MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

For the transition period from <> to <>

Commission file number: 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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

130 SOUTH CEDAR STREET, MANISTIQUE, MI	49854
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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

Large Accelerated Filer		Accelerated Filer
Non-accelerated Filer	(Do not check if a smaller reporting company)	Smaller reporting company
		Emerging growth company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

As of November 13, 2017, there were outstanding 6,294,930 shares of the registrant's common stock, no par value.

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MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	September 30, 2017 (Unaudited)	December 31, 2016
ASSETS		
Cash and due from banks	$ 52,676	$ 44,620
Federal funds sold	5,006	2,135
Cash and cash equivalents	57,682	46,755
Interest-bearing deposits in other financial institutions	13,374	14,047
Securities available for sale	85,009	86,273
Federal Home Loan Bank stock	3,250	2,911
Loans:		
Commercial	572,799	543,573
Mortgage	217,103	218,171
Consumer	18,247	20,113
Total Loans	808,149	781,857
Allowance for loan losses	(5,130)	(5,020)
Net loans	803,019	776,837
Premises and equipment	16,619	15,891
Other real estate held for sale	4,413	4,782
Deferred tax asset	6,266	8,760
Deposit based intangibles	1,985	2,172
Goodwill	5,694	5,694
Other assets	17,759	19,398
TOTAL ASSETS	$ 1,015,070	$ 983,520
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing deposits	$ 162,142	$ 164,179
NOW, money market, interest checking	275,854	286,622

Savings	61,832	58,315
CDs<$250,000	144,031	141,629
CDs>$250,000	9,126	8,489
Brokered	182,218	164,278
Total deposits	835,203	823,512
Federal funds purchased	—	6,000
Borrowings	91,397	67,579
Other liabilities	5,821	7,820
Total liabilities	932,421	904,911
SHAREHOLDERS’ EQUITY:		
Common stock and additional paid in capital - No par value Authorized - 18,000,000 shares Issued and outstanding - 6,294,930 and 6,263,371 respectively	61,881	61,583
Retained earnings	20,439	17,206
Accumulated other comprehensive income (loss)		
Unrealized (losses) gains on available for sale securities	407	(102)
Minimum pension liability	(78)	(78)
Total shareholders’ equity	82,649	78,609
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$ 1,015,070	$ 983,520

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Unaudited)		(Unaudited)	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	$ 10,799	$ 9,441	$ 31,016	$ 26,085
Tax-exempt	21	19	73	34
Interest on securities:				
Taxable	401	387	1,195	953
Tax-exempt	72	57	226	114
Other interest income	230	91	475	212
Total interest income	11,523	9,995	32,985	27,398
INTEREST EXPENSE:				
Deposits	1,157	870	3,170	2,410
Borrowings	577	429	1,541	1,008
Total interest expense	1,734	1,299	4,711	3,418
Net interest income	9,789	8,696	28,274	23,980
Provision for loan losses	200	200	400	350
Net interest income after provision for loan losses	9,589	8,496	27,874	23,630
OTHER INCOME:				
Deposit service fees	262	259	803	723
Income from mortgage loans sold on the secondary market	434	512	1,048	1,118
SBA/USDA loan sale gains	278	551	426	717
Net mortgage servicing (amortization) income	(6)	(12)	(24)	(74)
Net realized security gains	38	40	38	149
Other	147	139	433	379
Total other income	1,153	1,489	2,724	3,012
OTHER EXPENSE:				
Salaries and employee benefits	3,934	3,687	11,388	10,592
Occupancy	761	680	2,322	1,960
Furniture and equipment	616	440	1,640	1,248
Data processing	533	440	1,482	1,118
Advertising	227	157	524	494

Professional service fees	323	309	1,049	807
Loan origination expenses and deposit and card related fees	181	152	515	434
Writedowns and losses on other real estate held for sale	43	60	298	62
FDIC insurance assessment	210	131	556	356
Telephone	154	140	445	374
Transaction related expenses	—	359	—	2,928
Other	742	730	2,199	2,003
Total other expenses	7,724	7,285	22,418	22,376
Income before provision for income taxes	3,018	2,700	8,180	4,266
Provision for income taxes	925	922	2,681	1,481
NET INCOME	$ 2,093	$ 1,778	$ 5,499	$ 2,785
INCOME PER COMMON SHARE:				
Basic	$ 0.33	$ 0.29	$ 0.88	$ 0.45
Diluted	$ 0.33	$ 0.28	$ 0.87	$ 0.45

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CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	$ 2,093	$ 1,778	$ 5,499	$ 2,785
Other comprehensive income				
Change in securities available for sale:				
Unrealized gains (losses) arising during the period	(115)	(79)	809	890
Reclassification adjustment for securities gains included in net income	(38)	(40)	(38)	(149)
Tax effect	52	40	(262)	(252)
Net change in unrealized gains on available for sale securities	(101)	(79)	509	489
Total comprehensive income	$ 1,992	$ 1,699	$ 6,008	$ 3,274

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CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30, 2017				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Total
Balance, beginning of period	6,263,371	$ 61,583	$ 17,206	$ (180)	$ 78,609
Net income for period	—	—	5,499	—	5,499
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	509	509
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	5,499	509	6,008
Stock compensation	—	298	—	—	298
Issuance of common stock:					
Restricted stock award vesting	31,559	—	—	—	—
Dividend on common stock	—	—	(2,266)	—	(2,266)
Balance, end of period	6,294,930	$ 61,881	$ 20,439	$ 329	$ 82,649

	Nine Months Ended September 30, 2016				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, beginning of period	6,217,620	$ 61,133	$ 15,221	$ 248	$ 76,602
Net income for period	—	—	2,785	—	2,785
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	489	489
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	2,785	489	3,274
Stock compensation	—	450	—	—	450
Issuance of common stock:					
Restricted stock award vesting	59,751	—	—	—	—
Repurchase of common stock	(14,000)	(150)	—	—	(150)
Dividend on common stock	—	—	(1,891)	—	(1,891)
Balance, end of period	6,263,371	$ 61,433	$ 16,115	$ 737	$ 78,285

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2017	2016
Cash Flows from Operating Activities:		
Net income	$ 5,499	$ 2,785
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,801	1,336
Provision for loan losses	400	350
Deferred tax expense, net	1,125	1,481
Gain on sales/calls of securities	(38)	(149)
Gain on sale of loans sold in the secondary market	(873)	(959)
Origination of loans held for sale in the secondary market	(48,819)	(56,941)
Proceeds from sale of loans in the secondary market	49,692	57,900
Loss on sale of premises, equipment, and other real estate held for sale	28	10
Writedown of other real estate held for sale	270	53
Stock compensation	298	450
Change in other assets	3,382	12,462
Change in other liabilities	(1,999)	(1,174)
Net cash provided by operating activities	10,766	17,604
Cash Flows from Investing Activities:		
Net increase in loans	(28,977)	(28,118)
Net increase in interest bearing deposits in other financial institutions	673	3,015
Purchase of securities available for sale	(5,697)	(7,225)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	7,441	16,752
Redemption of FHLBI stock	192	—
Capital expenditures	(2,195)	(1,833)
Purchase additional FHLBI stock	(531)	—
Net cash used in Eagle acquisition and reimbursement of contract termination fee	—	(12,500)
Net cash used in Niagara acquisition	—	(7,325)
Proceeds from sale of premises, equipment, and other real estate	2,012	1,143
Net cash used in investing activities	(27,082)	(36,091)
Cash Flows from Financing Activities:		
Net increase in deposits	11,691	33,159
Net activity on line of credit	545	(8,550)

Decrease in fed funds purchased	(6,000)	—
New term debt issuance	25,000	19,800
Principal payments on borrowings	(1,727)	(274)
Repurchase of common stock	—	(150)
Dividend on common stock	(2,266)	(1,891)
Net cash used in financing activities	27,243	42,094
Net increase in cash and cash equivalents	10,927	23,607
Cash and cash equivalents at beginning of period	46,755	25,008
Cash and cash equivalents at end of period	$ 57,682	$ 48,615
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	$ 4,651	$ 3,273
Income taxes	—	100
Noncash Investing and Financing Activities:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	2,120	1,091

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the “Corporation”) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2016.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The “net” other income and other expenses were unchanged by these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. 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.

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. Management evaluates 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, recognizes a provision for loan loss in our consolidated statement of income. 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 Financial Accounting Standards Board ("FASB") 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.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to loans, when they 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 incurred 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.

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. At September 30, 2017 there were 268,836 shares available for issuance under this plan. 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.

2.RECENT ACCOUNTING PRONOUNCEMENTS

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 January 1, 2017. In this regard, management has completed a preliminary analysis of the impact of implementation. The key revenue streams affected by implementation would 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 of 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 in the same manner 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 the 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 effect of applying the new lease guidance on the financial statements has not yet been determined.

In September 2016, 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.

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.

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3.EARNINGS PER SHARE

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

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2017 and 2016 (dollars in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
(Numerator):				
Net income	$ 2,093	$ 1,778	$ 5,499	$ 2,785
(Denominator):				
Weighted average shares outstanding	6,294,930	6,238,756	6,286,722	6,226,900
Effect of dilutive stock options, and vesting of restricted stock awards	23,558	20,999	24,144	33,525
Diluted weighted average shares outstanding	6,318,488	6,259,755	6,310,866	6,260,425
Income per common share:				
Basic	$ 0.33	$ 0.29	$ 0.88	$ 0.45
Diluted	$ 0.33	$ 0.28	$ 0.87	$ 0.45

4.INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2017 and December 31, 2016 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value

September 30, 2017				
Corporate	$ 24,415	$ 164	$ (20)	$ 24,559
Equity	500	—	—	500
US Agencies	22,468	88	(13)	22,543
US Agencies - MBS	13,765	56	(58)	13,763
Obligations of states and political subdivisions	23,244	533	(133)	23,644
Total securities available for sale	$ 84,392	$ 841	$ (224)	$ 85,009
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

The Corporation has evaluated gross unrealized losses that exist within the portfolio and considers them temporary in nature. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

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The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $14.029 million and $14.038 million, respectively, at September 30, 2017.

5.LOANS

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

	September 30, 2017	December 31, 2016
Commercial real estate	$ 409,269	$ 389,420
Commercial, financial, and agricultural	154,638	142,648
Commercial construction	8,892	11,505
One to four family residential real estate	204,419	205,945
Consumer	18,247	20,113
Consumer construction	12,684	12,226
Total loans	$ 808,149	$ 781,857

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 the first nine months of 2017, the Corporation had positive resolution of acquired impaired loans, which resulted in the recognition of $.370 million of accretable interest. In the first nine months of 2016, the Corporation had positive resolution of one PFC acquired impaired loan which resulted in the recognition of approximately $96,000 of accretable interest.

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The table below details the outstanding balances of the PFC acquired portfolio and the 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

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

Acquired	Acquired	Acquired

	Impaired	Non-impaired	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 the nine months ended September 30, 2017 (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, 2016	$ 282	$ 642	$ 924	$ 236	$ 1,221	$ 1,457	$ 52	$ 505	$ 557
Accretion	(310)	(525)	(835)	(50)	(466)	(516)	(10)	(169)	(179)
Other adjustment to nonaccretable difference	215	—	215	37	—	37	(1)	—	(1)
Balance, September 30, 2017	$ 187	$ 117	$ 304	$ 223	$ 755	$ 978	$ 41	$ 336	$ 377

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The table below presents a rollforward of the accretable yield on acquired loans for the nine months ended September 30, 2016 (dollars in thousands):

	PFC			Eagle			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	—	(525)	(525)	—	(299)	(299)	—	(49)	(49)
Reclassification from nonaccretable difference	(80)	—	(80)	(54)	—	(54)	—	—	—
Balance, September 30, 2016	$ 346	$ 817	$ 1,163	$ 337	$ 1,401	$ 1,738	$ 88	$ 551	$ 639

Allowance for Loan Losses

An analysis of the allowance for loan losses for the nine months ended September 30, 2017 and the year ended September 30, 2016 is as follows (dollars in thousands):

	September 30, 2017	September 30, 2016
Balance, January 1	$ 5,020	$ 5,004
Recoveries on loans previously charged off	215	120
Loans charged off	(505)	(612)
Provision	400	350
Balance at end of period	$ 5,130	$ 4,862

In the first nine months of 2017, net charge-offs were $.290 million, compared to net charge-offs of $.492 million in the same period in 2016. In the first nine months of 2017, the Corporation recorded a provision for loan loss of $.400 million compared to a $.350 million provision in the first nine months of 2016. The Corporation's allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

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A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2017 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
Three Months Ended September 30, 2017								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,463	$ 695	$ 95	$ 259	$ 6	$ 15	$ 2,600	$ 5,133
Charge-offs	—	(171)	—	(27)	—	(52)	—	(250)
Recoveries	10	31	1	1	—	4	—	47
Provision	25	187	3	4	—	59	(78)	200
Ending balance ALLR	$ 1,498	$ 742	$ 99	$ 237	$ 6	$ 26	$ 2,522	$ 5,130
Nine Months Ended September 30, 2017								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,345	$ 614	$ 57	$ 296	$ 6	$ 90	$ 2,612	$ 5,020
Charge-offs	—	(264)	—	(76)	—	(165)	—	(505)
Recoveries	72	35	2	63	—	43	—	215
Provision	81	357	40	(46)	—	58	(90)	400
Ending balance ALLR	$ 1,498	$ 742	$ 99	$ 237	$ 6	$ 26	$ 2,522	$ 5,130
At September								

30, 2017								
Loans:								
Ending balance	$ 409,269	$ 154,638	$ 8,892	$ 204,419	$ 12,684	$ 18,247	$ —	$ 808,149
Ending balance ALLR	(1,498)	(742)	(99)	(237)	(6)	(26)	(2,522)	(5,130)
Net loans	$ 407,771	$ 153,896	$ 8,793	$ 204,182	$ 12,678	$ 18,221	$ (2,522)	$ 803,019
Ending balance ALLR:								
Individually evaluated	$ 571	$ 331	$ 38	$ 19	$ —	$ 17	$ —	$ 976
Collectively evaluated	927	411	61	218	6	9	2,522	4,154
Total	$ 1,498	$ 742	$ 99	$ 237	$ 6	$ 26	$ 2,522	$ 5,130
Ending balance Loans:								
Individually evaluated	$ 1,801	$ 1,283	$ 377	$ 525	$ —	$ 46	$ —	$ 4,032
Collectively evaluated	405,610	153,355	8,515	202,281	12,633	18,201	—	800,595
Acquired with deteriorated credit quality	1,858	—	—	1,613	51	—	—	3,522
Total	$ 409,269	$ 154,638	$ 8,892	$ 204,419	$ 12,684	$ 18,247	$ —	$ 808,149

Impaired loans, by definition, are individually evaluated.

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A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 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
Three Months Ended September 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,824	$ 700	$ 78	$ 348	$ 5	$ 23	$ 1,755	$ 4,733
Charge-offs	(20)	—	—	(76)	—	(10)	—	(106)
Recoveries	17	4	—	2	—	12	—	35
Provision	(235)	(180)	(16)	133	1	49	448	200
Ending balance ALLR	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
Nine Months Ended September 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Charge-offs	(245)	(206)	—	(125)	—	(36)	—	(612)
Recoveries	40	40	—	4	7	29	—	120
Provision	180	45	(17)	254	(8)	17	(121)	350
Ending balance ALLR	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
At September 30, 2016								
Loans:								

Ending balance	$ 362,858	$ 136,065	$ 14,343	$ 211,072	$ 11,768	$ 20,698	$ —	$ 756,804
Ending balance ALLR	(1,586)	(524)	(62)	(407)	(6)	(74)	(2,203)	(4,862)
Net loans	$ 361,272	$ 135,541	$ 14,281	$ 210,665	$ 11,762	$ 20,624	$ (2,203)	$ 751,942
Ending balance ALLR:								
Individually evaluated	$ 570	$ 252	$ —	$ 68	$ —	$ 64	$ —	$ 954
Collectively evaluated	1,016	272	62	339	6	10	2,203	3,908
Total	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
Ending balance Loans:								
Individually evaluated	$ 2,035	$ 329	$ —	$ 1,038	$ —	$ 288	$ —	$ 3,690
Collectively evaluated	357,030	135,736	14,343	206,199	11,709	20,410	—	745,427
Acquired with deteriorated credit quality	3,793	—	—	3,835	59	—	—	7,687
Total	$ 362,858	$ 136,065	$ 14,343	$ 211,072	$ 11,768	$ 20,698	$ —	$ 756,804

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans.

To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan’s credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

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

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, and other relevant characteristics.

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

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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, and other relevant characteristics.

Acceptable/Acceptable Watch (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.

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 not considered impaired, 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 is in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Below is a breakdown of loans by risk category as of September 30, 2017 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Special Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 4,058	$ 20,655	$ 156,563	$ 213,805	$ 9,529	$ 4,659	$ —	$ —	$ 409,269
Commercial, financial and agricultural	13,262	9,282	49,947	75,366	5,394	1,387	—	—	154,638
Commercial construction	—	313	3,043	1,170	377	653	—	3,336	8,892
One-to-four family residential real estate	125	1,356	2,588	5,370	1,111	3,720	—	190,149	204,419
Consumer construction	—	—	—	—	—	14	—	12,670	12,684
Consumer	—	—	—	29	6	75	—	18,137	18,247
Total loans	$ 17,445	$ 31,606	$ 212,141	$ 295,740	$ 16,417	$ 10,508	$ —	$ 224,292	$ 808,149

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) Special Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,021	$ 23,940	$ 140,618	$ 216,518	$	$ 5,323	$ —	$ —	$ 389,420
Commercial, financial and agricultural	10,421	13,434	49,434	67,582		1,777	—	—	142,648
Commercial construction	—	900	3,146	2,660		385	—	4,414	11,505
One-to-four family residential real estate	740	1,373	3,412	9,585		5,493	—	185,342	205,945

Consumer construction	28	—	—	—	—	17	—	12,181	12,226
Consumer	20	—	15	55		103	—	19,920	20,113
Total loans	$ 14,230	$ 39,647	$ 196,625	$ 296,400	$ —	$ 13,098	$ —	$ 221,857	$ 781,857

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 loan 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.

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

September 30, 2017	Nonaccrual Recorded Balance	Nonaccrual Unpaid Balance	Accrual Basis	QTD Average Investment	YTD Average Investment	Related Valuation Reserve	QTD Interest Income on Accrual Basis	YTD Interest Income on Accrual Basis
With no valuation reserve:								
Commercial real estate	$ 697	$ 698	$ 1,858	$ 1,243	$ 1,331	$ —	$ 29	$ 180
Commercial, financial and agricultural	7	8	—	29	152	—	—	—
Commercial construction	—	—	—	1,290	—	—	—	—
One to four family residential real estate	1,293	1,293	1,613	—	1,432	—	28	160
Consumer construction	14	14	53	14	14	—	1	3
Consumer	59	59	—	47	44	—	1	2
With a valuation reserve:								
Commercial real estate	$ 680	$ 680	$ —	$ 586	$ 426	$ 247	$ —	$ —
Commercial, financial and agricultural	201	201	—	169	140	49	—	—
Commercial construction	—	—	—	—	—	—	—	—
One to four family	114	115	—	160	178	53	—	—

residential real estate								
Consumer construction	—	—	—	—	—	—	—	—
Consumer	—	—	—	—	—	—	—	—
Total:								
Commercial real estate	$ 1,377	$ 1,378	$ 1,858	$ 1,829	$ 1,757	$ 247	$ 29	$ 180
Commercial, financial and agricultural	208	209	—	198	292	49	—	—
Commercial construction	—	—	—	1,290	—	—	—	—
One to four family residential real estate	1,407	1,408	1,613	160	1,610	53	28	160
Consumer construction	14	14	53	14	14	—	1	3
Consumer	59	59	—	47	44	—	1	2
Total	$ 3,065	$ 3,068	$ 3,524	$ 3,538	$ 3,717	$ 349	$ 59	$ 345

December 31, 2016	Nonaccrual Recorded Balance	Nonaccrual Unpaid Balance	Accrual Basis	YTD Average Investment	Related Valuation Reserve	YTD 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

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A summary of past due loans at September 30, 2017 and December 31, 2016 is as follows (dollars in thousands):

	September 30, 2017			December 31, 2016		
	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	$ 247	$ 1,320	$ 1,567	$ 942	$ 1,732	$ 2,674
Commercial, financial and agricultural	478	265	743	186	337	523
Commercial construction	—	14	14	—	—	—
One to four family residential real estate	1,847	1,408	3,255	2,113	1,956	4,069
Consumer construction	—	—	—	—	17	17
Consumer	86	58	144	133	82	215
Total past due loans	$ 2,658	$ 3,065	$ 5,723	$ 3,374	$ 4,124	$ 7,498

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 applicable 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.

There were no troubled debt restructurings that occurred during the nine months ended September 30, 2017 or September 30, 2016.

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):

	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Loans outstanding, January 1	$ 9,195	$ 6,887
New loans	—	—
Net activity on revolving lines of credit	554	1,720
Repayment	(476)	(2,269)
Loans outstanding at end of period	$ 9,273	$ 6,338

There were no loans to related parties classified substandard as of September 30, 2017 or September 30, 2016. In addition to the outstanding balances above, there were unfunded commitments of $1.921 million to related parties at Septemebr 30, 2017.

6.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 PFC. 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 associated with the acquisition of Niagara.

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The deposit based intangible is reported net of accumulated amortization at $1.985 million at September 30, 2017. Amortization expense in the first nine months of 2017 is $.187 million. Amortization expense for the next five years is expected to be at $.250 million per year.

7.SERVICING RIGHTS

Mortgage Loans

Mortgage servicing rights ("MSRs") are recorded when loans are sold in the secondary market with servicing retained. As of September 30, 2017, the Corporation had obligations to service approximately $204.087 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 MSRs include an annual constant prepayment speed of 10.84% and a discount rate of 9.73% for September 30, 2017. In 2016, management decided to no longer regularly retain the servicing on mortgage loans sold.

The following table summarizes MSRs capitalized and amortized, along with the aggregate activity in related valuation allowances (dollars in thousands):

	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Balance at beginning of period	$ 1,573	$ 1,965
Additions from loans sold with servicing retained	—	—
Acquired MSRs	—	207
Amortization	(411)	(495)
Balance at end of period	$ 1,162	$ 1,677
Balance of loan servicing portfolio	$ 204,087	$ 233,356
Mortgage servicing rights as % of portfolio	.57%	.72%

Commercial Loans

The Corporation also retains the servicing on certain 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 September 30, 2017 and September 30, 2016 was approximately $39.737 million and $43.2 million, respectively. The Corporation valued these servicing rights at $.117 million as of September 30, 2017 and at $.147 million as of September 30, 2016. This valuation was established in consideration of the discounted cash flow of net expected servicing income over the life of the loans.

8.BORROWINGS

Borrowings consist of the following at September 30, 2017 and December 31, 2016 (dollars in thousands):

	September 30, 2017	December 31, 2016
Federal Home Loan Bank fixed rate advances	$ 70,000	$ 45,000
Correspondent bank line of credit	1,295	750
Correspondent bank term note	19,549	21,199
USDA Rural Development note	553	630
	$ 91,397	$ 67,579

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The Federal Home Loan Bank borrowings bear a weighted average rate of 2.09% and mature in 2017, 2018, 2019, 2020 and 2021. They are collateralized at September 30, 2017 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $73.676 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $11.976 million and $11.993 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.250 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis and the Federal Home Loan Bank of Chicago in effect as of September 30, 2017.

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 a rate of 90-day LIBOR plus 2.75% and has an initial term that expires on April 30, 2018. LIBOR at September 30, 2017 was 1.33%. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $.550 million, which began March 31, 2017. This relationship is secured by all of the outstanding mBank stock.

The USDA Rural Development borrowing bears an interest rate of 1.00% and matures in August, 2024. It is collateralized by an assignment of a demand deposit account held by the Corporation's wholly owned subsidiary, First Rural Relending, in the amount of $.619 million, and guaranteed by the Corporation.

9.DEFINED BENEFIT PENSION PLAN

The Corporation acquired the Peninsula Financial Corporation noncontributory defined benefit pension plan in 2014. 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.

The anticipated distributions over the next five years and through December 31, 2026 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

At September 30, 2017, the plan's assets had a fair value of $2.049 million and the Corporation had a net unfunded liability of $1.138 million. The accumulated benefit obligation at September 30, 2017 was $3.187 million. At September 30, 2016, the plan's assets had a fair value of $2.033 million and the Corporation had a net unfunded liability of $1.147 million. The accumulated benefit obligation at September 30, 2016 was $3.180 million.

Assumptions in the actuarial valuation are:

	2017	2016
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

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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 September 30, 2017 and December 31, 2016.

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

10.STOCK COMPENSATION PLANS

Restricted Stock Awards

The Corporation's restricted stock awards are service-based and awarded based on performance. Each award has 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:

Date of Award	Units Granted	Market Value at grant date	Vesting Term
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
February, 2017	28,427	$ 13.39	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. In the first quarter of 2017, the Corporation issued 31,559 shares of its common stock for vested RSAs.

A summary of changes in our nonvested shares for the period follows:

	Number Outstanding	Weighted Average Grant Date Fair Value
Nonvested balance at January 1, 2017	90,417	$ 11.19
Granted during the period	28,427	13.39
Vested during the period	(31,559)	11.55
Nonvested balance at September 30, 2017	87,285	$ 11.78

11.INCOME TAXES

The Corporation has reported deferred tax assets of $6.266 million at September 30, 2017. 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 September 30, 2017 had a net operating loss and tax credit carryforwards for tax purposes of approximately $7.6 million, and $1.7 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of September 30, 2017 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.

The Corporation recognized a federal income tax expense of approximately $2.681 million for the nine months ended September 30, 2017 and $1.481 million for the nine months ended September 30, 2016.

12.FAIR VALUE MEASUREMENTS

Fair value estimates, methods, and assumptions are set forth below for the Corporation's financial instruments:

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

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

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

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

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

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

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

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

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

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

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The following table presents information for financial instruments at September 30, 2017 and December 31, 2016 (dollars in thousands):

		September 30, 2017		December 31, 2016	
	Level in Fair Value Hierarchy	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 57,682	57,682	$ 46,755	$ 46,755
Interest-bearing deposits	Level 2	13,374	13,374	14,047	14,047
Securities available for sale	Level 2	84,509	84,509	84,623	84,623
Securities available for sale	Level 3	500	500	1,650	1,650
Federal Home Loan Bank stock	Level 2	3,250	3,250	2,911	2,911
Net loans	Level 3	803,019	800,352	776,837	778,377
Accrued interest receivable	Level 3	2,224	2,224	2,016	2,016
Total financial assets		$ 964,558	$ 961,891	$ 928,839	$ 930,379
Financial liabilities:					
Deposits	Level 2	$ 835,203	811,066	$ 823,512	$ 815,960
Borrowings	Level 2	91,397	91,697	67,579	68,293
Accrued interest payable	Level 3	327	327	267	267
Total financial liabilities		$ 926,927	$ 903,090	$ 891,358	$ 884,520

Limitations - Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at September 30, 2017, 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 September 30, 2017 and December 31, 2016 were based on level 2 and level 3 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to “Note 4 - Investment Securities.”

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The table below shows investment securities measured at fair value on a recurring basis (dollars in thousands):

(dollars in thousands)	Balance at September 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended September 30, 2017	Total (Gains) Losses for Nine Months Ended September 30, 2017
Assets						
Corporate	$ 24,559	$ —	$ 24,559	$ —	$ —	$ —
Equity	500	—	—	500	—	—
US Agencies	22,543	—	22,543	—	—	—
US Agencies - MBS	13,763	—	13,763	—	38	38
Obligations of state and political subdivisions	23,644	—	23,644	—	—	—
	$ 85,009				$ 38	$ 38

(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 measured at fair value on a recurring basis as of September 30, 2017, or December 31, 2016 other than as described above.

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 certain impaired loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

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Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2017

(dollars in thousands)	Balance at September 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended September 30, 2017	Total (Gains) Losses for Nine Months Ended September 30, 2017
Assets						
Impaired loans	$ 6,589	$ —	$ —	$ 6,589	$ 209	$ 361
Other real estate owned	4,413	—	—	4,413	43	298
					$ 252	659

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

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).

13.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 publically announced of $.600 million on February 27, 2013, $.600 million on December 17, 2013 and an additional $.750 million on April 28, 2015. None of these authorizations has an expiration date. As of September 30, 2017, $25,000 of the total authorization was available for future purchases.

14.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

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instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

	September 30, 2017	December 31, 2016
Commitments to extend credit:		
Variable rate	$ 84,786	$ 59,496
Fixed rate	36,572	28,737
Standby letters of credit - Variable rate	8,193	8,252
Credit card commitments - Fixed rate	5,837	5,533
	$ 135,388	$ 102,018

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

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

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan 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 September 30, 2017 represents $116.526 million, or 20.56%, compared to $121.861 million, or 22.42%, of the commercial loan portfolio on December 31, 2016. 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.

15. BUSINESS COMBINATIONS

The First National Bank of Eagle River

The Corporation completed its acquisition of The First National Bank of Eagle River ("Eagle River") in April 2016. Eagle River had three branch offices and approximately $125 million in assets as of April 29, 2016, including total loans of $84 million and total deposits of $105 million. 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 $12.500 million. The Corporation recorded a $.933 million core deposit intangible asset and $1.839 million of goodwill in conjunction with the acquisition. Goodwill was recorded due to the synergies and economies of scale expected from combining operations of the Corporation with Eagle River.

Niagara Bancorporation

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The Corporation completed its acquisition of Niagara Bancorporation, Inc. ("Niagara") in August 2016. Niagara had four branch offices and approximately $67 million in assets as of August 31, 2016 including total loans of $33 million and total deposits of $59 million. 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 recorded a $.300 million core deposit intangible asset and $50,000 of goodwill in conjunction with the acquisition. Goodwill was recorded due to the synergies and economies of scale expected from combining operations of the Corporation with Niagara.

Forward Looking Statements/Risk Factors

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 the Corporation 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 estimated 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

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interest rates that are beyond our control, including but not limited to general economic conditions and governmental policy, 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.

· We may not realize the expected benefits of our acquisitions of The First National Bank of Eagle River and Niagara Bancorporation, Inc.

· 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 allowance 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 September 30, 2017, net deferred tax assets were approximately $7.139 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 or 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.

- 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 equals or exceeds its capital.

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

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MACKINAC FINANCIAL CORPORATION

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

The following discussion covers results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements, the related notes, and other supplemental information presented elsewhere in this report. It should be noted that there may be non-GAAP disclosures presented within this discussion to further assist readers in their analysis of the financial condition of the Corporation. This discussion should also be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation's Annual Report and Form 10-K for the year-ended December 31, 2016. Throughout this discussion and elsewhere in this report, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded third quarter 2017 net income of $2.093 million, or $.33 per share, compared to net income of $1.778 million, or $.29 per share for the third quarter of 2016. Net income for the first nine moths of 2017 totaled $5.499 million, or $.88 per share, compared to $2.785 million, or $.45 per share, for the same period in 2016.

Weighted average shares outstanding for the nine month period in 2017 totaled 6,286,722, compared to 6,226,900 shares in the same period of 2016.

The net interest margin for the third quarter of 2017 was $9.789 million, or 4.23%, compared to $8.696 million, or 4.18%, in the third quarter of 2016. The nine month net interest margin for 2017 was $28.274 million, or 4.21%, compared to $23.980 million, or 4.21%, for the same period in 2016.

Total assets of the Corporation at September 30, 2017 were $1.015 billion, up by $31.550 million, or 3.21%, from the $983.520 million in total assets reported at year-end 2016.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $10.927 million during the nine months of 2017, compared to 2016 year end. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale decreased $1.264 million from December 31, 2016 to September 30, 2017, with the balance on September 30, 2017 totaling $85.009 million. Investment securities are increased or decreased as appropriate in an effort to manage interest rate risk and liquidity. As of September 30, 2017, investment securities with an estimated fair value of $14.038 million were pledged against borrowings at the FHLB and certain customer relationships.

Loans

Through the first nine months of 2017, loan balances increased by $26.292 million from December 31, 2016 balances of $781.857 million. During the first nine months of 2017, the Bank had total loan production of $211.751 million, which included $48.819 million of secondary market loan production. The increase in loan production, however, was offset by loan amortization and pay-offs of $134.090 million.

Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue to pursue 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.

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Following is a summary of the loan portfolio at September 30, 2017 and December 31, 2016 (dollars in thousands):

	September 30, 2017	Percent of Total	December 31, 2016	Percent of Total
Commercial real estate	$ 409,269	50.65%	$ 389,420	49.81%
Commercial, financial, and agricultural	154,638	19.13	142,648	18.24
One to four family residential real estate	204,419	25.29	205,945	26.35
Consumer construction	12,684	1.57	12,226	1.56
Commercial construction	8,892	1.10	11,505	1.47
Consumer	18,247	2.26	20,113	2.57
Total loans	$ 808,149	100.00%	$ 781,857	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2017 and December 31, 2016 (dollars in thousands):

	September 30, 2017			December 31, 2016		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonresidential buildings	116,526	20.56%	140.99%	121,861	22.42%	155.02%
Hospitality and tourism	74,500	13.14	90.14	68,025	12.51	86.54
Lessors of residential buildings	31,985	5.64	38.70	27,590	5.08	35.10
Gasoline stations and convenience stores	20,210	3.57	24.45	20,509	3.77	26.09
Logging	16,363	2.89	19.80	19,903	3.66	25.32
Commercial construction	8,892	1.57	10.76	11,505	2.12	14.64
Other	298,260	52.63	360.88	274,180	50.44	348.79
Total Commercial Loans	$ 566,736	100.00%		$ 543,573	100.00%	

Management recognizes that additional risks presented by concentration in certain segments of the portfolio. Management does not believe that its current portfolio composition has increased such risk related to any specific industry concentration as of September 30, 2017. The current concentration of real estate-related loans represents a broad customer base composed of a high percentage of owner-occupied developments. The company will, and has, slowed growth and origination of certain types of lending where internal limits have been reached.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of September 30, 2017, our residential loan portfolio totaled $217.103 million, or 26.86%, of our total outstanding loans.

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

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Credit Quality

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

	September 30, 2017	December 31, 2016
Nonperforming Assets:		
Nonaccrual loans	$ 2,964	$ 3,959
Loans past due 90 days or more	—	—
Restructured loans	101	165
Total nonperforming loans	3,065	4,124
Other real estate owned	4,413	4,782
Total nonperforming assets	$ 7,478	$ 8,906
Nonperforming loans as a % of loans	0.38%	0.53%
Nonperforming assets as a % of assets	0.74%	0.91%
Reserve for Loan Losses:		
At period end	$ 5,130	$ 5,020
As a % of outstanding loans	.63%	.64%
As a % of nonperforming loans	167.37%	121.73%
As a % of nonaccrual loans	173.08%	126.80%
Texas Ratio	9.34%	11.76%

The following ratios provide additional information relative to the Corporation's credit quality (dollars in thousands):

	At Period End	
	September 30, 2017	December 31, 2016
Total loans, at period end	$ 808,149	781,857
Average loans for the period	$ 791,227	$ 703,047
	For the Period Ended	
	Nine Months Ended September 30, 2017	Twelve Months Ended December 31, 2016

Net charge-offs during the period	$ 290	584
Net charge-offs to average loans, annualized	.05%	.08%

Management seeks to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan 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. In 2017, the Corporation has continued to utilize a consultant for loan review.

As of September 30, 2017, the allowance for loan losses represented .63% of total loans. At September 30, 2017, the allowance included specific reserves in the amount of $.976 million, as compared to specific reserves of $.958 million at December 31, 2016. 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. Purchased impaired credits do not have an effect on the allowance for loan losses, in accordance with ASC 310-30.

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

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

	Nine Months Ended September 30, 2017	Year Ended December 31, 2016
Balance at beginning of period	$ 4,782	$ 2,324
Other real estate acquired, net of purchase accounting	—	1,205
Other real estate transferred from loans due to foreclosure	2,120	3,292
Proceeds from sale of other real estate	(2,012)	(1,640)
Transfer to premise and equipment	—	(197)
Writedowns on other real estate held for sale	(449)	(212)
Gain (loss) on other real estate held for sale	(28)	10
Balance at end of period	$ 4,413	$ 4,782

During the first nine months of 2017, the Corporation received real estate in lieu of loan payments of $2.120 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 balances and records any additional reductions in the fair value as a write-down of other real estate held for sale.

Deposits

The Corporation had an increase in deposits in the first nine months of 2017. Total deposits increased by $11.691 million, or 1.42%, in the first nine months of 2017. The increase in deposits for the first nine months of 2017 is composed of a decrease in core deposits of $6.886 million and an increase in noncore deposits of $18.577 million. The decrease in core deposits is largely a result of seasonality inherent in our overall deposit portfolio, as well as the decision to exit one large high-cost deposit relationship. Management utilizes brokered deposits as a funding source, which provides flexibility in managing interest rate risk for fixed rate longer term loan fundings.

Management continues to monitor existing deposit products in order to stay competitive, both as to terms and pricing, which will remain important as we move through this rate cycle to protect our margin. This focus on deposits has become especially important with changing client banking habits and demographics, as well as customer desire for more electronic and mobile based banking products and services. It is the intent of management to focus on growing core deposit levels, as the comparatively inexpensive deposits, inrelation to wholesale deposit sources, will continue to prove valuable as rates continue to increase.

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

	September 30, 2017	% of Total	December 31, 2016	% of Total
Noninterest bearing	$ 162,142	19.41%	$ 164,179	19.94%
NOW, money market, checking	275,854	33.03	286,622	34.80
Savings	61,832	7.40	58,315	7.08
Certificates of Deposit <$250,000	144,031	17.25	141,629	17.20
Total core deposits	643,859	77.09	650,745	79.02
Certificates of Deposit >$250,000	9,126	1.09	8,489	1.03
Brokered CDs	182,218	21.82	164,278	19.95
Total non-core deposits	191,344	22.91	172,767	20.98
Total deposits	$ 835,203	100.00%	$ 823,512	100.00%

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Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At September 30, 2017, this source of funding totaled $70 million and the Corporation secured this funding by pledging loans and investments. The $70 million of FHLB borrowings have a weighted average maturity of 1.04 years and a weighted average interest rate of 2.09% at September 30, 2017. The FHLB balances at September 30, 2017 reflect an additional $25 million of balances obtained during the second quarter. The additional balances were garnered as part of a strategy to secure longer-term funding to help support new fixed rate commercial lending originations and lock in margin given the outlook for continued rising interest rates. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending, that has an outstanding balance of $.533 million, with a fixed interest rate of 1% that matures in August 2024.

The Corporation currently has one correspondent 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 a rate of LIBOR plus 2.75% and has an initial term that expires on April 30, 2018. LIBOR was 1.33% at September 30, 2017. The term note had a balance of $19.549 million at September 30, 2017 and bears the same interest as the line of credit. The term note matures on April 30, 2019 and requires quarterly principal payments of $.550 million which began in March 31, 2017. This relationship is secured by all of the outstanding mBank stock.

Shareholders’ Equity

Total shareholders’ equity increased $4.040 million from December 31, 2016 to September 30, 2017. Contributing to the increase in shareholders’ equity was net income of $5.499 million, offset by a reduction for cash dividends on common stock of $2.266 million, an increase due to stock compensation of $.298 million, and an increase in the market value of securities of $.509 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income of $5.499 million, or $.88 per share, in the first nine months of 2017, compared to $2.785 million, or $.45 per share, for the first nine months of 2016.

Net Interest Income

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

Net interest margin on a fully taxable equivalent basis amounted to $28.428 million, 4.23% of average earning assets, in the nine months of 2017, compared to $24.049 million, and 4.23% of average earning assets, in the first nine months of 2016.

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

	Three Months Ended									
	Average Balances September 30,		Increase/	Average Rates September 30,		Interest September 30,		2017-2016 Income/ Expense	Volume	Rate
usands)	2017	2016	(Decrease)	2017	2016	2017	2016	Variance	Variance	Varia
	$ 803,825	$ 734,702	$ 69,123	5.34%	5.13%	$ 10,831	$ 9,470	$ 1,361	$ 893	$ 40
ities	69,003	59,881	9,122	2.30	2.57	400	387	13	59	(4
ecurities	13,825	16,927	(3,102)	2.07	2.02	109	86	23	(16)	47
sold	14,843	12,358	2,485	1.07	0.23	40	7	33	1	26
-earning	17,313	11,043	6,270	4.38	3.03	191	84	107	48	38
assets	918,809	834,911	83,898	4.98	4.78	11,571	10,034	1,537	985	47
an	(5,014)	(4,855)	(159)							
from	55,207	52,367	2,840							
	16,688	15,185	1,503							
tate	3,687	3,480	207							
	31,775	29,265	2,510							
	$ 1,021,152	$ 930,353	$ 90,799							
ney ts	$ 202,779	$ 215,372	$ (12,593)	.35	.33	$ 181	$ 180	$ 1	$ (11)	$ 11
ing	67,998	59,443	8,555	.15	.15	25	23	2	3	(1)
sits	61,536	53,338	8,198	.07	.09	11	12	(1)	2	(2)
f deposit	154,260	144,466	9,794	.94	0.84	367	306	61	21	36
osits	191,710	149,839	41,871	1.19	.93	573	349	224	98	99
	92,004	69,308	22,696	2.49	2.03	577	354	223	116	80
bearing	770,287	691,766	78,521	.89	.70	1,734	1,224	510	229	22
sits	163,416	157,808	5,608							
es	5,287	2,752	2,535							
equity	82,162	78,027	4,135							
es and equity	$ 1,021,152	$ 930,353	$ 90,799							
				4.08%	4.08%					
ue				4.23%	4.20%	$ 9,837	$ 8,810	$ 1,027	$ 756	$ 25

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	Nine Months Ended									
	Average Balances September 30,		Increase/	Average Rates September 30,		Interest September 30,		2017-2016 Income/ Expense	Volume	Rate
ousands)	2017	2016	(Decrease)	2017	2016	2017	2016	Variance	Variance	Varian
)	$ 791,227	$ 680,137	$ 111,090	5.25%	5.13%	$ 31,127	$ 26,128	$ 4,999	$ 4,263	$ 653
rities	69,450	54,014	15,436	2.30	2.36	1,195	954	241	272	(24)
ecurities	14,559	12,863	1,696	2.08	1.80	342	173	169	23	129
s sold	6,289	4576	1,713	.98	0.26	46	9	37	3	24
t-earning	16,974	8,598	8,376	3.38	3.15	429	203	226	198	14
g assets	898,499	760,188	138,311	4.91	4.83	33,139	27,467	5,672	4,759	796
oan	(5,066)	(5,015)	(51)							
e from	48,579	36,529	12,050							
	16,381	13,935	2,446							
state	4,138	3,371	767							
	32,911	25,370	7,541							
	$ 995,442	$ 834,378	$ 161,064							
oney sits	$ 207,951	$ 189,765	$ 18,186	.34	.33	$ 526	$ 462	$ 64	$ 44	$ 19
king	67,266	52,063	15,203	.15	.16	74	62	12	18	(5)
osits	60,093	43,467	16,626	.07	.10	31	32	(1)	11	(10)
of deposit	150,897	135,162	15,735	.89	0.90	1,003	914	89	107	(15)
posits	186,357	130,280	56,077	1.10	.96	1,536	940	596	404	135
	80,120	65,505	14,615	2.57	2.06	1,541	1008	533	225	253
t-bearing	752,684	616,242	136,442	.84	.74	4,711	3,418	1,293	809	377
osits	156,624	137,395	19,229							
ies	5,301	2,477	2,824							
’ equity	80,833	78,264	2,569							
es and ’ equity	$ 995,442	$ 834,378	$ 161,064							
				4.07%	4.09%					
ue				4.23%	4.23%	$ 28,428	$ 24,049	$ 4,379	$ 3,950	$ 419

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax equivalent basis, using a 34% tax rate.

(3) Interest income on loans includes fees.

In this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our interest rate spread. The Corporation is anticipating some margin pressure in future periods as we continue to see extremely competitive pricing on new and renewable loans.

Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first nine months of 2017, the Corporation recorded a loan loss provision of $400,000, compared to $350,000 in the first nine months of 2016. There were net charge-offs of $.290 million in the first nine months of 2017, compared to net charge-offs of $.492 million for the same period in 2016. There was no provision for loan losses for acquired loans as a result of acquisition fair value adjustments.

Other Income

Other income was $2.724 million in the first nine months of 2017, compared to $3.012 million in the same period in 2016. The decrease year over year was largely a result of decreased secondary market and SBA fees.

Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

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The following table details other income for the three and nine months ended September 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended September 30,		Increase/(Decrease)		Nine Months Ended September 30,		Increase/(Decrease)	
	2017	2016	Dollars	Percent	2017	2016	Dollars	Percent
Deposit service fees	$ 262	$ 259	$ 3	1.16%	$ 803	$ 723	$ 80	11.07%
Income from loans sold in the secondary market	434	512	(78)	(15.23)	1,048	1,118	(70)	(6.26)
SBA/USDA loan sale gains	278	551	(273)	N/A	426	717	(291)	(40.59)
Net mortgage servicing (amortization) income	(6)	(12)	6	(50.00)	(24)	(74)	50	(67.57)
Net realized security gains	38	40	(2)	N/A	38	149	(111)	(74.50)
Other noninterest income	147	139	8	5.76	433	379	54	14.25
Total other income	$ 1,153	$ 1,489	$ (336)	-22.57%	$ 2,724	$ 3,012	$ (288)	-9.56%

Other Expense

For the first nine months of 2017, the Corporation recorded other expenses of $22.419 million, compared to $22.376 million in 2016, an increase of $.043 million. The increase in other expesnes is a result of the larger operating platform of the Corporation stemming from the acquisitions in 2016. The increase in salaries and benefits and other customary operating expenses are necessary to ensure our platform infrastructure keeps pace with our growing asset base and the associated regulatory and risk management needs.

The following table details other expense for the three and nine months ended September 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended September 30,		Increase/(Decrease)		Nine Months Ended September 30,		Increase/(Decrease)	
	2017	2016	Dollars	Percentage	2017	2016	Dollars	Percentage
Salaries and employee benefits	$ 3,934	$ 3,687	$ 247	6.70%	$ 11,388	$ 10,592	$ 796	7.52%
Occupancy	761	680	81	11.91	2,322	1,960	362	18.47
Furniture and equipment	616	440	176	40.00	1,640	1,248	392	31.41
Data processing	533	440	93	21.14	1,482	1,118	364	32.56
Advertising	227	157	70	44.59	524	494	30	6.07
Professional service fees	323	309	14	4.53	1,049	807	242	29.99
Loan origination expenses and deposit and card related fees	181	152	29	19.08	515	434	81	18.66
Writedowns and losses on other real estate held for sale	43	60	(17)	(28.33)	298	62	236	380.65
FDIC insurance assessment	210	131	79	60.31	556	356	200	56.18
Telephone	154	140	14	10.00	445	374	71	18.98
Transaction related expenses	—	359	(359)	N/A	—	2,928	(2,928)	N/A
Other	742	730	12	1.64	2,199	2,003	196	9.79
Total other expense	$ 7,724	$ 7,285	$ 439	6.03%	$ 22,418	$ 22,376	$ 42	0.19%

Federal Income Taxes

The Corporation recognized a federal income tax expense for the nine months ended September 30, 2017 of $2.681 million, compared to $1.481 million a year earlier.

The Corporation has reported deferred tax assets of $6.266 million at September 30, 2017. 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

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realized. The Corporation, as of September 30, 2017 had a net operating loss and tax credit carryforwards for tax purposes of approximately $7.6 million and $1.7 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of September 30, 2017 and determined 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 all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 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.

LIQUIDITY

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

Current balance sheet liquidity consists of $57.682 million in cash and cash equivalents and $70.971 million of unpledged investment securities.   Although current liquidity is deemed adequate, management has the ability to increase on hand liquidity by acquiring brokered CDs in order to fund any anticipated loan growth.

During the first nine months of 2017, the Corporation increased cash and cash equivalents by $10.927 million. A large portion of this increase, $25 million, is attributable to the increase in FHLB borrowings, which management implemented to lock in a longer term source of funding, given the increasing rate environment. 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 Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. During the first nine months of 2017, the Bank paid dividends to the Corporation of $4.700 million. Bank capital after the payment of this dividend remained strong and above the "well capitalized" level for regulatory purposes. The Corporation also has a line of credit with a correspondent bank with current availability of $5.000 million. The Corporation's current plan for dividends from the Bank are dependent upon the profitability of the Bank, growth of assets at the Bank and the level of capital needed to stay "adequately capitalized." The Corporation will continue to explore 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 (“ALCO”). 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 noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $250,000. Noncore funding consists of certificates of deposit greater than $250,000, brokered deposits, and FHLB, Farmers’ Home Administration and other borrowings. At September 30, 2017, the Bank’s core deposits in relation to total funding were 71.18% compared to 72.54% at December 31, 2016. These ratios indicate that at September 30, 2017, that the Bank had slightly increased its reliance on noncore deposits and borrowings to fund the Bank’s long-term assets, namely loans and investments. The Bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of September 30, 2017, the Bank had $63 million of unsecured lines available and additional funding sources available if secured. The Bank 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 strategy is to increase core deposits in the Corporation's local markets. Management continually evaluates deposit products offered in order to remain competitive in its goal of increasing core deposits. The Corporation also has the ability to augment local deposit growth efforts with wholesale CD funding.

CAPITAL AND REGULATORY

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, Tier 1 capital and Common Equity Tier 1 Capital to risk-weighted assets and of Tier 1 capital to average assets. Management has determined that, as of September 30, 2017, the Corporation is adequately capitalized.

In order to be "well-capitalized" under the current 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.

The Corporation's and the Bank's actual capital and ratios compared to generally applicable regulatory requirements as of September 30, 2017 are as follows (dollars in thousands):

	Actual	Adequacy Purposes	Well-Capitalized

	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital to risk weighted assets:						
Consolidated	$ 73,902	9.1% >	$ 64,938 >	8.0% >	$ 81,173 >	10.0%
mBank	$ 94,544	11.7%>	$ 64,910 >	8.0% >	$ 81,137 >	10.0%
Tier 1 capital to risk weighted assets:						
Consolidated	$ 68,772	8.5% >	$ 48,704 >	6.0% >	$ 64,938 >	8.0%
mBank	$ 89,455	11.0%>	$ 48,682 >	6.0% >	$ 64,910 >	8.0%
Common equity Tier 1 capital to risk weighted assets						
Consolidated	$ 68,772	8.5% >	$ 36,528 >	4.5% >	$ 52,762 >	6.5%
mBank	$ 89,455	11.0%>	$ 36,512 >	4.5% >	$ 52,739 >	6.5%
Tier 1 capital to average assets:						
Consolidated	$ 68,772	6.8% >	$ 40,324 >	4.0% >	$ 50,406 >	5.0%
mBank	$ 89,455	8.9% >	$ 40,301 >	4.0% >	$ 50,376 >	5.0%

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

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MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

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

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

Loans are the 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. In addition, the Corporation prices the majority of its fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

As of September 30, 2017, the Corporation had established interest rate floors on approximately $143.289 million of its variable rate commercial loans. These interest rate floors will result in a “lag” on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $74.033 million of the “floor rate” loan balances will reprice with a 25 basis point increase on the prime rate, with another $52.010 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $85.009 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal as of September 30, 2017. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. The balance of fed funds sold at September 30, 2017 was $5.006 million. 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 managing the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income.

Management realizes certain interest rate risks are inherent in the business of banking 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 regular asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

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.

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

The following is the Corporation's repricing opportunities at September 30, 2017 (dollars in thousands):

	1-90 Days	91-365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 292,921	182,838	324,059	8,331	$ 808,149
Securities	3,420	12,901	47,128	21,560	85,009
Other (1)	12,241	3,952	5,190	247	21,630
Total interest-earning assets	308,582	199,691	376,377	30,138	914,788
Interest-bearing obligations:					
NOW, money market, savings and interest checking	337,686	—	—	—	337,686
Time deposits	19,309	67,264	64,375	2,209	153,157
Brokered CDs	31,742	136,938	13,538	—	182,218
Borrowings and fed funds purchased	11,845	11,727	67,663	162	91,397
Total interest-bearing obligations	400,582	215,929	145,576	2,371	764,458
Gap	$ (92,000)	$ (16,238)	$ 230,801	$ 27,767	$ 150,330
Cumulative gap	$ (92,000)	$ (108,238)	$ 122,563	$ 150,330	

(1) Includes Federal Home Loan Bank Stock.

The above analysis indicates that at September 30, 2017, the Corporation had a cumulative liability sensitivity gap position of $92.000 million within the one-year time frame. 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. This is because 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

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would increase. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2016, the Corporation had a cumulative liability sensitivity gap position of $115.670 million within the one-year time frame.

The borrowings in the gap analysis include $70.000 million of FHLB advances that have a weighted average maturity of 1.04 years and a weighted average rate of 2.09%.

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

FOREIGN EXCHANGE RISK

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation has decided to curtail its foreign exchange services for customer, however, management believes the exposure to short-term foreign exchange risk is minimal.

OFF-BALANCE-SHEET RISK

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

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

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation’s operations. Nearly all the assets and

liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation's performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation's performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

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MACKINAC FINANCIAL CORPORATION

ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2017, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of September 30, 2017.

Changes in Internal Control Over Financial Reporting

There were no changes in the Corporation’s internal control over financial reporting that occurred during the quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

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MACKINAC FINANCIAL CORPORATION

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking. Although the results of litigation and claims cannot be predicted, management believes there are no legal proceedings, the outcome of which, if determined adversely to the Corporation, would individually or in the aggregate be reasonably expected to have a material adverse effect on the Corporation's result of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The shares reported in the table below 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. As of September 30, 2017 there remains $25,335 to be utilized under the current authorizations. As presented below, there were no purchases during the third quarter of 2017.

Issuer purchase of Equity Securities

Period of purchases	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of a publically announced plan or program	Maximum dollars yet to be used for stock purchases
July 1, 2017 to July 31, 2017	—	$ —	—	$ 25,335
August 1, 2017 to August 31, 2017	—	$ —	—	25,335
September 1, 2017 to September 30, 2017	—	$ —	—	25,335
Total Third Quarter 2017	—	$ —	—	

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

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

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SIGNATURES

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

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date:	November 14, 2017	By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
		By:	/s/ Jesse A. Deering JESSE A. DEERING EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)