to review all areas of noninterest expense in order to evaluate where opportunities may exist which could reduce expenses without compromising service to customers.

Table of Contents

The following table details noninterest expense for the three years ended December 31 (dollars in thousands):

	2016	2015	2014	% Increase (Decrease) 2016-2015	2015-2014
Salaries and benefits	$ 14,625	$ 12,449	$ 10,303	17.48%	20.83%
Occupancy	2,680	2,424	2,129	10.56	13.86
Furniture and equipment	1,749	1,551	1,268	12.77	22.32
Data processing	1,620	1,381	1,150	17.31	20.09
Professional service fees:					
Accounting	415	443	375	(6.32)	18.13
Legal	62	139	205	(55.40)	(32.20)
Consulting and other	692	688	583	0.58	18.01
Total professional service fees	1,169	1,270	1,163	(7.95)	9.20
Loan origination expenses and deposit and card related fees	1,100	955	699	15.18	36.62
Writedowns and losses on OREO held for sale	202	332	280	(39.16)	18.57
FDIC insurance assessment	488	506	362	(3.56)	39.78
Telephone	528	455	327	16.04	39.14
Advertising	620	507	449	22.29	12.92
Transaction related expenses	3,101	—	2,475	100.00	(100.00)
Other operating expenses	2,003	2,046	2,005	(2.10)	2.04
Total noninterest expense	$ 29,885	$ 23,876	$ 22,610	25.17%	5.60%

Federal Income Taxes

Current Federal Tax Provision

The Corporation recognized a federal income tax expense of approximately $2.283 million for the year ended December 31, 2016 and $2.333 million for the year ended December 31, 2015.

The Corporation has reported deferred tax assets of $8.760 million at December 31, 2016. 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. The Corporation, as of December 31, 2016, had a net operating loss and tax credit carryforwards for tax purposes of approximately $9.1 million, and $2.2 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of December 31, 2016 and determined that it was “more likely than not” that they would be utilized prior to expiration. 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 and credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 million for the NOL and the equivalent value of tax credits, which is

approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

Table of Contents

The table below details the major components of the Corporation's net deferred tax assets (dollars in thousands):

	2016	2015
Deferred tax assets:		
NOL carryforward	$ 3,080	$ 4,331
Allowance for loan losses	1,413	1,705
Alternative Minimum Tax Credit	1,944	1,999
OREO Tax basis > book basis	142	162
Tax credit carryovers	235	338
Deferred compensation	443	517
Pension liability	387	384
Stock compensation	116	141
Unrealized gain (loss) on securities	52	(153)
Purchase accounting adjustments	1,791	955
Other	805	141
Total deferred tax assets	10,408	10,520
Valuation allowance	$ —	$ —
Deferred tax liabilities:		
Core deposit premium	(739)	(366)
FHLB stock dividend	(91)	(100)
Depreciation	(208)	(113)
Mortgage servicing rights	(583)	(667)
Other	(27)	(61)
Total deferred tax liabilities	(1,648)	(1,307)
Net deferred tax asset	$ 8,760	$ 9,213

Table of Contents

FINANCIAL POSITION

The table below illustrates the relative composition of various liability funding sources and asset make-up.

	December 31,					
	2016		2015		2014	
(dollars in thousands)	Balance	Mix	Balance	Mix	Balance	Mix
Sources of funds:						
Deposits:						
Non-interest bearing transactional deposits	$ 164,179	16.69%	$ 122,775	16.61%	$ 95,498	12.84%
Interest-bearing transactional deposits	344,937	35.07	233,666	31.61	240,580	32.35
CD's <$250,000	141,629	14.40	105,859	14.32	134,951	18.14
Total core deposit funding	650,745	66.16	462,300	62.54	471,029	63.33
CD's >$250,000	8,489	0.86	26,757	3.62	30,316	4.08
Brokered deposits	164,278	16.71	121,266	16.4	105,628	14.2
Total noncore deposit funding	172,767	17.57	148,023	20.02	135,944	18.28
FHLB and other borrowings	73,579	7.48	45,754	6.19	49,846	6.7
Other liabilities	7,820	0.80	6,590	0.89	12,970	1.74
Shareholders' equity	78,609	7.99	76,602	10.36	73,996	9.95
Total	$ 983,520	100.00%	$ 739,269	100.00%	$ 743,785	100.00%
Uses of Funds:						
Net Loans	$ 776,837	78.99%	$ 613,390	82.29%	$ 595,795	80.11%
Securities available for sale	86,273	8.77	53,728	7.27	65,832	8.85
Federal funds sold	2,135	0.22	3	—	—	—
Federal Home Loan Bank Stock	2,911	0.30	2,169	0.29	2,973	0.4
Interest-bearing deposits	14,047	1.43	5,089	0.69	5,797	0.78
Cash and due from banks	44,620	4.54	25,005	3.38	21,947	2.95
Other assets	56,697	5.75	39,885	5.4	51,441	6.92
Total	$ 983,520	100.00%	$ 739,269	100.00%	$ 743,785	100.00%

Securities

The securities portfolio is an important component of the Corporation's asset composition to provide diversity in its asset base and provide liquidity. Securities increased $32.545 million in 2016, from $53.728 million at December 31, 2015 to $86.273 million at December 31, 2016, largely a result of the acquisitions of Eagle River and Niagara.

The carrying value of the Corporation's securities at December 31 (dollars in thousands) is as follows:

	2016	2015
US Agencies	$ 23,952	$ 27,377
US Agencies - MBS	16,833	3,759
Corporate	19,910	12,646
Equity	500	—
Obligations of states and political subdivisions	25,078	9,946
Total securities	$ 86,273	$ 53,728

The Corporation's policy is to purchase securities of high credit quality, consistent with its asset/liability management strategies. The Corporation classifies all securities as available for sale, in order to maintain adequate liquidity and to maximize its ability to react to changing market conditions. At December 31, 2016, investment securities with an estimated fair market value of $17.425 million were pledged as collateral for FHLB borrowings and certain customer relationships.

Table of Contents

Loans

The Bank is a full service lender and offers a variety of loan products in all of its markets. The majority of its loans are commercial, which represents approximately 70% of total loans outstanding at December 31, 2016.

The Corporation continued to experience strong loan demand in 2016 with approximately $301.893 million of new organic loan production, including $81.693 million of mortgage loans sold in the secondary market. At 2016 year-end, the Corporation's loans stood at $781.857 million, an increase from the 2015 year-end balances of $618.394 million. The production of loans was distributed among the regions, with the Upper Peninsula at $163.338 million, $58.896 million in the Northern Lower Peninsula, $60.881 million in Southeast Michigan and $18.778 million in Wisconsin.

The December 2016 acquisitions of Eagle River and Niagara added loans of $112.582 million to our consolidated loan portfolio. These acquired loans did not result in any significant concentration risk.

Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with the current 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. The Corporation is highly competitive in structuring loans to meet borrowing needs and satisfy strong underwriting requirements.

The following table details the loan activity for 2015 and 2016 (dollars in thousands):

Loan balances as of December 31, 2014	$ 600,935
Total production	234,271
Secondary market sales	(53,229)
SBA loan sales	(8,959)
Loans transferred to OREO	(1,376)
Loans charged off, net of recoveries	(1,340)
Normal amortization/paydowns and payoffs	(151,908)
Loan balances as of December 31, 2015	$ 618,394
Total production	301,893
Total loans acquired	112,582

Secondary market sales	(81,693)
SBA loan sales	(7,202)
Loans transferred to OREO	(3,292)
Loans charged off, net of recoveries	(584)
Normal amortization/paydowns and payoffs	(158,241)
Loan balances as of December 31, 2016	$ 781,857

Table of Contents

Following is a table that illustrates the balance changes in the loan portfolio from 2014 through 2016 year-end (dollars in thousands):

	2016	2015	2014	Percent Change 2016-2015	2015-2014
Commercial real estate	$ 389,420	$ 312,805	$ 315,387	24.49%	(0.82)%
Commercial, financial, and agricultural	142,648	122,140	101,895	16.79	19.87
One-to-four family residential real estate	205,945	140,502	139,553	46.58	0.68
Construction:					
Consumer	12,226	11,770	9,431	3.87	24.80
Commercial	11,505	15,330	16,284	(24.95)	(5.86)
Consumer	20,113	15,847	18,385	26.92	(13.80)
Total	$ 781,857	$ 618,394	$ 600,935	26.43%	2.91%

Our commercial real estate loan portfolio predominantly relates to owner occupied real estate, and our loans are generally secured by a first mortgage lien. We make commercial loans for many purposes, including: working capital lines, which are generally renewable annually and supported by business assets, personal guarantees and additional collateral. Commercial business lending is generally considered to involve a higher degree of risk than traditional consumer bank lending.

Following is a table showing the composition of loans by significant industry types in the commercial loan portfolio as of December 31 (dollars in thousands):

	2016			2015		
	Balance	% of Loans	% of Capital	Balance	% of Loans	% of Capital
Real estate - operators of nonres bldgs	$ 121,861	22.42%	155.02	$ 102,620	22.79%	133.97
Hospitality and tourism	68,025	12.51	86.54	41,300	9.17	53.92
Lessors of residential buildings	27,590	5.08	35.10	25,930	5.76	33.85
Gasoline stations and convenience stores	20,509	3.77	26.09	21,647	4.81	28.26
Logging	19,903	3.66	25.32	17,346	3.85	22.64
Commercial construction	11,505	2.12	14.64	15,330	3.40	20.01
Other	274,180	50.44	348.79	226,102	50.22	295.16
Total commercial loans	$ 543,573	100.00%		$ 450,275	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of 2016 year-end. 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 December 31, 2016, our residential loan portfolio totaled $218.171 million, or 28%, of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases increased from $1.153 million at the end of 2015 to $7.634 million at 2016 year-end. The Corporation has elected to make limited tax-exempt loans, since they provide no current tax benefit due to tax net operating loss carryforwards.

Table of Contents

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 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.

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. 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. 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.

The Corporation has, in accordance with generally accepted accounting principles standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan's original rate, or for collateral dependent loans, to the fair value of the collateral.

The Corporation, at December 31, 2016, had performing loans of $6.864 million and $.292 million of nonperforming loans for which repayment terms were modified to the extent that they were deemed to be "restructured" loans. The total restructured loans of $7.156 million is comprised of 31 performing loans, the largest of which had a December 31, 2016 balance of $1.136 million and seven nonperforming loans.

Credit Quality

The table below shows balances of nonperforming assets for the years ended December 31 (dollars in thousands):

	December 31, 2016	December 31, 2015
Nonperforming Assets:		
Nonaccrual loans	$ 3,959	$ 2,353
Loans past due 90 days or more	—	32

Restructured loans	165	154
Total nonperforming loans	4,124	2,539
Other real estate owned	4,782	2,324
Total nonperforming assets	$ 8,906	$ 4,863
Nonperforming loans as a % of loans	1.14%	0.41%
Nonperforming assets as a % of assets	0.91%	0.66%
Reserve for Loan Losses:		
At period end	$ 5,020	$ 5,004
As a % of outstanding loans	.64%	.81%
As a % of nonperforming loans	121.73%	197.09%
As a % of nonaccrual loans	126.80%	212.66%
Texas Ratio	11.76%	6.34%

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 a loan review consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the 2016 independent review provided findings similar to management with respect to credit quality. The Corporation will again utilize a consultant for loan review in 2017.

Table of Contents

The following table details the impact of nonperforming loans on interest income for the three years ended December 31 (dollars in thousands):

	2016	2015	2014
Interest income that would have been recorded at original rate	$ 640	$ 1,125	$ 130
Interest income that was actually recorded	437	795	—
Net interest lost	$ 203	$ 330	$ 130

Allowance for Loan Losses

Management analyzes the allowance for loan losses on a quarterly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs in 2016 amounted to $.584 million, or .08% of average loans outstanding, compared to $1.340 million, or .22% of loans outstanding in 2015. The current reserve balance is representative of the relevant risk inherent within the Corporation's loan portfolio. The balance of the allowance for loan losses does not contemplate acquisition fair value adjustments, as detailed in Note 4 – "Loans." 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.

A two year history of relevant information on the Corporation's credit quality is displayed in the following table (dollars in thousands):

Allowance for Loan Losses	2016	2015
Balance at beginning of period	$ 5,004	$ 5,140
Loans charged off:		
Commercial	477	1,801
One-to-four family residential real estate	133	142
Consumer	113	87
Total loans charged off	723	2,030
Recoveries of loans previously charged off:		
Commercial	102	662
One-to-four family residential real estate	5	2
Consumer	32	26
Total recoveries of loans previously charged off	139	690
Net loans charged off	584	1,340
Provision for loan losses	600	1,204

Balance at end of period	$ 5,020	$ 5,004
Total loans, period end	$ 781,857	$ 618,394
Average loans for the year	703,047	608,938
Allowance to total loans at end of year	0.64%	.81%
Net charge-offs to average loans	0.08	0.22
Net charge-offs to beginning allowance balance	11.67	26.07

*The above does not include information regarding the quality of acquired impaired loans.

The computation of the required allowance for loan losses as of any point in time is one of the critical accounting estimates made by management in the financial statements. As such, factors used to establish the allowance could change significantly from the assumptions made and impact future earnings positively or negatively. The future of the national and local economies and the resulting impact on borrowers' ability to repay their loans and the value of collateral are examples of areas where assumptions must be made for individual loans, as well as the overall portfolio.

The allowance for loan losses consists of specific and general components. Our internal risk system is used to identify loans that meet the criteria for being "impaired" as defined in the accounting guidance. The specific component relates

Table of Contents

to loans that are individually classified as impaired and where expected cash flows are less than carrying value. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. These qualitative factors include: (1) changes in the nature, volume and terms of loans, (2) changes in lending personnel, (3) changes in the quality of the loan review function, (4) changes in nature and volume of past-due, nonaccrual and/or classified loans, (5) changes in concentration of credit risk, (6) changes in economic and industry conditions, (7) changes in legal and regulatory requirements, (8) unemployment and inflation statistics, and (9) underlying collateral values.

At the end of 2016, the allowance for loan losses represented .64% of total loans. 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. This position is further illustrated by the ratio of the allowance as a percent of nonperforming loans, which stood at 121.73% at December 31, 2016.

The Corporation completed the acquisition of PFC on December 5, 2014, Eagle River on April 29, 2016 and Niagara on August 31, 2016. The PFC acquired impaired loans totaled $13.290 million, the Eagle River acquired impaired loans totaled $3.401 million, and the Niagara acquired impaired loans totaled $2.105 million. In 2016, the Corporation had positive resolution of acquired nonperforming loans, which resulted in the recognition of approximately $96,000 of accretable interest. In 2015, the Corporation had positive resolution of acquired nonperforming loans, which resulted in the recognition of approximately $.578 million of the accretable interest.

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

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

Balance at December 31, 2014	$ 3,010
Other real estate transferred from loans due to foreclosure	1,376
Proceeds from sale of other real estate	(1,702)
Writedowns on other real estate held for sales	(295)
Loss on other real estate held for sale	(65)
Balance at December 31, 2015	$ 2,324
Other real estate transferred from loans due to foreclosure	3,292
Other real estate acquired, net of purchase accounting	1,205
Proceeds from sale of other real estate	(1,640)
Transfer to premise and equipment	(197)

Writedowns on other real estate held for sales	(212)
Gain (loss) on other real estate held for sale	10
Balance at December 31, 2016	$ 4,782

During 2016, the Corporation received real estate in lieu of loan payments of $3.292 million. In determining the carrying value of other real estate held for sale, the Corporation generally starts with a third party appraisal of the underlying collateral and then deducts estimated selling costs to arrive at a net asset value. After the initial receipt, management periodically re-evaluates the recorded balance and records any additional reductions in the fair value as a write-down of other real estate held for sale.

Table of Contents

Deposits

Total deposits at December 31, 2016 were $823.512 million, an increase of $213.189 million, or 34.93%, from December 31, 2015 deposits of $610.323 million. The table below shows the deposit mix for the periods indicated (dollars in thousands):

	2016	Mix	2015	Mix
CORE:				
Non-interest-bearing	$ 164,179	19.94%	$ 122,775	20.12%
NOW, money market, checking	286,622	34.80	202,784	33.23
Savings	58,315	7.08	30,882	5.06
Certificates of Deposit <$250,000	141,629	17.20	124,084	20.33
Total core deposits	650,745	79.02	480,525	78.73
NONCORE:				
Certificates of Deposit >$250,000	8,489	1.03	8,532	1.40
Brokered CDs	164,278	19.95	121,266	19.87
Total non-core deposits	172,767	20.98	129,798	21.27
Total deposits	$ 823,512	100.00%	$ 610,323	100.00%

The increase in deposits, resulting primarily from the acquisitions of Eagle River and Niagara, is composed of an increase in noncore deposits of $42.969 million, and an increase in core deposits of $170.220 million. Through the acquisitions of Eagle River and Niagara, the Corporation has enhanced its core deposit portfolio with additional stable deposit relationships from the acquired institutions' long term customer bases.

Management has increased its efforts to grow core deposits in recent years by introducing several new deposit products. As shown in the table above, core deposits now represent approximately 79% of total deposits. The Corporation will continue to emphasize core deposit growth in its funding sources, but will also supplement this funding with strategic utilization of wholesale brokered deposits to help manage interest rate risk.

Management continues to monitor existing deposit products in order to stay competitive, both as to 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 accounts.

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At 2016 year end, this source of funding totaled $45.000 million and the Corporation secured this funding by pledging loans and investments. The $45.000 million of FHLB borrowings had a weighted average maturity of 1.9 years, with a weighted average rate of 2.10% at December 31, 2016.

The Corporation currently has one banking borrowing relationship. The relationship consists of a non-revolving line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017. The credit facility is secured by all of the outstanding mBank stock.

Shareholders' Equity

Changes in shareholders' equity are discussed in detail in the "Capital and Regulatory" section of this report.

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 making payments on existing borrowing

Table of Contents

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.

During 2016, the Corporation increased cash and cash equivalents by $21.747 million. As shown on the Corporation's consolidated statement of cash flows, liquidity was primarily impacted by cash used in investing activities and cash provided by financing activities. The net change in investing activities included a net increase in loans of $56.237 million and a net decrease in securities available for sale of $10.584 million. The net increase in assets was partially offset by an increase in deposit liabilities of $49.491 million. This increase in deposits was composed of an increase in non-core deposits of $42.969 million combined with an increase in core deposits of $170.220 million. Deposits garnered in the acquisitions of Eagle River and Niagara amounted to $163.698 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.

The Bank's investment portfolio provides added liquidity during periods of market turmoil and overall liquidity concerns in the financial markets. As of December 31, 2016, $68.848 million of the Bank's investment portfolio was unpledged, which makes them readily available for sale to address any short term liquidity needs.

It is anticipated that during 2017, the Corporation will fund anticipated loan production with a combination of core-deposit growth and noncore funding, primarily brokered CDs to the extent the level of brokered CDs remains within our conservative policy limitations.

The Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. In 2016, the Bank paid an $11.825 million dividend to the Corporation, the majority of which was utilized to fund the acquisition of Niagara. Bank capital, after payment of this dividend, remained strong and above the "well capitalized" regulatory level. The Corporation has a $5.0 million line of credit with a correspondent bank, which also serves as a source of liquidity. As of December 31, 2016, $4.250 million was available to the Corporation under this line. The Corporation will continue to explore alternative opportunities for longer term sources of liquidity and permanent equity to support projected asset growth.

Liquidity is managed by the Corporation through its Asset and Liability Committee (the "ALCO" Committee). The ALCO Committee meets regularly 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 non-core funding dependency ratio, which explains the degree of reliance on non-core 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 $250,000. Non-core funding consists of certificates of deposit greater than $250,000, brokered deposits, and FHLB and other borrowings.

At December 31, 2016, the Bank's core deposits in relation to total funding were 72.54% compared to 70.56% in 2015. These ratios indicated at December 31, 2016, that the Bank has decreased its reliance on non-core 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 December 31, 2016, the Bank had $42.0 million of unsecured overnight borrowing lines available and additional amounts available if secured. Management believes that its liquidity position remains 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 liquidity plan for 2017 includes strategies to increase core deposits in the Corporation's local markets and a continuation of efforts to augment local deposit growth efforts with wholesale CD funding, to the extent necessary.

Table of Contents

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

As disclosed in the Notes to the Consolidated Financial Statements, the Corporation has certain obligations and commitments to make future payments under contracts. At December 31, 2016, the aggregate contractual obligations and commitments are (dollars in thousands):

	Payments Due by Period				
	Less than 1 Year	1 to 3 Years	4 to 5 Years	After 5 Years	Total
Contractual Obligations					
Total deposits	$ 741,086	$ 64,666	$ 15,256	$ 2,504	$ 823,512
Federal Home Loan Bank borrowings	10,000	25,000	10,000	—	45,000
Other borrowings	9,026	19,153	156	244	28,579
Directors’ deferred compensation	300	494	419	607	1,820
Annual rental / purchase commitments under noncancelable leases / contracts	717	1,094	932	3,570	6,313
TOTAL	$ 761,129	$ 110,407	$ 26,763	$ 6,925	$ 905,224
Other Commitments					
Letters of credit	$ 8,252	$ —	$ —	$ —	$ 8,252
Commitments to extend credit	88,233	—	—	—	88,233
Credit card commitments	5,533	—	—	—	5,533
TOTAL	$ 102,018	$ —	$ —	$ —	$ 102,018

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.

The Corporation and Bank capital is also impacted by the disallowed portion of the Corporation’s deferred tax asset. The portion of the deferred tax asset which is allowed to be included in regulatory capital is based on the amount of the asset, net of any valuation allowance and deferred tax liabilities. The amount included is phased in

through 2018. See “Business — Supervision and Regulation” and “— Basel III for additional information regarding regulatory capital, as well as Note 16 to the Corporation’s Consolidated Financial Statements in Item 8 of this Form 10-K below.

Impact of Inflation and Changing Prices

The accompanying 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 prices of goods and services.

Table of Contents

Item 7A.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 Corporation’s 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. When loans are made with longer-term fixed rates, the Corporation attempts to match these balances with sources of funding with similar maturities in order to mitigate interest rate risk. In addition, the Corporation prices loans so it has an opportunity to reprice the loan within 12 to 36 months.

At December 31, 2016 the Bank had $86.273 million of securities, with a weighted average maturity of 55.32 months. The investment portfolio is intended to provide a source of liquidity to the Corporation with limited interest rate risk. The Corporation may also elect to sell cash to correspondent banks as investments in federal funds. The Corporation also has other interest bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation offers deposit products with 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 speed of change 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 ("ALCO") meetings, whose membership includes senior management, board representation and third party investment consultants. During these monthly meetings, we review the current ALCO position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

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

Table of Contents

The following are the Corporation’s repricing opportunities at December 31, 2016 (dollars in thousands):

	1-90 Days	91-365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 275,939	184,650	318,552	2,716	$ 781,857
Securities	6,796	2,184	53,854	23,439	86,273
Other (1)	8,917	1,777	8,152	247	19,093
Total interest-earning assets	291,652	188,611	380,558	26,402	887,223
Interest-bearing obligations:					
NOW, money market, savings and interest checking	344,937	—	—	—	344,937
Time deposits	22,561	65,708	59,345	2,504	150,118
Brokered CDs	32,590	111,111	20,577	—	164,278
Borrowings	6,000	13,026	54,309	244	73,579
Total interest-bearing obligations	406,088	189,845	134,231	2,748	732,912
Gap	$ (114,436)	$ (1,234)	$ 246,327	$ 23,654	$ 154,311
Cumulative gap	$ (114,436)	$ (115,670)	$ 130,657	$ 154,311	

(1) includes Federal Home Loan Bank stock

The above analysis indicates that at December 31, 2016, the Corporation had a cumulative liability sensitivity gap position of $115.670 million within the one-year timeframe. The Corporation’s cumulative liability sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn less net interest income since more liabilities would reprice at higher rates than assets. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation’s net interest income would increase. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or unexpected 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, 2016, the Corporation had $362.176 million of variable rate loans that reprice primarily with the prime rate index. Approximately $149.588 million of these variable rate loans have interest rate floors. This means that the prime rate will have to increase above the floor rate before these loans will reprice. At year end, $127.490 million of these floor-rate loans would reprice with a 100 basis point prime rate increase, with the majority of the remainder repricing with an additional 100 basis point prime rate increase.

At December 31, 2015, the Corporation had a cumulative liability sensitive gap position of $37.492 million within the one-year time frame.

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.

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

Table of Contents

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, 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.

The table below measures current maturity levels of interest-earning assets and interest-bearing obligations, along with average stated rates and estimated fair values at December 31, 2016 (dollars in thousands). Nonaccrual loans of $4.124 million are included in the table at an average interest rate of 0.00% and a maturity greater than five years.

Principal/Notional Amount Maturing/Repricing In:

	2017	2018	2019	2020	2021	Thereafter	Total	Fair Value 12/31/2016
Rate Sensitive Assets								
Fixed interest rate securities	$ 1,498	$ 13,551	$ 16,430	$ 17,693	$ 13,003	$ 24,098	$ 86,273	$ 86,273
Average interest rate	0.89	1.19	1.41	1.70	1.66	2.71	1.83%	
Fixed interest rate loans	153,227	129,763	97,539	25,129	11,306	2,717	419,681	420,513
Average interest rate	4.50	4.52	4.65	4.39	4.47	4.61	4.55	
Variable interest rate loans	362,176	—	—	—	—	—	362,176	362,894
Average interest rate	4.67	—	—	—	—	—	4.67	
Other assets	10,694	4,548	1,439	1,965	200	247	19,093	19,093
Average interest rate	1.97	1.59	1.59	1.59	1.59	1.57	1.80	
Total rate sensitive assets	$ 527,595	$ 147,862	$ 115,408	$ 44,787	$ 24,509	$ 27,062	$ 887,223	$ 888,773
Average interest rate	4.55%	4.12%	4.15%	3.20%	2.96%	2.89%	4.18%	
Rate Sensitive Liabilities								
Interest-bearing savings, NOW, MMAs,	$ 344,937	$ —	$ —	$ —	$ —	$ —	$ 344,937	$ 344,937

checking								
Average interest rate	0.15	—	—	—	—	—	0.15%	
Time deposits	231,970	46,502	18,164	12,121	3,135	2,504	314,396	312,090
Average interest rate	0.01	0.01	1.51	1.40	1.32	0.30	0.96	
Variable interest rate borrowings	2,950	2,200	16,799	—	—	—	21,949	22,204
Average interest rate	4.00	4.00	4.00	—	—	—	4.00	
Fixed interest rate borrowings	10,076	10,077	15,077	10,078	78	244	45,630	46,159
Average interest rate	4.10	1.11	1.77	1.59	1.00	1.00	1.66	
Total rate sensitive liabilities	$ 589,933	$ 58,779	$ 50,040	$ 22,199	$ 3,213	$ 2,748	$ 726,912	$ 725,390
Average interest rate	0.53%	1.12%	2.42%	1.49%	1.31%	0.36%	0.74%	

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 office in Sault Ste. Marie. 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 interest bearing accounts. 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. In 2016, the Corporation did 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 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. See Note 19 to the consolidated financial statements for additional information.

Table of Contents

Item 8.Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

Board of Directors

Mackinac Financial Corporation, Inc.

We have audited the accompanying consolidated balance sheet of Mackinac Financial Corporation (the Corporation) as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2016. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mackinac Financial Corp. as of December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/Plante & Moran, PLLC

March 28, 2017

Auburn Hills, Michigan

Table of Contents

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2016 and 2015

(Dollars in Thousands)

	December 31, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$ 44,620	$ 25,005
Federal funds sold	2,135	3
Cash and cash equivalents	46,755	25,008
Interest-bearing deposits in other financial institutions	14,047	5,089
Securities available for sale	86,273	53,728
Federal Home Loan Bank stock	2,911	2,169
Loans:		
Commercial	543,573	450,275
Mortgage	218,171	152,272
Consumer	20,113	15,847
Total Loans	781,857	618,394
Allowance for loan losses	(5,020)	(5,004)
Net loans	776,837	613,390
Premises and equipment	15,891	12,524
Other real estate held for sale	4,782	2,324
Deferred tax asset	8,760	9,213
Deposit based intangibles	2,172	1,076
Goodwill	5,694	3,805
Other assets	19,398	10,943
TOTAL ASSETS	$ 983,520	$ 739,269
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing deposits	$ 164,179	$ 122,775
NOW, money market, interest checking	286,622	202,784

Savings	58,315	30,882
CDs<$250,000	141,629	124,084
CDs>$250,000	8,489	8,532
Brokered	164,278	121,266
Total deposits	823,512	610,323
Federal funds purchased	6,000	-
Borrowings	67,579	45,754
Other liabilities	7,820	6,590
Total liabilities	904,911	662,667
SHAREHOLDERS’ EQUITY:		
Common stock and additional paid in capital - No par value Authorized - 18,000,000 shares Issued and outstanding - 6,263,371 and 6,217,620, respectively	61,583	61,133
Retained earnings	17,206	15,221
Accumulated other comprehensive income		
Unrealized (losses) gains on available for sale securities	(102)	297
Minimum pension liability	(78)	(49)
Total shareholders’ equity	78,609	76,602
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$ 983,520	$ 739,269

See accompanying notes to consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands, Except Per Share Data)

	For the Year Ended December 31,		
	2016	2015	2014
INTEREST INCOME:			
Interest and fees on loans:			
Taxable	$ 36,078	$ 32,034	$ 26,461
Tax-exempt	64	13	30
Interest on securities:			
Taxable	1,322	1,095	962
Tax-exempt	220	162	64
Other interest income	299	209	152
Total interest income	37,983	33,513	27,669
INTEREST EXPENSE:			
Deposits	3,322	3,251	3,218
Borrowings	1,563	1,142	924
Total interest expense	4,885	4,393	4,142
Net interest income	33,098	29,120	23,527
Provision for loan losses	600	1,204	1,200
Net interest income after provision for loan losses	32,498	27,916	22,327
OTHER INCOME:			
Deposit service fees	995	836	701
Income from mortgage loans sold on the secondary market	1,575	1,071	637
SBA/USDA loan sale gains	897	610	757
Mortgage servicing (amortization) income	(40)	547	675
Net realized security gains	150	455	54
Other	576	370	288
Total other income	4,153	3,889	3,112
OTHER EXPENSE:			
Salaries and employee benefits	14,625	12,449	10,303

Occupancy	2,680	2,424	2,129
Furniture and equipment	1,749	1,551	1,268
Data processing	1,620	1,381	1,150
Advertising	620	507	449
Professional service fees	1,169	1,270	1,163
Loan origination expenses and deposit and card related fees	1,100	955	699
Writedowns and losses on other real estate held for sale	202	332	280
FDIC insurance assessment	488	506	362
Telephone	528	455	327
Transaction related expenses	3,101	—	2,475
Other	2,003	2,046	2,005
Total other expenses	29,885	23,876	22,610
Income before provision for income taxes	6,766	7,929	2,829
Provision for income taxes	2,283	2,333	1,129
NET INCOME	$ 4,483	$ 5,596	$ 1,700
INCOME PER COMMON SHARE:			
Basic	$ .72	$ .90	$ .30
Diluted	$ .72	$ .89	$ .30

See accompanying notes to consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands)

	December 31,		
	2016	2015	2014
Net income	$ 4,483	$ 5,596	$ 1,700
Other comprehensive income			
Change in securities available for sale:			
Unrealized (losses) gains arising during the period	(455)	(24)	578
Reclassification adjustment for securities gains included in net income	(150)	(455)	(54)
Tax effect	206	214	(178)
Net change in unrealized gains on available for sale securities	(399)	(265)	346
Defined benefit pension plan:			
Net unrealized actuarial loss on defined benefit pension obligation	(44)	—	(74)
Amortization of net loss and settlement cost recognized in income	—	—	—
Tax effect	15	—	25
Changes from defined benefit pension plan	(29)	—	(49)
Other comprehensive (loss) income, net of tax	(428)	(265)	297
Total comprehensive income	$ 4,055	$ 5,331	$ 1,997

See accompanying notes to consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands)

	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2014	5,541,390	$ 53,621	$ 11,412	$ 216	$ 65,249
Net income	—	—	1,700	—	1,700
Other comprehensive income (loss):					
Net change in unrealized gain on securities available for sale	—	—	—	346	346
Actuarial loss on defined benefit	—	—	—	—	—
pension obligation	—	—	—	(49)	(49)
Total comprehensive income				297	1,997
Stock compensation	—	429	—	—	429
Issuance of common stock:					
Acquisition - Peninsula Financial Corp	695,361	7,804	—	—	7,804
Stock option exercise	6,580	(32)	—	—	(32)
Restricted stock award vesting	37,125	—	—	—	—
Total issuance of common stock	739,066	7,772	—	—	7,772
Repurchase of common stock	(13,700)	(143)	—	—	(143)
Dividend on common stock	—	—	(1,308)	—	(1,308)
Balance, December 31, 2014	6,266,756	$ 61,679	$ 11,804	$ 513	$ 73,996
Net income	—	—	5,596	—	5,596
Other comprehensive income (loss):					
Net change in unrealized gain on securities available for sale	—	—	—	(265)	(265)
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	—	(265)	5,331

Stock compensation	—	576	—	—	576
Issuance of common stock:					
Restricted stock award vesting	53,319	—	—	—	—
Repurchase of common stock	(102,455)	(1,122)	—	—	(1,122)
Dividend on common stock	—	—	(2,179)	—	(2,179)
Balance, December 31, 2015	6,217,620	$ 61,133	$ 15,221	$ 248	$ 76,602
Net income	—	—	4,483	—	4,483
Other comprehensive income (loss):					
Net change in unrealized gain on securities available for sale	—	—	—	(399)	(399)
Actuarial loss on defined benefit pension obligation	—	—	—	(29)	(29)
Total comprehensive income	—	—	—	(428)	4,055
Stock compensation	—	600	—	—	600
Issuance of common stock:					
Restricted stock award vesting	59,751	—	—	—	—
Repurchase of common stock	(14,000)	(150)	—	—	(150)
Dividend on common stock	—	—	(2,498)	—	(2,498)
Balance, December 31, 2016	6,263,371	$ 61,583	$ 17,206	$ (180)	$ 78,609

See accompanying notes to consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS CASH FLOWS

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands)

	For the year ended December 31,		
	2016	2015	2014
Cash Flows from Operating Activities:			
Net income	$ 4,483	$ 5,596	$ 1,700
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,921	1,670	1,503
Provision for loan losses	600	1,204	1,200
Deferred tax expense	2,283	2,333	1,129
(Gain) on sales/calls of securities	(150)	(455)	(54)
(Gain) on sale of loans sold in the secondary market	(1,575)	(873)	(493)
Origination of loans held for sale in secondary market	(81,693)	(53,229)	(29,871)
Proceeds from sale of loans in the secondary market	83,268	54,102	30,364
(Gain) loss on sale of premises, equipment, and other real estate held for sale	(10)	65	81
Writedown of other real estate held for sale	212	295	228
Stock compensation	600	576	429
Change in other assets	(10,282)	8,188	(4,112)
Change in other liabilities	720	(6,380)	6,337
Net cash provided by operating activities	377	13,092	8,441
Cash Flows from Investing Activities:			
Net increase in loans	(56,237)	(19,321)	(50,969)
Net decrease (increase) in interest-bearing deposits in other financial institutions	3,015	708	(225)
Purchase of securities available for sale	(16,105)	(23,894)	(8,317)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	26,689	35,091	9,449
Capital expenditures	(2,137)	(1,341)	(1,433)
Proceeds from life insurance	301	263	—
Net cash used in Peninsula acquisition	—	—	(4,484)
Net cash used in Eagle acquisition and reimbursement of contract termination fee	(1,900)	—	—
Net cash received in Niagara acquisition	2,453	—	—
Proceeds from sale of premises, equipment, and other real estate	1,608	1,702	912
Redemption of FHLB stock	15	804	87
Net cash (used in) investing activities	(42,298)	(5,988)	(54,980)

Cash Flows from Financing Activities:			
Net increase in deposits	49,491	3,350	39,724
Net activity on line of credit	(8,801)	(3,367)	9,367
Increase in fed funds purchased	6,000	—	—
Repurchase of common stock	(150)	(1,122)	(143)
Dividend on common stock	(2,498)	(2,179)	(1,308)
Proceeds from term borrowing	19,800	—	3,000
Principal payments on borrowings	(174)	(725)	(373)
Net cash provided by (used in) financing activities	63,668	(4,043)	50,267
Net increase (decrease) in cash and cash equivalents	21,747	3,061	3,728
Cash and cash equivalents at beginning of period	25,008	21,947	18,219
Cash and cash equivalents at end of period	$ 46,755	$ 25,008	$ 21,947
Supplemental Cash Flow Information:			
Cash paid during the year for:			
Interest	$ 4,792	$ 4,423	$ 4,119
Income taxes	1,100	150	100
Business Combinations			
Fair value of tangible assets acquired (noncash)	$ 188,537	$ —	$ 105,265
Goodwill and identifiable intangible assets acquired	2,845	—	5,011
Liabilities assumed	175,209	—	104,151
Common stock issued	—	—	695,361
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)	$ 3,292	$ 1,376	$ 588

See accompanying notes to consolidated financial statements.

Table of Contents

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of Mackinac Financial Corporation (the “Corporation”) and Subsidiaries conform to accounting principles generally accepted in the United States and prevailing practices within the banking industry. Significant accounting policies are summarized below.

Principles of Consolidation

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, mBank (the “Bank”) and other minor subsidiaries, after elimination of intercompany transactions and accounts.

Nature of Operations

The Corporation’s and the Bank’s revenues and assets are derived primarily from banking activities. The Bank’s primary market area is the Upper Peninsula, the northern portion of the Lower Peninsula of Michigan, Northeastern Wisconsin and Oakland County in Lower Michigan.   The Bank provides to its customers commercial, real estate, agricultural, and consumer loans, as well as a variety of traditional deposit products. Less than 1.0% of the Corporation’s business activity is with Canadian customers and denominated in Canadian dollars.

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

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of investment securities, the valuation of foreclosed real estate, deferred tax assets, mortgage servicing rights, and the assessment of goodwill for impairment.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing deposits in correspondent banks, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

Securities

The Corporation's securities are classified and accounted for as securities available for sale. These securities are stated at fair value. Premiums and discounts are recognized in interest income using the interest method over the period to maturity. Unrealized holding gains and losses on securities available for sale are reported as accumulated other comprehensive income within shareholders' equity until realized. When it is determined that securities or other investments are impaired and the impairment is other than temporary, an impairment loss is recognized in earnings and a new basis in the affected security is established. Gains and losses on the sale of securities are recorded on the trade date and determined using the specific-identification method.

Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank (FHLB) system, the Bank is required to hold stock in the FHLB based on the anticipated level of borrowings to be advanced. This stock is recorded at cost, which approximates fair value. Transfer of the stock is substantially restricted.

Table of Contents

Interest Income and Fees on Loans

Interest income on loans is reported on the level-yield method and includes amortization of deferred loan fees and costs over the loan term. Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period. The accrual of interest on loans is discontinued when, in the opinion of management, it is probable that the borrower may be unable to meet payments as they become due as well as when required by regulatory provisions. 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. Interest income on impaired and nonaccrual loans is recorded on a cash basis.

Acquired Loans

Loans acquired with evidence of credit deterioration since inception and for which it is probable that all contractual payments will not be received are accounted for under ASC Topic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (“ASC 310-30”). These loans are recorded at fair value at the time of acquisition, with no carryover of the related allowance for loan losses. Fair value of acquired loans is determined using a discounted cash flow methodology based on assumptions about the amount and timing of principal and interest payments, principal prepayments and principal defaults and losses, and current market rates. In recording the fair values of acquired impaired loans at acquisition date, management calculates a non-accretable difference (the credit component of the purchased loans) and an accretable difference (the yield component of the purchased loans).

Over the life of the acquired loans, management continues to estimate cash flows expected to be collected on pools of loans sharing common risk characteristics, which are treated in the aggregate when applying various valuation techniques. We evaluate at each balance sheet date whether the present value of our pools of loans determined using the effective interest rates has decreased significantly and if so, recognize a provision for loan loss in our consolidated statement of operations. For any significant increases in cash flows expected to be collected, we adjust the amount of the accretable yield recognized on a prospective basis over the pool’s remaining life.

Performing acquired loans are accounted for under ASC Topic 310-20, Receivables – Nonrefundable Fees and Other Costs. Performance of certain loans may be monitored and based on management’s assessment of the cash flows and other facts available, portions of the accretable difference may be delayed or suspended if management deems appropriate. The Corporation’s policy for determining when to discontinue accruing interest on performing acquired loans and the subsequent accounting for such loans is essentially the same as the policy for originated loans.

Servicing Rights

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based on the fair value of the rights compared to amortized cost. Impairment is determined by using prices for similar assets with similar characteristics, such as interest rates and terms. Fair value is determined by using prices for similar assets with similar characteristics, when available, or based on discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to 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 an unallocated 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.

Troubled Debt Restructuring

Troubled debt restructuring of loans is undertaken to improve the likelihood that the loan will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. All modified loans are evaluated to determine whether the loans should be reported as a Troubled Debt Restructure (TDR). A loan is a TDR when the Corporation, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower by modifying or renewing a loan that the Corporation would not otherwise consider. To make this determination, the Corporation must determine whether (a) the borrower is experiencing financial difficulties and (b) the Corporation granted the borrower a concession. This determination requires consideration of all of the facts and circumstances surrounding the modification. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean the borrower is experiencing financial difficulties.

Other Real Estate Held for Sale

Other real estate held for sale consists of assets acquired through, or in lieu of, foreclosure and other long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Other real estate held for sale is initially recorded at fair value, less costs to sell, establishing a new cost basis. Valuations are periodically performed by management or a third party, and the assets' carrying values are adjusted to the lower of cost basis or fair value less costs to sell. Impairment losses are recognized for any initial or subsequent write-downs. Net revenue and expenses from operations of other real estate held for sale are included in other expense.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Maintenance and repair costs are charged to expense as incurred. Gains or losses on disposition of premises and equipment are reflected in income. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

Goodwill and Other Intangible Assets

The excess of the cost of acquired entities over the fair value of identifiable assets acquired less liabilities assumed is recorded as goodwill. In accordance with ASC 350 (SFAS No. 142, Goodwill and Other Intangible Assets), amortization of goodwill and indefinite-lived assets is not recorded. However, the recoverability of goodwill is annually tested for impairment. The Corporation's core deposit intangible is currently being amortized over its estimated useful life of ten years.

Stock Compensation Plans

On May 22, 2012, the Corporation's shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, shares of restricted stock awards ("RSAs"), or stock appreciation rights. The aggregate number of shares of the Corporation's common stock issuable under the plan is 575,000. Awards are made to certain other senior officers at the discretion of the Corporation's management. Compensation cost equal to the fair value of the award is recognized over the vesting period.

Table of Contents

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) is composed of unrealized gains and losses on securities available for sale, and unrecognized actuarial gains and losses in the defined benefit pension plan, arising during the period. These gains and losses for the period are shown as a component of other comprehensive income. The accumulated gains and losses are reported as a component of equity, net of any tax effect. At December 31, 2016, the balance in accumulated other comprehensive income consisted of a unrealized losses on available for sales securities of $.102 million and actuarial losses on the defined benefit pension obligation of $78,000. At December 31, 2015, the balance in accumulated other comprehensive income consisted of unrealized gains on available for sale securities of $.297 million and actuarial losses on the defined benefit pension obligation of $49,000.

Earnings per Common Share

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options and warrants 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 years ended December 31, 2016, 2015 and 2014 (dollars in thousands, except per share data):

	Year Ended December 31,		
	2016	2015	2014
(Numerator):			
Net income	$ 4,483	$ 5,596	$ 1,700
(Denominator):			
Weighted average shares outstanding	6,236,067	6,241,921	5,592,738
Effect of dilutive stock options, and vesting of restricted stock awards	32,636	31,400	61,073
Diluted weighted average shares outstanding	6,268,703	6,273,321	5,653,811
Income per common share:			
Basic	$ .72	$ .90	$ .30
Diluted	$ .72	$ .89	$ .30

Income Taxes

Deferred income taxes have been provided under the liability method. Deferred tax assets and liabilities are determined based upon the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences are expected to reverse. Deferred tax expense (benefit) is the result of changes in the deferred tax asset and liability. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred asset will not be realized.

Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Corporation has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. For letters of credit, the Corporation recognizes a liability for the fair market value of the obligations it assumes under that guarantee.

Recent Developments

In May 2014, the Financial Accounting Standards Board (FASB) issued guidance on the recognition of revenue from contracts with customers. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The guidance is effective January 1, 2018 and early adoption is permitted, only as of

Table of Contents

January 1, 2017. In this regard, management has completed a preliminary analysis of the impact of implementation. The key revenue streams identified include service charges and mortgage banking income. The new guidance is not expected to have a significant impact on the Corporation's financial results. Interest income is outside the scope of the new standard and will not be impacted upon adoption.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 amends current guidance by requiring companies to recognize changes in fair value for equity investments that have a readily determinable fair value through net income rather than through other comprehensive income. Under ASU 2016-01, equity investments that do not have a readily determinable fair value will either be accounted for the same as equity investments that have a readily determinable fair value, with changes in fair value recognized through net income or carried at cost, adjusted for changes in observable prices based on orderly transactions for identical or similar investments issued by the same issuer and further adjusted for impairment, if applicable. ASU 2016-01 also requires a qualitative assessment of impairment indicators each reporting period. If this assessment indicates that impairment exists, companies must adjust the investment to fair value and recognize an impairment loss in net income, even if the impairment is determined to be temporary. ASU 2016-01 is effective for public companies for interim and annual periods beginning after December 15, 2017. The Corporation's adoption of ASU 2016-01 is not expected to have a material impact on the Corporation's consolidated financial condition or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize an asset with right of use and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending December 31, 2019 and will be applied using modified retrospective transition method to the beginning of the earliest period presented. The Corporation currently has no capital leases, but does maintain seven operating leases for branch locations that will be impacted by the implementation of this guidance. The effect of applying the new lease guidance on the financial statements has not yet been determined.

In September, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income.

ASU 2016-13 requires an entity to measure expected credit losses for financial assets over the estimated lifetime of expected credit loss and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The standard includes the following core concepts in determining the expected credit loss. The estimate must: (a) be based on an asset's amortized cost (including premiums or discounts, net deferred fees and costs, foreign exchange and fair value hedge accounting adjustments), (b) reflect losses expected over the remaining contractual life of an asset (considering the effect of

voluntary prepayments), (c) consider available relevant information about the estimated collectability of cash flows (including information about past events, current conditions, and reasonable and supportable forecasts), and (d) reflect the risk of loss, even when that risk is remote.

ASU 2016-13 also amends the recording of purchased credit-deteriorated assets. Under the new guidance, an allowance will be recognized at acquisition through a gross-up approach whereby an entity will record as the initial amortized cost the sum of (a) the purchase price and (b) an estimate of credit losses as of the date of acquisition. In addition, the guidance also requires immediate recognition in earnings of any subsequent changes, both favorable and unfavorable, in expected cash flows by adjusting this allowance.

ASU 2016-13 also amends the impairment model for available-for-sale debt securities and requires entities to determine whether all or a portion of the unrealized loss on an available-for-sale debt security is a credit loss. Management may not use the length of time a security has been in an unrealized loss position as a factor in concluding whether a credit loss exists, as is currently permitted. In addition, an entity will recognize an allowance for credit losses on available-for-sale debt securities as a contra-account to the amortized cost basis rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. As a result, entities will recognize improvements to credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time under current practice.

Table of Contents

New disclosures required by ASU 2016-13 include: (a) for financial assets measured at amortized cost, an entity will be required to disclose information about how it developed its allowance, including changes in the factors that influenced management's estimate of expected credit losses and the reasons for those changes, (b) for financial receivables and net investments in leases measured at amortized cost, an entity will be required to further disaggregate the information it currently discloses about the credit quality of these assets by year or the asset's origination or vintage for as many as five annual periods, and (c) for available-for-sale debt securities, an entity will be required to provide a roll-forward of the allowance for credit losses and an aging analysis for securities that are past due.

Upon adoption of ASU 2016-13, a cumulative-effect adjustment to retained earnings will be recorded as of the beginning of the first reporting period in which the guidance is effective. ASU 2016-13 is effective for public companies for interim and annual periods beginning after December 15, 2019, with early adoption permitted for annual periods beginning after December 15, 2018. The Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact on the Corporation's consolidated financial condition and results of operations.

Reclassifications

Certain amounts in the 2015 and 2014 consolidated financial statements have been reclassified to conform to the 2016 presentation.

NOTE 2 — RESTRICTIONS ON CASH AND CASH EQUIVALENTS

Cash and cash equivalents in the amount of $17.518 million were restricted on December 31, 2016 to meet the reserve requirements of the Federal Reserve System.

In the normal course of business, the Corporation maintains cash and due from bank balances with correspondent banks. Balances in these accounts may exceed the Federal Deposit Insurance Corporation's insured limit of $250,000.

Management believes that these financial institutions have strong credit ratings and the credit risk related to these deposits is minimal.

NOTE 3 — SECURITIES AVAILABLE FOR SALE

The carrying value and estimated fair value of securities available for sale are as follows (dollars in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
December 31, 2016				
Corporate	$ 19,899	$ 49	$ (38)	$ 19,910
Equity	500	—	—	500
US Agencies	23,991	47	(86)	23,952
US Agencies - MBS	16,980	48	(195)	16,833
Obligations of states and political subdivisions	25,057	447	(426)	25,078
Total securities available for sale	$ 86,427	$ 591	$ (745)	$ 86,273
December 31, 2015				
Corporate	12,710	—	(64)	12,646
US Agencies	27,358	62	(43)	27,377
US Agencies - MBS	3,738	31	(10)	3,759
Obligations of states and political subdivisions	9,472	592	(118)	9,946
Total securities available for sale	$ 53,278	$ 685	$ (235)	$ 53,728

Table of Contents

Following is information pertaining to securities with gross unrealized losses at December 31, 2016 and 2015 aggregated by investment category and length of time these individual securities have been in a loss position (dollars in thousands):

	Less Than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
December 31, 2016				
Corporate	$ (38)	$ 12,085	$ —	$ —
Equity	—	—	—	—
US Agencies	(86)	19,153	—	—
US Agencies - MBS	(192)	11,589	(3)	932
Obligations of states and political subdivisions	(426)	13,328	—	—
Total securities available for sale	$ (742)	$ 56,155	$ (3)	$ 932
December 31, 2015				
Corporate	(64)	11,299	—	—
US Agencies	(43)	15,957	—	—
US Agencies - MBS	(10)	1,651	—	—
Obligations of states and political subdivisions	(118)	573	—	—
Total securities available for sale	$ (235)	$ 29,480	$ —	$ —

There were 118 securities in an unrealized loss position in 2016 and 13 in 2015. The gross unrealized losses in the current portfolio are considered temporary in nature and related to interest rate fluctuations. The Corporation has both the ability and intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

Following is a summary of the proceeds from sales and calls of securities available for sale, as well as gross gains and losses for the years ended December 31 (dollars in thousands):

	2016	2015	2014
Proceeds from sales and calls	$ 19,719	$ 25,628	$ 5,200
Gross gains on sales and calls	190	455	54
Gross (losses) on sales and calls	(40)	—	—

The carrying value and estimated fair value of securities available for sale at December 31, 2016, by contractual maturity, are shown below (dollars in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 1,010	$ 902
Due after one year through five years	48,665	48,587
Due after five years through ten years	13,469	13,633
Due after ten years	6,303	6,318
Subtotal	69,447	69,440
US Agencies - MBS	16,980	16,833
Total	$ 86,427	$ 86,273

Contractual maturities may differ from expected maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities with a market value of $11.931 million are pledged as collateral to the Federal Home Loan Bank and $5.494 million are pledged to certain customer relationships. See Note 10 for information on securities pledged to secure borrowings from the Federal Home Loan Bank.

Table of Contents

NOTE 4 — LOANS

The composition of loans at December 31 is as follows (dollars in thousands):

	2016	2015
Commercial real estate	$ 389,420	$ 312,805
Commercial, financial, and agricultural	142,648	122,140
Commercial construction	11,505	15,330
One to four family residential real estate	205,945	140,502
Consumer	20,113	15,847
Consumer construction	12,226	11,770
Total loans	$ 781,857	$ 618,394

The Corporation completed the acquisition of Peninsula Financial Corporation, ("PFC"), on December 5, 2014, The First National Bank of Eagle River ("Eagle River") on April 29, 2016 and Niagara Bancorporation ("Niagara") on August 31, 2016. The PFC acquired impaired loans totaled $13.290 million, the Eagle River acquired impaired loans totaled $3.401 million, and the Niagara acquired impaired loans totaled $2.105 million. In 2016, the Corporation had positive resolution of acquired nonperforming loans, which resulted in the recognition of approximately $96,000 of accretable interest. In 2015, the Corporation had positive resolution of acquired nonperforming loans, which resulted in the recognition of approximately $.578 million of the accretable interest.

The table below details the outstanding balances of the PFC acquired portfolio and the acquisition fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 13,290	$ 53,849	$ 67,139
Nonaccretable difference	(2,234)	—	(2,234)
Expected cash flows	11,056	53,849	64,905
Accretable yield	(744)	(2,100)	(2,844)
Carrying balance at acquisition date	$ 10,312	$ 51,749	$ 62,061

53

Table of Contents

The table below details the outstanding balances of the Eagle River acquired portfolio and the acquisition fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 3,401	$ 80,737	$ 84,138
Nonaccretable difference	(1,172)	—	(1,172)
Expected cash flows	2,229	80,737	82,966
Accretable yield	(391)	(1,700)	(2,091)
Carrying balance at acquisition date	$ 1,838	$ 79,037	$ 80,875

The table below details the outstanding balances of the Niagara acquired portfolio and the acquisition fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 2,105	$ 30,555	$ 32,660
Nonaccretable difference	(265)	—	(265)
Expected cash flows	1,840	30,555	32,395
Accretable yield	(88)	(600)	(688)
Carrying balance at acquisition date	$ 1,752	$ 29,955	$ 31,707

The table below presents a rollforward of the accretable yield on acquired loans for year ended December 31, 2016 (dollars in thousands):

	PFC			Eagle River			Niagara		
	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2015	$ 426	$ 1,342	$ 1,768	$ —	$ —	$ —	$ —	$ —	$ —
Acquisitions	—	—	—	391	1,700	2,091	88	600	688
Accretion	(50)	(700)	(750)	(46)	(479)	(525)	—	(95)	(95)
Reclassification from nonaccretable	94	—	94	109	—	109	36	—	36

difference									
Balance, December 31, 2016	$ 282	$ 642	$ 924	$ 236	$ 1,221	$ 1,457	$ 52	$ 505	$ 557

The table below presents a rollforward of the accretable yield on acquired loans for year ended December 31, 2015 (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2014	$ 744	$ 2,042	$ 2,786
Accretion	(578)	(700)	(1,278)
Reclassification from nonaccretable difference	260	—	260
Balance, December 31, 2015	$ 426	$ 1,342	$ 1,768

Table of Contents

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2016 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	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Charge-offs	(245)	(232)	—	(133)	—	(113)	—	(723)
Recoveries	54	41	7	5	—	32	—	139
Provision	(75)	160	(29)	150	(1)	107	288	600
Ending balance ALLR	$ 1,345	$ 614	$ 57	$ 296	$ 6	$ 90	$ 2,612	$ 5,020
Loans:								
Ending balance	$ 389,420	$ 142,648	$ 11,505	$ 205,945	$ 12,226	$ 20,113	$ —	$ 781,857
Ending balance ALLR	(1,345)	(614)	(57)	(296)	(6)	(90)	(2,612)	(5,020)
Net loans	$ 388,075	$ 142,034	$ 11,448	$ 205,649	$ 12,220	$ 20,023	$ (2,612)	$ 776,837
Ending balance ALLR:								
Individually evaluated	$ 470	$ 365	$ —	$ 43	$ —	$ 80	$ —	$ 958
Collectively evaluated	875	249	57	253	6	10	2,612	4,062
Total	$ 1,345	$ 614	$ 57	$ 296	$ 6	$ 90	$ 2,612	$ 5,020
Ending balance Loans:								
Individually evaluated	$ 1,304	$ 1,461	$ —	$ 1,125	$ —	$ 181	$ —	$ 4,071
Collectively evaluated	384,882	141,187	11,505	202,028	12,169	19,928	—	771,699
Acquired with deteriorated	3,234	—	—	2,792	57	4	—	6,087

credit quality Total	$ 389,420	$ 142,648	$ 11,505	$ 205,945	$ 12,226	$ 20,113	$ —	$ 781,857

Impaired loans, by definition, are individually evaluated.

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2015 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	$ 2,813	$ 1,539	$ 142	$ 285	$ 6	$ 13	$ 342	$ 5,140
Charge-offs	(52)	(1,749)	—	(142)	—	(87)	—	(2,030)
Recoveries	588	22	52	2	—	26	—	690
Provision	(1,738)	833	(115)	129	1	112	1,982	1,204
Ending balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Loans:								
Ending balance	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394
Ending balance ALLR	(1,611)	(645)	(79)	(274)	(7)	(64)	(2,324)	(5,004)
Net loans	$ 311,194	$ 121,495	$ 15,251	$ 140,228	$ 11,763	$ 15,783	$ (2,324)	$ 613,390
Ending balance ALLR:								
Individually evaluated	$ 420	$ 192	$ —	$ 60	$ —	$ 55	$ —	$ 727
Collectively evaluated	1,191	453	79	214	7	9	2,324	4,277
Total	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Ending balance Loans:								

Individually evaluated	$ 1,086	$ 617	$ —	$ 325	$ 83	$ —	$ —	$ 2,111
Collectively evaluated	307,336	121,345	15,330	136,940	11,686	15,845	—	608,482
Acquired with deteriorated credit quality	4,383	178	—	3,237	1	2	—	7,801
Total	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394

Impaired loans, by definition, are individually evaluated.

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.

Table of Contents

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.

Strong (1)

Borrower is not vulnerable to sudden economic or technological changes. They have "strong" balance sheets and are within an industry that is very typical for our markets or type of lending culture. Borrowers also have "strong" financial and cash flow performance and excellent collateral (low loan to value or readily available to liquidate collateral) in conjunction with an impeccable repayment history.

Good (2)

Borrower shows limited vulnerability to sudden economic change. These borrowers have "above average" financial and cash flow performance and a very good repayment history. The balance sheet of the company is also very good as compared to peer and the company is in an industry that is familiar to our markets or our type of lending. The collateral securing the deal is also very good in terms of its type, loan to value, etc.

Average (3)

Borrower is typically a well-seasoned business, however may be susceptible to unfavorable changes in the economy, and could be somewhat affected by seasonal factors. The borrowers within this category exhibit financial and cash flow performance that appear "average" to "slightly above average" when compared to peer standards and they show an adequate payment history. Collateral securing this type of credit is good, exhibiting above average loan to values, etc.

Acceptable (4)

A borrower within this category exhibits financial and cash flow performance that appear adequate and satisfactory when compared to peer standards and they show a satisfactory payment history. The collateral securing the request is within supervisory limits and overall is acceptable. Borrowers rated acceptable could also be newer businesses that are typically susceptible to unfavorable changes in the economy, and more than likely could be affected by seasonal factors.

Special Mention (5)

The borrower may have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Examples of this type of credit include a start-up company fully based on projections, a documentation issue that needs to be corrected or a general market condition that the borrower is working through to get corrected.

Substandard (6)

Substandard loans are classified assets exhibiting 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 classified as substandard clearly represent troubled and deteriorating credit situations requiring constant supervision.

Doubtful (7)

Loans in this category exhibit the same, if not more pronounced weaknesses used to describe the substandard credit. 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.

Table of Contents

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.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. 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.

Commercial construction loans in the amount of $4.414 million and $2.409 million at December 31, 2016, and 2015, respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases.

Below is a breakdown of loans by risk category as of December 31, 2016 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Spec Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,021	$ 23,940	$ 140,618	$ 205,710	$ 10,808	$ 5,323	$ —	$ —	$ 389,420
Commercial, financial and agricultural	10,421	13,434	49,434	65,097	2,485	1,777	—	—	142,648

Commercial construction	—	900	3,146	1,877	783	385	—	4,414	11,505
One-to-four family residential real estate	740	1,373	3,412	6,927	2,658	5,493	—	185,342	205,945
Consumer construction	28	—	—	—	—	17	—	12,181	12,226
Consumer	20	—	15	42	13	103	—	19,920	20,113
Total loans	$ 14,230	$ 39,647	$ 196,625	$ 279,653	$ 16,747	$ 13,098	$ —	$ 221,857	$ 781,857

Table of Contents

Below is a breakdown of loans by risk category as of December 31, 2015 (dollars in thousands)

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 2,072	$ 26,197	$ 113,868	$ 164,954	$ —	$ 5,714	$ —	$ —	$ 312,805
Commercial, financial and agricultural	13,067	5,954	47,194	53,791	—	2,134	—	—	122,140
Commercial construction	—	400	3,869	8,257	—	395	—	2,409	15,330
One-to-four family residential real estate	591	1,222	3,172	4,078	—	4,093	—	127,346	140,502
Consumer construction	—	—	—	—	—	—	—	11,770	11,770
Consumer	24	—	19	—	—	61	—	15,743	15,847
Total loans	$ 15,754	$ 33,773	$ 168,122	$ 231,080	$ —	$ 12,397	$ —	$ 157,268	$ 618,394

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.

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):

December 31, 2016	Nonaccrual Recorded Balance	Nonaccrual Unpaid Balance	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income on Accrual Basis
With no valuation reserve:						
Commercial real estate	$ 1,426	$ 1,891	$ 3,234	$ 5,318	$ —	$ 232
Commercial, financial and agricultural	11	11	—	116	—	3
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	1,623	2,198	2,792	4,500	—	196
Consumer construction	17	22	57	36	—	4
Consumer	82	86	4	127	—	2
With a valuation reserve:						
Commercial real estate	$ 306	$ 328	$ —	$ 103	$ 50	$ —
Commercial, financial and agricultural	326	357	—	109	231	—
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	333	333	—	171	94	—
Consumer construction	—	—	—	—	—	—
Consumer	—	—	—	5	5	—
Total:						
Commercial real estate	$ 1,732	$ 2,219	$ 3,234	$ 5,421	$ 50	$ 232
Commercial, financial and agricultural	337	368	—	225	231	3
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	1,956	2,531	2,792	4,671	94	196
Consumer construction	17	22	57	36	—	4
Consumer	82	86	4	132	5	2
Total	$ 4,124	$ 5,226	$ 6,087	$ 10,485	$ 380	$ 437

Table of Contents

December 31, 2015						
With no valuation reserve:						
Commercial real estate	$ 471	$ 803	$ 4,051	$ 7,205	$ —	$ 224
Commercial, financial and agricultural	—	—	1,778	4,849	—	9
Commercial construction	—	—	—	260	—	—
One to four family residential real estate	1,267	1,598	2,385	5,413	—	128
Consumer construction	20	22	2	99	—	—
Consumer	50	51	1	102	—	0
With a valuation reserve:						
Commercial real estate	$ —	$ —	$ —	$ —	$ —	$ —
Commercial, financial and agricultural	460	1,139	—	699	192	—
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	229	244	—	232	58	—
Consumer construction	—	—	—	—	—	—
Consumer	10	9	—	10	1	—
Total:						
Commercial real estate	$ 471	$ 803	$ 4,051	$ 7,205	$ —	$ 224
Commercial, financial and agricultural	460	1,139	1,778	5,548	192	9
Commercial construction	—	—	—	260	—	—
One to four family residential real estate	1,496	1,842	2,385	5,645	58	128
Consumer construction	20	22	2	99	—	—
Consumer	60	60	1	112	1	—
Total	$ 2,507	$ 3,866	$ 8,217	$ 18,869	$ 251	$ 361

A summary of past due loans at December 31, is as follows (dollars in thousands):

	2016			2015		
	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total
Commercial real estate	$ 942	$ 1,732	$ 2,674	$ 521	$ 471	$ 992

Commercial, financial and agricultural	186	337	523	222	460	682
Commercial construction	—	—	—	270	—	270
One to four family residential real estate	2,113	1,956	4,069	807	1,528	2,335
Consumer construction	—	17	17	—	20	20
Consumer	133	82	215	130	60	190
Total past due loans	$ 3,374	$ 4,124	$ 7,498	$ 1,950	$ 2,539	$ 4,489

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. 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. 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.

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. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan's original rate, or for collateral dependent loans, to the fair value of the collateral.

Table of Contents

There were no troubled debt restructurings that occurred during the years ended December 31 2016, and December 31, 2015.

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):

	2016	2015
Loans outstanding, January 1	$ 6,887	$ 8,789
New loans	2,510	0
Net activity on revolving lines of credit	2,119	778
Repayment	(2,321)	(2,680)
Loans outstanding at end of period	$ 9,195	$ 6,887

There were no loans to related-parties classified substandard as of December 31, 2016 and 2015. In addition to the outstanding balances above, there were unfunded commitments of $.592 million to related parties at December 31, 2016.

NOTE 5 — PREMISES AND EQUIPMENT

Details of premises and equipment at December 31 are as follows (dollars in thousands):

	2016	2015
Land	$ 2,566	$ 1,812
Buildings and improvements	18,001	15,497
Furniture, fixtures, and equipment	9,142	8,567
Construction in progress	310	142
Total cost basis	30,019	26,018

Less - accumulated depreciation	14,128	13,494
Net book value	$ 15,891	$ 12,524

Depreciation of premises and equipment charged to operating expenses amounted to $1.617 million in 2016, $1.457 million in 2015, and $1.337 million in 2014.

NOTE 6 — OTHER REAL ESTATE HELD FOR SALE

An analysis of other real estate held for sale for the years ended December 31 is as follows (dollars in thousands):

	2016	2015
Balance, January 1	$ 2,324	$ 3,010
Other real estate transferred from loans due to foreclosure	3,292	1,376
Other real estate acquired	1,205	-
Proceeds from other real estate sold	(1,640)	(1,702)
Transfer to premise and equipment	(197)	-
Writedowns of other real estate held for sale	(212)	(295)
Gain (loss) on sale of other real estate held for sale	10	(65)
Total other real estate held for sale	$ 4,782	$ 2,324

Table of Contents

Foreclosed residential real estate property of $2.094 million is included in other real estate as of December 31, 2016. The recorded investment in consumer mortgage loans secured by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdictions was $.195 million as of December 31, 2016.

NOTE 7 — DEPOSITS

The distribution of deposits at December 31 is as follows (dollars in thousands):

	2016	2015
Noninterest bearing deposits	$ 164,179	$ 122,775
NOW, money market, interest checking	286,622	202,784
Savings	58,315	30,882
CDs <$250,000	141,629	124,084
CDs >$250,000	8,489	8,532
Brokered	164,278	121,266
Total deposits	$ 823,512	$ 610,323

Maturities of non-brokered time deposits outstanding at December 31, 2016 are as follows (dollars in thousands):

2017	$ 88,269
2018	33,427
2019	10,662
2020	12,121
2021	3,135
Thereafter	2,504
Total	$ 150,118

NOTE 8 — GOODWILL AND OTHER INTANGIBLE ASSETS

During the fourth quarter of 2014, the Corporation recorded $3.805 million of goodwill and $1.206 million of deposit based intangible assets associated with the acquisition of Peninsula. During 2016, the Corporation recorded $1.839 million of goodwill and $.993 million of deposit based intangible assets associated with the acquisition of Eagle River. Also in 2016, the Corporation recorded $50,000 of goodwill and $.300 million of deposit based intangible assets with the acquisition of Niagara.

The deposit based intangible is reported net of accumulated amortization at $2.172 million at December 31, 2016, compared to $1.076 million at December 31, 2015. Amortization expense in 2016 is $.197 million, compared to $.121 million in 2015 and $10,000 in 2014. Amortization expense for the next five years is expected to be at $.250 million per year.

NOTE 9 – SERVICING RIGHTS

Mortgage Loans

Mortgage servicing rights ("MSRs") are recorded when loans are sold in the secondary market with servicing retained. As of December 31, 2016, the Corporation had obligations to service $221.355 million of residential first mortgage loans. The valuation of MSRs is 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. The fair value of the capitalized servicing rights approximates the carrying value. On a quarterly basis, management evaluates the MSRs for impairment. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 10.74% and a discount rate of 9.59% for December 31, 2016.

In 2016, management decided to no longer retain the servicing on mortgage loans sold.

Table of Contents

The following summarizes the fair value of the mortgage servicing rights capitalized and amortized. There was no valuation allowance required (dollars in thousands):

	December 31, 2016	December 31, 2015
Balance at beginning of period	$ 1,965	$ 1,994
Additions from loans sold with servicing retained	—	585
Acquired MSRs	207	—
Amortization	(599)	(614)
Balance at end of period	$ 1,573	$ 1,965
Balance of loan servicing portfolio	$ 221,355	$ 224,612
Mortgage servicing rights as % of portfolio	0.71%	.87%

Commercial Loans

The Corporation also retains the servicing on commercial loans that have been sold. These loans were originated and underwritten under the SBA and USDA government guarantee programs, in which the guaranteed portion of the loan was sold to a third party with servicing retained. The balance of these sold loans with servicing retained at December 31, 2016 and December 31, 2015 was approximately $41 million and $63 million, respectively. The Corporation valued these servicing rights at $.140 million as of December 31, 2016 and $.170 million at December 31, 2015. This valuation was established in consideration of the discounted cash flow of expected servicing income over the life of the loans.

NOTE 10 — BORROWINGS

Borrowings consist of the following at December 31 (dollars in thousands):

	2016	2015

Federal Home Loan Bank fixed rate advances	$ 45,000	$ 35,000
Correspondent bank line of credit	750	7,750
Correspondent bank term note	21,199	2,300
USDA Rural Development note	630	704
	$ 67,579	$ 45,754

The Federal Home Loan Bank borrowings bear a weighted average rate of 2.10% and mature in 2017, 2018, 2019 and 2020. They are collateralized at December 31, 2016 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $44.042 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $11.966 million and $11.931 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $2.911 million. Prepayment of the advances is subject to the provisions and conditions of the credit policies of the Federal Home Loan Bank of Indianapolis and the Federal Home Loan Bank of Chicago in effect as of December 31, 2016.

The Corporation currently has one banking borrowing relationship. The relationship consists of a $5.0 million revolving line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017. This relationship is secured by all of the outstanding common stock of mBank.

The USDA Rural Development borrowing bears an interest rate of 1.00% and matures in August, 2024. It is collateralized by loans totaling $.106 million originated and held by the Corporation's wholly owned subsidiary, First

Table of Contents

Rural Relending, and an assignment of a demand deposit account in the amount of $.583 million, and guaranteed by the Corporation.

Maturities and principal payments of borrowings outstanding at December 31, 2016 are as follows (dollars in thousands):

2017	$ 13,026
2018	12,277
2019	31,876
2020	10,078
2021	78
Thereafter	244
Total	$ 67,579

NOTE 11 — INCOME TAXES

The components of the federal income tax provision (credit) for the years ended December 31 are as follows (dollars in thousands):

	2016	2015	2014
Current tax expense	$ 485	$ —	$ —
Change in valuation allowance		(760)	—
Deferred tax expense	1,798	3,093	1,129
Provision for income taxes	$ 2,283	$ 2,333	$ 1,129

A summary of the source of differences between income taxes at the federal statutory rate and the provision (credit) for income taxes for the years ended December 31 is as follows (dollars in thousands):

2016	2015	2014

Tax expense at statutory rate	$ 2,301	$ 2,695	$ 962
Increase (decrease) in taxes resulting from:			
Tax-exempt interest	(96)	(60)	(25)
Change in valuation allowance	—	(760)	—
Expiration of deferred tax assets	—	429	—
Nondeductible transaction expenses	95	—	176
Other	(17)	29	16
Provision for income taxes, as reported	$ 2,283	$ 2,333	$ 1,129

Table of Contents

Deferred income taxes are provided for the temporary differences between the financial reporting and tax bases of the Corporation's assets and liabilities. The major components of net deferred tax assets at December 31 are as follows (dollars in thousands):

	2016	2015
Deferred tax assets:		
NOL carryforward	$ 3,080	$ 4,331
Allowance for loan losses	1,413	1,705
Alternative Minimum Tax Credit	1,944	1,999
OREO Tax basis > book basis	142	162
Tax credit carryovers	235	338
Deferred compensation	443	517
Pension liability	387	384
Stock compensation	116	141
Unrealized gain (loss) on securities	52	(153)
Purchase accounting adjustments	1,791	955
Other	805	141
Total deferred tax assets	10,408	10,520
Valuation allowance	$ —	$ —
Deferred tax liabilities:		
Core deposit premium	(739)	(366)
FHLB stock dividend	(91)	(100)
Depreciation	(208)	(113)
Mortgage servicing rights	(583)	(667)
Other	(27)	(61)
Total deferred tax liabilities	(1,648)	(1,307)
Net deferred tax asset	$ 8,760	$ 9,213

The Corporation has reported deferred tax assets of $8.760 million at December 31, 2016. 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. The Corporation, as of December 31, 2016 had a net operating loss and tax credit carryforwards for tax purposes of approximately $9.1 million, and $2.2 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of December 31, 2016 and determined that it was "more likely than not" that they would be utilized prior to expiration. 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 and credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

NOTE 12 — OPERATING LEASES

The Corporation currently maintains seven operating leases for office locations. The first operating lease, for the Corporation's location in Birmingham, was originated in September 2005 and had an original term of 66 months with an option to renew for an additional five -year period. The original term of this was extended during 2011 for an additional three year term and again in 2014 for an additional three year term.

The second operating lease, for a second location in Manistique, was executed in April 2010, the terms of which began at that time. The original term of this lease expired in 2013, and the second of the four consecutive renewal terms of two years each is in place.

The third operating lease, for a loan production office in Traverse City, was executed in May 2012, the terms of which began in August 2012. The original term of this lease expired in 2015 and automatically renewed at that time. The lease was renegotiated in 2016 for a term of 36-months, with two consecutive options to extend the lease for 36 months each.

The fourth operating lease was initiated in December 2013 as the Corporation consolidated its banking offices in Marquette. The original term of this lease is 15 years with options for two consecutive renewal terms of four years each.

The fifth operating lease, located in Troy, for the asset based lending office, was initiated in December 2013 and expires on May 31, 2019.

With the acquisition of PFC, the Corporation acquired three additional operating leases for office locations. The first, for an additional location in Marquette, was executed in February 2011 with a term of five years and expired in 2016. The Corporation opted not to renew this lease, and subsequently closed that office location. The second, for the location in Negaunee was executed in September 2012 with an initial term of five years, expiring in 2017, with option to renew for one additional term of five years. The final, for a location in Ishpeming was executed in April 2008 for an initial term of five years. This lease was renewed in May 2013 for an additional five years.

Future minimum payments for base rent, by year and in the aggregate, under the initial terms of the operating lease agreements, consist of the following (dollars in thousands):

2017	$ 722
2018	587
2019	517
2020	467
2021	476
Thereafter	3,609
Total	$ 6,378

Rent expense for all operating leases amounted to $1.053 million in 2016, $.985 million in 2015, and $.885 million in 2014.

NOTE 13 — RETIREMENT PLAN

The Corporation has established a 401(k) profit sharing plan. Employees who have completed three months of service and attained the age of 18 are eligible to participate in the plan. Eligible employees can elect to have a portion, not to exceed 80%, of their annual compensation paid into the plan. In addition, the Corporation may make discretionary contributions into the plan. Retirement plan contributions charged to operations totaled $300,000, $288,000, and $214,000 in 2016, 2015, and 2014, respectively.

NOTE 14 — DEFINED BENEFIT PENSION PLAN

The Corporation acquired the Peninsula Financial Corporation noncontributory defined benefit pension plan. Effective December 31, 2005, the plan was amended to freeze participation in the plan; therefore, no additional employees are eligible to become participants in the plan. The benefits are based on years of service and the employee’s compensation at the time of retirement. The Plan was amended effective December 31, 2010, to freeze benefit accrual for all participants. Expected contributions to the Plan in 2017 are $19,000.

Table of Contents

The anticipated distributions over the next five years and through December 31, 2016 are detailed in the table below (dollars in thousands):

2017	$ 128
2018	125
2019	122
2020	121
2021	120
2022-2026	723
Total	$ 1,339

The following table sets forth the plan's funded status and amounts recognized in the Corporation's balance sheets and the activity from date of acquisition (dollars in thousands):

	2016	2015
Change in benefit obligation:		
Benefit obligation, beginning of year	$ 3,180	$ 3,290
Service cost	—	—
Interest cost	187	24
Actuarial loss	(44)	—
Benefits paid	(136)	(134)
Benefit obligation at end of year	3,187	3,180
Change in plan assets:		
Fair value of plan assets, beginning of year	2,033	2,107
Actual return on plan assets	103	(8)
Employer contributions	49	68
Benefits paid	(136)	(134)
Fair value of plan assets at end of year	2,049	2,033
Funded status, included with other liabilities	$ (1,138)	$ (1,147)

Net pension costs included in the Corporation's results of operations was immaterial.

Assumptions in the actuarial valuation were:

	2016	2015

Weighted average discount rate	3.78%	3.99%
Rate of increase in future compensation levels	N/A	N/A
Expected long-term rate of return on plan assets	8.00%	8.00%

The expected long-term rate of return on plan assets reflects management's expectations of long-term average rates of return on funds invested to provide for benefits included in the projected benefit obligation. The expected return is based on the outlook for inflation, fixed income returns and equity returns, while also considering historical returns, asset allocation and investment strategy. The discount rate assumption is based on investment yields available on AA rated long-term corporate bonds.

The primary investment objective is to maximize growth of the pension plan assets to meet the projected obligations to the beneficiaries over a long period of time, and to do so in a manner that is consistent with the Corporation's risk tolerance. The intention of the plan sponsor is to invest the plan assets in mutual funds with the following asset allocation, which was in place at both December 31, 2016 and December 31, 2015:

	Target Allocation	Actual Allocation
Equity securities	50% to 70%	60%
Fixed income securities	30% to 50%	40%

NOTE 15 — DEFERRED COMPENSATION PLAN

Prior to the recapitalization in 2004, as an incentive to retain key members of management and directors, the Corporation established a deferred compensation plan, with benefits based on the number of years the individuals have served the Corporation. This plan was discontinued and no longer applies to current officers and directors. A liability was recorded on a present value basis and discounted using the rates in effect at the time the deferred compensation agreement was entered into. The liability may change depending upon changes in long-term interest rates. The liability at December 31, 2016 and 2015, for vested benefits under this plan, was $.179 million and $.273 million, respectively. These benefits were originally contracted to be paid over a ten to fifteen-year period. The final payment is scheduled to occur in 2023. The deferred compensation plan is unfunded; however, the Bank maintains life insurance policies on the majority of the plan participants. The cash surrender value of the policies was $1.398 million and $1.545 million at December 31, 2016 and 2015, respectively.

Peninsula Financial Corporation, acquired by the Corporation in December 2014, also had a deferred compensation plan, which was similar in nature to the Corporation’s discontinued plan. The liability for this plan at December 31, 2016 and 2015, for vested benefits under this plan was $1.124 million and $1.219 million, respectively. The bank owned life insurance policy as of December 31, 2016 and 2015 had cash surrender values of $1.722 million and $1.692 million, respectively. This Plan was also discontinued by the Corporation and will not apply to future employees or directors of the Corporation.

Deferred compensation expense for both plans was $77,000 and $27,000 for 2016 and 2015, respectively.

NOTE 16 — REGULATORY MATTERS

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporation’s consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation’s assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Corporation’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of

Tier 1 capital to average assets. Management has determined that, as of December 31, 2016, the Corporation is well capitalized.

Effective January 1, 2015, the Corporation was subject to new capital requirements due to the Basel III regulation, including:

- A new minimum ratio of Common Equity Tier I Capital to risk-weighted assets of 4.5%;
- An increase in the minimum required amount of Additional Tier 1 Capital to 6% of risk-weighted assets;
- A continuation of the current minimum required amount of Total Capital (Tier 1 plus Tier 2) at 8% of risk-weighted assets; and
- A minimum leverage ratio of Tier I Capital to total assets equal to 4% in all circumstances.

In order to be “well-capitalized” under the new guidelines, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; an Additional Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

Table of Contents

The Corporation's and the Bank's actual capital and ratios compared to generally applicable regulatory requirements as of December 31, 2016 are as follows (dollars in thousands):

	Actual			Adequacy Purposes			Well-Capitalized	
	Amount	Ratio		Amount		Ratio		Amount	Ratio
Total capital to risk weighted assets:									
Consolidated	$ 73,811	9.5%	>	$ 62,503	>	8.0%	>	$ 78,128	10.0%
mBank	$ 92,521	11.9%	>	$ 62,102	>	8.0%	>	$ 77,627	10.0%
Tier 1 capital to risk weighted assets:									
Consolidated	$ 68,791	8.8%	>	$ 46,877	>	6.0%	>	$ 62,503	8.0%
mBank	$ 87,542	11.3%	>	$ 46,576	>	6.0%	>	$ 62,102	8.0%
Common equity Tier 1 capital to risk weighted assets									
Consolidated	$ 68,791	8.8%	>	$ 35,158	>	4.5%	>	$ 50,783	6.5%
mBank	$ 87,542	11.3%	>	$ 34,932	>	4.5%	>	$ 50,458	6.5%
Tier 1 capital to average assets:									
Consolidated	$ 68,791	7.3%	>	$ 37,939	>	4.0%	>	$ 47,242	5.0%
mBank	$ 87,542	9.2%	>	$ 37,889	>	4.0%	>	$ 47,361	5.0%

The Corporation's and the Bank's actual capital and ratios compared to generally applicable regulatory requirements as of December 31, 2015 are as follows (dollars in thousands):

	Actual			Adequacy Purposes				Well-Capitalized	
	Amount	Ratio		Amount		Ratio		Amount	Ratio
Total capital to risk weighted assets:									
Consolidated	$ 75,122	11.8%	>	$ 51,017	>	8.0%	>	$ 63,772	10.0%
mBank	$ 82,217	13.0%	>	$ 50,763	>	8.0%	>	$ 63,454	10.0%
Tier 1 capital to risk weighted assets:									
Consolidated	$ 70,118	11.0%	>	$ 38,263	>	6.0%	>	$ 51,017	8.0%
mBank	$ 77,254	12.2%	>	$ 38,072	>	6.0%	>	$ 50,763	8.0%
Common equity Tier 1 capital to risk weighted assets									
Consolidated	$ 70,118	11.0%	>	$ 28,697	>	4.5%	>	$ 41,451	6.5%
mBank	$ 77,254	12.2%	>	$ 28,554	>	4.5%	>	$ 41,245	6.5%

Tier 1 capital to average assets:									
Consolidated	$ 70,118	9.7%	>	$ 29,000	>	4.0%	>	$ 36,251	5.0%
mBank	$ 77,254	10.6%	>	$ 29,528	>	4.0%	>	$ 36,572	5.0%

NOTE 17 — STOCK COMPENSATION PLANS

Restricted Stock Awards

The Corporation’s restricted stock awards require certain service-based or performance requirements and have a vesting period of four years. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants.

The Corporation has historically granted RSAs to members of the Board of Directors and management. Awards granted are set to vest equally over their award terms and are issued at no cost to the recipient. The table below summarizes each of the grant awards.

Table of Contents

Date of Award	Units Granted	Market Value at grant date	Vesting Term
August, 2012	148,500	$ 7.91	4 years
March, 2014	52,774	12.95	4 years
March, 2015	37,730	11.15	4 years
May, 2015	3,000	10.77	Immediate
February, 2016	35,733	9.91	4 years

On August 31, 2013, 2014, 2015 and 2016, the Corporation issued 37,125 shares of its common stock for vested RSAs, in each year. In March 2015, the Corporation issued 13,194 shares of its common stock for vested RSAs. In May 2015, the Corporation granted 3,000 shares, which were immediately vested and issued. In March 2016, the Corporation issued 22,626 shares of its common stock for vested RSAs.

The Corporation recognized annual compensation expense of $.600 million in 2016, $.576 million in 2015 and $.480 million. Unrecognized compensation expense at the end of 2016 was $.669 million.

A summary of changes in our nonvested awards for the year follows:

	Number Outstanding	Weighted Average Grant Date Fair Value
Nonvested balance at January 1, 2016	114,435	$ 10.72
Granted during the year	35,733	9.91
Vested during the year	(59,751)	9.53
Nonvested balance at December 31, 2016	90,417	$ 11.19

NOTE 18 — SHAREHOLDERS' EQUITY

The Corporation currently has a share repurchase program. The program is conducted under authorizations by the Board of Directors. The Corporation repurchased 14,000 shares in 2016, 102,455 shares in 2015, 13,700 shares in 2014 and 55,594 shares in 2013. The share repurchases were conducted under Board authorizations made and publicly announced of $600,000 on February 27, 2013, $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date. As of December 31, 2016, $26,000 of the total authorization was available for future purchases.

NOTE 19 — 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 at December 31 are as follows (dollars in thousands):

	2016	2015
Commitments to extend credit:		
Variable rate	$ 59,496	$ 53,628
Fixed rate	28,737	26,846
Standby letters of credit - Variable rate	8,252	6,390
Credit card commitments - Fixed rate	5,533	3,747
	$ 102,018	$ 90,611

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.

Legal Proceedings and Contingencies

At December 31, 2016, there were no pending material legal proceedings to which the Corporation is a party or to which any of its property was subject, except for proceedings which arise in the ordinary course of business. In the opinion of management, pending legal proceedings will not have a material effect on the consolidated financial position or results of operations of the Corporation.

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan and Northeastern Wisconsin. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at December 31, 2016 represents $121.861 million, or 22.42%, compared to $102.620 million, or 22.79%, of the commercial loan portfolio on December 31, 2015. 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.

NOTE 20 — FAIR VALUE

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 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.

The following table presents information for financial instruments at December 31 (dollars in thousands):

	Level in Fair Value Hierarchy	December 31, 2016 Carrying Amount	December 31, 2016 Estimated Fair Value	December 31, 2015 Carrying Amount	December 31, 2015 Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 46,755	$ 46,755	$ 25,008	$ 25,008
Interest-bearing deposits	Level 2	14,047	14,047	5,089	5,089
Securities available for sale	Level 2	84,623	84,623	53,728	53,728
Securities available for sale	Level 3	1,650	1,650	—	—
Federal Home Loan Bank stock	Level 2	2,911	2,911	2,169	2,169
Net loans	Level 3	776,837	778,377	613,390	614,187
Accrued interest receivable	Level 3	2,016	2,016	1,416	1,416
Total financial assets		$ 928,839	$ 930,379	$ 700,800	$ 701,597
Financial liabilities:					
Deposits	Level 2	$ 823,512	$ 815,960	$ 610,323	$ 607,636
Borrowings	Level 2	67,579	68,293	45,754	45,989
Accrued interest payable	Level 3	267	267	174	174
Total financial liabilities		$ 891,358	$ 884,520	$ 656,251	$ 653,799

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

Table of Contents

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 following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at December 31, 2016 and the valuation techniques used by the Corporation to determine those fair values.

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.

The fair value of all investment securities at December 31, 2016 were based on level 2 and level 3 inputs. In December 31, 2015 all investment securities 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 3 — Investment Securities." The table below shows investment securities measured at fair value on a recurring basis (dollars in thousands):

(dollars in thousands)	Balance at December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2016

Assets

Corporate	$ 19,910	$ —	$ 19,910	$ —	$ —
Equity	500	—	—	500	—
US Agencies	23,952	—	23,952	—	—
US Agencies - MBS	16,833	—	15,683	1,150	—
Obligations of state and political subdivisions	25,078	—	25,078	—	—
	86,273				$ —

The Corporation had no Level 3 assets or liabilities on a recurring basis as of December 31, 2015.

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.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include loans and other real estate held for sale. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

Table of Contents

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2016

(dollars in thousands)	Balance at December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2016
Assets					
Impaired loans	$ 9,856	$ —	$ —	$ 9,856	$ 643
Other real estate held for sale	4,782	—	—	4,782	202
					$ 845

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2015

(dollars in thousands)	Balance at December 31, 2015	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, 2015
Assets					
Impaired loans	$ 10,724	$ —	$ —	$ 10,724	$ 1,852
Other real estate held for sale	2,324	—	—	2,324	332
					$ 2,184

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).

NOTE 21 — BUSINESS COMBINATIONS

The First National Bank of Eagle River

The Corporation completed its acquisition of Eagle River on April 29, 2016. Eagle River had three branch offices and approximately $125 million in assets of April 29, 2016. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected with a cash payment of $12.500 million.

Table of Contents

The table below highlights the allocation of the purchase price:

Purchase Price:		
Eagle River shares outstanding	85,776	
Price per share/Cash price	$ 145.73	
Total purchase price		$ 12,500
Reimbursement of termination fees		(1,763)
Cash consideration		$ 10,737
Net assets acquired:		
Cash and cash equivalents	$ 10,600	
Securities available for sale, net of purchase accounting marks	23,296	
FRB & FHLB Stock	575	
Total Loans, net of purchase accounting marks	80,875	
Premises and equipment	1,931	
Other real estate owned, net of purchase accounting marks	904	
Deposit based intangible	993	
Mortgage servicing rights	120	
Deferred tax asset	948	
Bank owned life insurance	4,132	
Other assets	323	
Total assets	124,697	
Non-interest bearing deposits	22,349	
Interest bearing deposits	82,165	
Total deposits	104,514	
FHLB Borrowings	11,000	
Other liabilities	285	
Total liabilities	115,799	
Net assets acquired		8,898
Goodwill		$ 1,839

The results of operations for the twelve months ended December 31, 2016, include the operating results of the acquired assets and assumed liabilities for the 245 days subsequent to the acquisition date. Eagle River's results of operations prior to the acquisition date are not included in the Corporation's consolidated statement of comprehensive income.

In addition to the data processing termination fees of $1.763 million, the Corporation incurred other Eagle River transaction related expenses of $.954 million, for a total of $2.717 million, or $1.793 million on an after tax basis during 2016. These expenses included professional services such as legal, accounting, employee severance payments and contractual arrangements for consulting services.

Niagara Bancorporation

The Corporation completed its acquisition of Niagara on August 31, 2016. Niagara had four branch offices and approximately $67 million in assets as of August 31, 2016. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected with a cash payment of $7.325 million.

Table of Contents

The table below highlights the allocation of the purchase price (dollars in thousands, except per share data):

Purchase Price:		
Niagara shares outstanding	4,354	
Price per share/Cash price	$ 1,682.36	
Total purchase price		$ 7,325
Net assets acquired:		
Cash and cash equivalents	$ 9,778	
Securities available for sale	21,491	
FRB & FHLB Stock	287	
Total Loans, net of purchase accounting marks	31,707	
Premises and equipment	926	
Other real estate owned, net of purchase accounting marks	301	
Deposit based intangible	300	
Mortgage servicing rights	87	
Deferred tax assets	397	
Bank owned life insurance	1,109	
Other assets	302	
Total assets	66,685	
Non-interest bearing deposits	5,396	
Interest bearing deposits	53,788	
Total deposits	59,184	
Other liabilities	226	
Total liabilities	59,410	
Net assets acquired		7,275
Goodwill		$ 50

The results of operations for the twelve months ended December 31, 2016, include the operating results of the acquired assets and assumed liabilities for the 122 days subsequent to the acquisition date. Niagara’s results of operations prior to the acquisition date are not included in the Corporation’s consolidated statement of comprehensive income.

The Corporation incurred Niagara transaction related expenses of $.384 million, or $.253 million on an after tax basis during 2016. These expenses included professional services such as legal, accounting, employee severance payments and contractual arrangements for consulting services.

Table of Contents

The following table provides the unaudited pro forma information for the results of operations for the twelve months ended December 31, 2016 and 2015, as if both the Eagle River acquisition and Niagara acquisition had occurred on January 1. These adjustments reflect the impact of certain purchase accounting fair value measurements, primarily on the loan and deposit portfolios of Eagle River and Niagara. In addition, the merger-related costs noted above are excluded from the 2016 results of operations, for comparative purposes. Further operating cost savings are expected along with additional business synergies as a result of the merger which are not presented in the pro forma amounts. These unaudited pro forma results are presented for illustrative purposes only and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of the period presented, nor are they intended to represent or be indicative of future results of the Corporation.

	2016	2015
Net interest income	$ 36,902	$ 32,924
Noninterest income	5,129	4,865
Noninterest expense	30,857	26,851
Net income	7,375	7,219
Net income per diluted share	$ 1.18	$ 1.15

Fair Value

In most instances, determining the fair value of the acquired assets and assumed liabilities required the Corporation to estimate the cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations is related to the valuation of acquired loans. For such loans, the excess cash flows expected at merger over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at merger and the cash flows expected to be collected at merger reflects the impact of estimated credit losses, interest rate changes, and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of the acquired banks' previously established allowance for loan losses.

Goodwill recognized in these acquisitions was based primarily due to the synergies and economies of scale expected from combining the operations of the Corporation with Eagle River and Niagara.

76

Table of Contents

NOTE 22 — PARENT COMPANY ONLY FINANCIAL STATEMENTS

BALANCE SHEETS

December 31, 2016 and 2015

(Dollars in Thousands)

	2016	2015
ASSETS		
Cash and cash equivalents	$ 106	$ 986
Investment in subsidiaries	97,407	83,786
Other assets	4,014	2,981
TOTAL ASSETS	$ 101,527	$ 87,753
LIABILITIES AND SHAREHOLDERS' EQUITY		
Line of Credit	$ 750	$ 7,750
Other borrowing	21,199	2,300
Other liabilities	969	1,101
Total liabilities	22,918	11,151
Shareholders' equity:		
Common stock and additional paid in capital - no par value		
Authorized 18,000,000 shares		
Issued and outstanding - 6,263,371 and 6,217,620 shares respectively	61,583	61,133
Retained earnings	17,206	15,221
Accumulated other comprehensive income	(180)	248
Total shareholders' equity	78,609	76,602
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 101,527	$ 87,753

Table of Contents

STATEMENTS OF OPERATIONS

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands)

	2016	2015	2014
INCOME:			
Interest income	$ 2	$ —	$ —
Total income	$ 2	$ —	$ —
EXPENSES:			
Interest expense on borrowings	707	453	210
Salaries and benefits	900	876	609
Professional service fees	173	256	247
Transaction related expenses	443	—	1,284
Other	152	184	304
Total expenses	2,375	1,769	2,654
Loss before income taxes and equity in undistributed net income of subsidiaries	(2,373)	(1,769)	(2,654)
(Benefit of) income taxes	(807)	(602)	(726)
Loss before equity in undistributed net income of subsidiaries	(1,566)	(1,167)	(1,928)
Equity in undistributed net income of subsidiaries	6,049	6,763	3,628
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$ 4,483	$ 5,596	$ 1,700

Table of Contents

STATEMENTS OF CASH FLOWS

Years Ended December 31, 2016, 2015, and 2014

(Dollars in Thousands)

	2016	2015	2014
Cash Flows from Operating Activities:			
Net income	$ 4,483	$ 5,596	$ 1,700
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net (income) of subsidiaries	(6,049)	(6,763)	(3,628)
Increase in capital from stock based compensation	600	576	429
Change in other assets	(1,033)	2,903	(5,664)
Change in other liabilities	(132)	(4,907)	8,790
Net cash provided by (used in) operating activities	(2,131)	(2,595)	1,627
Cash Flows from Investing Activities:			
Investments in subsidiaries	11,825	5,839	(4,000)
Net cash paid in acquisitions	(19,825)	—	(4,484)
Net cash (used in) investing activities	(8,000)	5,839	(8,484)
Cash Flows from Financing Activities:			
Increase on term borrowing	19,799	—	3,000
Principal payments on term borrowings	(100)	(100)	(300)
Net activity on line of credit	(7,800)	(550)	6,000
Repurchase of common stock	(150)	(1,122)	(143)
Dividend on common stock	(2,498)	(2,179)	(1,308)
Net cash provided by (used in) financing activities	9,251	(3,951)	7,249
Net increase (decrease) in cash and cash equivalents	(880)	(707)	392
Cash and cash equivalents at beginning of period	986	1,693	1,301
Cash and cash equivalents at end of period	$ 106	$ 986	$ 1,693

Table of Contents

Item 9.Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A.Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this report, management of the company, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the Corporation’s disclosure controls and procedures as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the “Exchange Act”). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation’s disclosure controls and procedures were effective, in ensuring the information relating to the Corporation (and its consolidated subsidiaries) required to be disclosed by the Corporation in the reports it files or submits under the Exchange Act was recorded, processed, summarized and reported to the Corporation’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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 December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

Report on Management’s Assessment of Internal Control over Financial Reporting

Mackinac Financial Corporation is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this Form 10-K. The consolidated financial statements and notes included in this Form 10-K have been prepared in conformity with generally accepted accounting principles in the United States and necessarily include some amounts that are based on management’s best estimates and judgments.

We, as management of Mackinac Financial Corporation, are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with generally accepted accounting principles in the United States. The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Corporation’s system of internal control over financial reporting as of December 31, 2016, in relation to criteria for the effective internal control over financial reporting as described in “Internal Control — Integrated Framework,” issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concludes that, as of December 31, 2016, its system of internal control over financial reporting is effective and meets the criteria of the “Internal Control — Integrated Framework.”

Item 9B.Other Information

None.

Table of Contents

PART III

Item 10.Directors, Executive Officers, and Corporate Governance

Executive Officers of the Registrant

The executive officers of the Corporation are listed below. The executive officers serve at the pleasure of the Board of Directors and are appointed by the Board annually. There are no arrangements or understandings between any officer and any other person pursuant to which the officer was selected.

Name	Age	Position
Paul D. Tobias	66	Chairman and Chief Executive Officer
Kelly W. George	49	President
Jesse A. Deering	37	Executive Vice President/Chief Financial Officer

Additional information for the executive officers of the registrant is included in the Corporation's Proxy Statement for its 2017 Annual Meeting of Shareholders under the caption "Executive Officers."

The information set forth under the captions "Information About Directors and Nominees," "Director Independence," "Board of Directors and Committees," "Indebtedness and Transactions with Management," and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Corporation's definitive Proxy Statement for its 2017 Annual Meeting of Shareholders (the "Proxy Statement"), a copy of which will be filed with the SEC prior to the meeting date, is incorporated herein by reference.

Item 11.Executive Compensation

Information relating to compensation of the Corporation's executive officers and directors is contained under the caption "Compensation of Executive Officers and Directors" in the Corporation's Proxy Statement and is incorporated herein by reference.

Item 12.Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information relating to security ownership of certain beneficial owners and management is contained under the caption “Beneficial Ownership of Common Stock” in the Corporation’s Proxy Statement is incorporated herein by reference.

The following table provides information as of December 31, 2016 with respect to compensation plans (including individual compensation arrangements) under which equity securities of the Corporation are authorized for issuance. All such compensation plans were previously approved by security holders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise issue price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)	
Equity stock based compensation plans approved by security holders:				
Issued and outstanding:				
Restricted stock awards - August 2012	37,125	7.91	—	
Restricted stock awards - March 2014	39,580	12.95	—	
Restricted stock awards - March 2015	37,730	11.15	—	
Restricted stock awards - February 2016	35,733	9.91	—	
Shares available for future issuance	—	—	165,299	
Total	150,168	$ 10.53	165,299	—

Item 13.Certain Relationships, Related Transactions and Director Independence

Information relating to certain relationships and related transactions is contained under the caption “Indebtedness of and Transactions with Management” in the Corporation’s Proxy Statement and is incorporated herein by reference.

Additional information is contained under the captions “Information about Directors and Nominees and “Board of Directors Meetings and Committees.” within the Corporation’s Proxy Statement and is incorporated herein by reference.

Item 14.Principal Accountant Fees and Services

Information relating to principal accountant fees and services is contained under the caption “Principal Accountant Fees and Services” in the Corporation’s Proxy Statement and is incorporated herein by reference.

Table of Contents

PART IV

Item 15.Exhibits and Financial Statement Schedules

(commission file number for all incorporated documents: 0-20167)

(a)The following documents are filed as a part of this report.

1.Consolidated Financial Statements

(i)The financial statements of the Corporation included in this Form 10-K are listed in Part II, Item 8.

2.All of the schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are either not required under the related instruction, the required information is contained elsewhere in the Form 10-K, or the schedules are inapplicable, and therefore have been omitted.

3.Exhibits

The exhibits required to be filed as part of this Form 10-K are listed in the attached Exhibit Index.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Corporation has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, dated March 30, 2017.

MACKINAC FINANCIAL CORPORATION

/s/ Paul D. Tobias
Paul D. Tobias
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on March 30, 2017, by the following persons on behalf of the Corporation and in the capacities indicated. Each director of the Corporation, whose signature appears below, hereby appoints Paul D. Tobias and Jesse A. Deering, and each of them severally, as his attorney-in-fact, to sign in his name and on his behalf, as a director of the Corporation, and to file with the Commission any and all Amendments to this Report on Form 10-K.

Signature	
/s/ Paul D. Tobias Paul D. Tobias — Chairman, Chief Executive Officer & Director (principal executive officer)	/s/ Jesse A. Deering Executive Vice President/Chief Financial Officer (principal financial and accounting officer)
/s/ Walter J. Aspatore Walter J. Aspatore - Director	/s/ Joseph D. Garea Joseph D. Garea — Director
/s/ Robert E. Mahaney Robert E. Mahaney — Director	/s/ Robert H. Orley Robert H. Orley - Director
/s/ Dennis B. Bittner Dennis B. Bittner — Director	/s/ L. Brooks Patterson L. Brooks Patterson — Director
/s/ Kelly W. George Kelly W. George — President & Director	/s/ Randolph C. Paschke Randolph C. Paschke — Director
/s/ David R. Steinhardt David R. Steinhardt — Director	

Table of Contents

INDEX TO EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date	Filed Herewith
2.1	Stock Purchase Agreement, dated as of January 19, 2016, by and between Ellis Bankshares, Inc. and Mackinac Financial Corporation	8-K	000-20167	2.1	1/19/2016	
2.2	Stock Purchase Agreement, dated as of May 24, 2016, by and among Mackinac Financial Corporation, the Sellers named therein, and Niagara Bancorporation, Inc.	8-K	000-20167	2.1	5/24/2016	
3.1	Articles of Incorporation and all amendments (most recent amendment filed December 14, 2004)	10-K	000-20167	3.1	3/31/2009	
3.3	Third Amended and Restated Bylaws adopted March 18, 2014	8-K	000-20167	3.1	3/24/2014	
10.1	Deferred Compensation, Deferred Stock, and Current Stock Purchase Plan for the Corporation's Nonemployee directors**	10-K	000-20167	10.2	3/28/2000	
10.2	North Country Financial Corporation Supplemental Executive Retirement Plan**	10-Q	000-20167	10.6	11/5/1999	
10.3	Form of Director and Officer Indemnification Agreement**	8-K	000-20167	10.1	3/24/2014	
10.4	Mackinac Financial Corporation 2012 Incentive Compensation Plan**	DEF14A	000-20167	Annex I	4/25/2012	
10.5	Employment Agreement, dated as of August 10, 2012, by and between Mackinac Financial Corporation and Paul D. Tobias**	8-K	000-20167	10.1	8/15/2012	
10.6	Employment Agreement, dated as of August 10, 2012, by and between Mackinac	8-K	000-20167	10.2	8/15/2012	

	Financial Corporation and Kelly W. George**					
10.7	First Amendment to Employment Agreement, dated as of March 24, 2015, by and between Mackinac Financial Corporation and Paul D. Tobias **	8-K	000-20167	10.1	3/27/2015	
10.8	First Amendment to Employment Agreement, dated as of March 24, 2015, by and between Mackinac Financial Corporation and Kelly W. George **	8-K	000-20167	10.2	3/27/2015	
10.9	Amended and Restated Employment Agreement, dated as of August 1, 2016, by and between Mackinac Financial Corporation and Jesse A. Deering **	8-K	000-20167	10.1	8/1/2016	
10.10	Form of Restricted Stock Unit Award Agreement under the Mackinac Financial Corporation 2012 Incentive Compensation Plan**	8-K	000-20167	10.3	8/13/2012	
21	Subsidiaries of the Corporation					*
23.1	Consent of Plante & Moran, PLLC					*
31	Rule 13(a) — 14(a) Certifications					*

85

Table of Contents

32.1	Section 1350 Chief Executive Officer Certification	*
32.2	Section 1350 Chief Financial Officer Certification	*
101.INS	XBRL Instance Document	*
101.SCH	XBRL Taxonomy Extension Schema Document***	*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document***	*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document***	*
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document***	*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document***	*

* Filed herewith.

** Management compensatory plan, contract, or arrangement.

*** As provided in Rule 406T of Regulation S-T, this information shall not be deemed “filed” for the purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 or otherwise subject to liability under those Sections.