

First Federal of Northern Michigan Bancorp, Inc.  
Form 10-Q  
November 13, 2015

**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, 2015**

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 000-31957

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of incorporation or organization)

**32-0135202**

(I.R.S. Employer Identification No.)

**100 S. Second Avenue, Alpena, Michigan 49707**

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(989) 356-9041**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

|                                |                                  |
|--------------------------------|----------------------------------|
| Common Stock, Par Value \$0.01 | Outstanding at November 13, 2015 |
| (Title of Class)               | 3,727,014 shares                 |

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.**

**FORM 10-Q**

**Quarter Ended September 30, 2015**

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## PART I - FINANCIAL INFORMATION

### ITEM 1 - FINANCIAL STATEMENTS

#### First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries

##### Consolidated Balance Sheet (in thousands)

|  | September<br>30, 2015<br>(Unaudited) | December<br>31, 2014 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and cash equivalents:   |                                      |                      |
| Cash on hand and due from banks  | \$ 8,040                             | \$ 11,205            |
| Overnight deposits with FHLB   | 478                                  | 267                  |
| Total cash and cash equivalents  | 8,518                                | 11,472               |
| Deposits held in other financial institutions  | 8,924                                | 8,429                |
| Securities available for sale  | 130,923                              | 119,968              |
| Securities held to maturity  | 745                                  | 790                  |
| Loans held for sale  | 132                                  | 88                   |
| Loans receivable, net of allowance for loan losses of \$1,514 and \$1,429 as of September 30, 2015 and December 31, 2014, respectively | 168,063                              | 163,647              |
| Foreclosed real estate and other repossessed assets  | 2,495                                | 2,823                |
| Federal Home Loan Bank stock, at cost  | 1,636                                | 2,591                |
| Premises and equipment   | 6,295                                | 6,336                |
| Assets held for sale   | 271                                  | 478                  |
| Accrued interest receivable  | 1,065                                | 986                  |
| Intangible assets  | 1,105                                | 1,286                |
| Deferred tax asset   | 2,394                                | 851                  |
| Mortgage servicing rights  | 602                                  | 710                  |
| Bank owned life insurance  | 4,824                                | 4,727                |
| Other assets   | 831                                  | 685                  |
| Total assets   | \$ 338,823                           | \$ 325,867           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Liabilities:   |                                      |                      |
| Deposits   | \$ 279,297                           | \$ 270,734           |
| Advances from borrowers for taxes and insurance  | 270                                  | 203                  |

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|   |            |            |
|---|------------|------------|
| Advances from Federal Home Loan Bank  | 25,072     | 22,885     |
| Accrued expenses and other liabilities  | 1,107      | 1,509      |
| Total liabilities   | 305,746    | 295,331    |
| Stockholders' equity:   |            |            |
| Common stock (\$0.01 par value 20,000,000 shares authorized<br>4,034,764 shares issued) | 40         | 40         |
| Additional paid-in capital  | 28,264     | 28,264     |
| Retained earnings   | 7,127      | 4,765      |
| Treasury stock at cost (307,750 shares)   | (2,964 )   | (2,964 )   |
| Accumulated other comprehensive income  | 610        | 431        |
| Total stockholders' equity  | 33,077     | 30,536     |
| Total liabilities and stockholders' equity  | \$ 338,823 | \$ 325,867 |

See accompanying notes to consolidated financial statements.

**First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**  
**Consolidated Statement of Income and Comprehensive Income (in thousands)**

|   | For the Three Months<br>Ended September 30,<br>2015      2014<br>(Unaudited) |           | For the Nine Months<br>Ended September 30,<br>2015      2014<br>(Unaudited) |            |
|---|--|-----------|---|------------|
| Interest income:  |  |           |   |            |
| Interest and fees on loans  | \$2,056  | \$1,934   | \$6,094   | \$5,335    |
| Interest and dividends on investments   |  |           |   |            |
| Taxable   | 317  | 217       | 938   | 518        |
| Tax-exempt  | 28   | 44        | 89  | 127        |
| Interest on mortgage-backed securities  | 259  | 192       | 811   | 477        |
| Total interest income   | 2,660  | 2,387     | 7,932   | 6,457      |
| Interest expense:   |  |           |   |            |
| Interest on deposits  | 234  | 205       | 709   | 583        |
| Interest on borrowings  | 83   | 65        | 217   | 195        |
| Total interest expense  | 317  | 270       | 926   | 778        |
| Net interest income   | 2,343  | 2,117     | 7,006   | 5,679      |
| (Recovery of) Provision for loan losses   | (4      )  | 257       | (26      )  | 273        |
| Net interest income after provision for loan losses   | 2,347  | 1,860     | 7,032   | 5,406      |
| Non-interest income:  |  |           |   |            |
| Service charges and other fees  | 242  | 206       | 696   | 576        |
| Mortgage banking activities   | 128  | 127       | 378   | 351        |
| Net gain on sale of securities  | 2  | 1         | 4   | 1          |
| Net (loss) income on sale of premises and equipment, real estate owned and other repossessed assets | (8      )  | (1      ) | 82  | (27      ) |
| Bargain purchase gain   | —  | 1,982     | —   | 1,982      |
| Other   | 104  | 76        | 289   | 188        |
| Total non-interest income   | 468  | 2,391     | 1,449   | 3,071      |
| Non-interest expense:   |  |           |   |            |
| Compensation and employee benefits  | 1,345  | 1,331     | 4,271   | 3,550      |
| FDIC Insurance Premiums   | 62   | 56        | 181   | 147        |
| Advertising   | 43   | 54        | 136   | 125        |
| Occupancy   | 286  | 274       | 833   | 730        |
| Amortization of intangible assets   | 61   | 42        | 182   | 82         |
| Service bureau charges  | 114  | 92        | 319   | 238        |
| Professional services   | 141  | 50        | 388   | 220        |
| Collection activity   | 25   | 5         | 82  | 34         |
| Real estate owned & other repossessed assets  | 251  | 91        | 297   | 120        |
| Merger related expense  | —  | 140       | —   | 264        |
| Other   | 250  | 336       | 819   | 871        |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Total non-interest expense   | 2,578     | 2,471     | 7,508     | 6,381     |
| Income before income tax recovery  | 237       | 1,780     | 973       | 2,096     |
| Income tax recovery  | (1,650 )  | —         | (1,650 )  | —         |
| Net Income   | \$1,887   | \$1,780   | \$2,623   | \$2,096   |
| Other Comprehensive Income:  |           |           |           |           |
| Unrealized gain (loss) on investment securities - available for sale securities - net of tax | 234       | (161 )    | 182       | 272       |
| Reclassification adjustment for gains realized in earnings - net of tax                      | (2 )      | —         | (3 )      | —         |
| Comprehensive Income   | \$2,119   | \$1,619   | \$2,802   | \$2,368   |
| Per share data:  |           |           |           |           |
| Net Income per share   |           |           |           |           |
| Basic  | \$0.51    | \$0.53    | \$0.70    | \$0.69    |
| Diluted  | \$0.51    | \$0.53    | \$0.70    | \$0.69    |
| Weighted average number of shares outstanding  |           |           |           |           |
| Basic  | 3,727,014 | 3,369,670 | 3,727,014 | 3,047,702 |
| Including dilutive stock options   | 3,727,014 | 3,369,670 | 3,727,014 | 3,047,702 |
| Dividends per common share   | \$0.03    | \$0.02    | \$0.07    | \$0.06    |

See accompanying notes to consolidated financial statements.



**First Federal of Northern Michigan Bancorp Inc. and Subsidiaries**  
**Consolidated Statement of Changes in Stockholders' Equity (Unaudited)**

|   | Common<br>Stock | Treasury<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total    |
|---|-----------------|-------------------|----------------------------------|----------------------|--|----------|
| Balance at January 1, 2015  | \$ 40           | \$(2,964 )        | \$ 28,264                        | \$ 4,765             | \$ 431   | \$30,536 |
| Net income for the period   | —               | —                 | —                                | 2,623                | —  | 2,623    |
| Changes in unrealized gain:<br>on available-for-sale securities<br>(net of tax of \$92) | —               | —                 | —                                | —                    | 179  | 179      |
| Dividends declared  | —               | —                 | —                                | (261 )               | —  | (261 )   |
| Balance at September 30, 2015   | \$ 40           | \$(2,964 )        | \$ 28,264                        | \$ 7,127             | \$ 610   | \$33,077 |

See accompanying notes to the consolidated financial statements.

|  | Common<br>Stock | Treasury<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total    |
|--|-----------------|-------------------|----------------------------------|----------------------|---|----------|
| Balance at January 1, 2014   | \$ 32           | \$(2,964 )        | \$ 23,854                        | \$ 2,763             | \$ (160 )   | \$23,525 |
| Exchange of Alpena Banking Corp Stock<br>(842,965 shares issued)                         | 8               | —                 | 4,410                            | —                    | —   | 4,418    |
| Net income for the period  | —               | —                 | —                                | 2,096                | —   | 2,096    |
| Changes in unrealized gain:<br>on available-for-sale securities<br>(net of tax of \$141) | —               | —                 | —                                | —                    | 272   | 272      |
| Dividends declared   | —               | —                 | —                                | (173 )               | —   | (173 )   |
| Balance at September 30, 2014  | \$ 40           | \$(2,964 )        | \$ 28,264                        | \$ 4,686             | \$ 112  | \$30,138 |

See accompanying notes to the consolidated financial statements.



**First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**  
**Consolidated Statement of Cash Flows (in thousands)**

|  | For Nine Months<br>Ended<br>September 30,<br>2015      2014<br>(Unaudited) |          |
|--|--|----------|
| Cash Flows from Operating Activities:                                      |  |          |
| Net income   | \$2,623  | \$2,096  |
| Adjustments to reconcile net income to net cash from operating activities: |  |          |
| Depreciation and amortization  | 474  | 321      |
| (Recovery of) provision for loan loss                                      | (26 )  | 273      |
| Accretion of acquired loans  | (57 )  | (18 )    |
| Amortization and accretion on securities                                   | 680  | 345      |
| Bargain purchase gain  | —  | (1,982 ) |
| Gain on sale of loans held for sale  | (204 )   | (155 )   |
| (Gain) loss on sale of property and equipment and asset held for sale      | (81 )  | 23       |
| Gain on sale of available for sale securities                              | (4 )   | (1 )     |
| (Gain) loss on sale of real estate owned and other repossessed assets      | (1 )   | 4        |
| Originations of loans held for sale  | (12,112)   | (9,624 ) |
| Proceeds from sale of loans held for sale                                  | 12,272   | 8,726    |
| Deferred income tax benefit  | (1,650 )   | (20 )    |
| Net change in:   |  |          |
| Accrued interest receivable  | (80 )  | (98 )    |
| Other assets   | (23 )  | (152 )   |
| Bank owned life insurance  | (97 )  | (87 )    |
| Accrued expenses and other liabilities                                     | (403 )   | 191      |
| Net cash provided by (used in) operating activities                        | 1,311  | (158 )   |
| Cash Flows from Investing Activities:                                      |  |          |
| Net cash received in bank acquisition                                      | —  | 41,357   |
| Net (increase) decrease in loans   | (4,910 )   | 4,049    |
| Proceeds from maturities and calls of available-for-sale securities        | 23,031   | 7,473    |
| Proceeds from maturities and calls of held to maturity securities          | 45   | 40       |
| Proceeds from sale of real estate and other repossessed assets             | 906  | 413      |
| Proceeds from sale of available-for-sale securities                        | 1,831  | 218      |
| Proceeds from sale of property and equipment                               | 288  | 3        |
| Proceeds from redemption of FHLB stock                                     | 955  | —        |
| Purchase of securities   | (36,716)   | (48,517) |
| Purchase of premises and equipment   | (251 )   | (180 )   |
| Net cash (used in) provided by investing activities                        | (14,821)   | 4,856    |
| Cash Flows from Financing Activities:                                      |  |          |
| Dividends paid on common stock   | (261 )   | (173 )   |
| Net increase in deposits   | 8,562  | 2,691    |
| Net increase in advances from borrowers                                    | 67   | 104      |

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|   |          |          |
|---|----------|----------|
| Advances from Federal Home Loan Bank                | 14,000   | 12,555   |
| Repayments of Federal Home Loan Bank advances       | (11,812) | (15,600) |
| Net cash provided by (used in) financing activities | 10,556   | (423 )   |

|  |          |         |
|--|----------|---------|
| Net (decrease) increase in cash and cash equivalents | (2,954 ) | 4,275   |
| Cash and cash equivalents at beginning of period     | 11,472   | 2,766   |
| Cash and cash equivalents at end of period           | \$8,518  | \$7,041 |

Supplemental disclosure of cash flow information:

|   |         |       |
|---|---------|-------|
| Cash refunded for taxes paid  | \$1,665 | \$—   |
| Cash paid during the period for interest                            | 927     | 788   |
| Transfers of loans to foreclosed real estate and repossessed assets | 577     | 1,481 |

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1—BASIS OF FINANCIAL STATEMENT PRESENTATION**

The accompanying unaudited condensed consolidated interim financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q. Accordingly, certain information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The interim financial statements should be read in conjunction with the financial statements of First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries and the notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2014.

All adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary for a fair presentation of financial position, results of operations and cash flows, have been made. The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015.

**Note 2—PRINCIPLES OF CONSOLIDATION**

The consolidated financial statements include the accounts of First Federal of Northern Michigan Bancorp, Inc., its wholly owned subsidiary First Federal of Northern Michigan (the "Bank"), and the Bank's wholly owned subsidiaries, Financial Services & Mortgage Corporation ("FSMC") and FFNM Financial Services, Inc. FSMC invested in real estate, which includes leasing, selling, developing, and maintaining real estate properties. FSMC was dissolved in the first quarter of 2015 since all real estate properties were sold in 2011. The main activity of FFNM Financial Services, Inc. is to collect commission from the sale of non-insured investment products resulting from investment advisory services offered in our branch network. All significant intercompany balances and transactions have been eliminated in the consolidation.

**Note 3—BUSINESS COMBINATIONS**

As of August 8, 2014 (“Merger Date”), the Company completed its merger with Alpena Banking Corporation and its wholly owned subsidiary Bank of Alpena (“Alpena”). Alpena had one branch office and assets with a fair value of \$102.6 million as of August 8, 2014. The results of operations due to the merger have been included in the Company’s results since the Merger Date. The merger was effected by the issuance of shares of the Company’s common stock to Alpena Banking Corporation shareholders. Each share of Alpena’s common stock was converted into the right to receive 1.549 shares of the Company’s common stock, with cash paid in lieu of fractional shares. The conversion of Alpena’s shares resulted in the issuance of 842,965 shares of the Company’s common stock.

The merger transaction was recorded using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair values on the Merger Date. The fair value measurements, based on third-party valuations, have been retrospectively reflected and the following table provides the purchase price calculation as of the Merger Date and the identifiable assets acquired and liabilities assumed at their estimated fair values.

**Purchase Price:**

(,000's omitted)

|   |         |
|---|---------|
| First Federal of Northern Michigan Bancorp, Inc. common stock issued for Alpena Banking Corporation common shares | 843     |
| Price per share, based on First Federal of Northern Michigan Bancorp, Inc. closing price on August 8, 2014        | \$5.59  |
| Total purchase price  | \$4,712 |

**Preliminary Statement of Net Assets Acquired at Fair Value:**

|                                  |           |
|----------------------------------|-----------|
| Assets                           |           |
| Cash and cash equivalents        | \$41,650  |
| Securities                       | 24,008    |
| Loans                            | 33,051    |
| Premises and Equipment           | 1,667     |
| Core Deposit Intangible          | 1,392     |
| Deferred Tax Asset               | 337       |
| Other Assets                     | 467       |
| Total Assets                     | \$102,572 |
| Liabilities                      |           |
| Deposits                         | 95,787    |
| Other Liabilities                | 91        |
| Total Liabilities                | \$ 95,878 |
| Net Identifiable Assets Acquired | \$6,694   |
| Bargain Purchase Gain            | \$(1,982) |

The results of operations for the three and nine months ended September 30, 2014 include the operating results of the acquired assets and assumed liabilities for the 51 days subsequent to the Merger Date. Alpena's results of operations prior to the Merger Date are not included in the Company's consolidated statement of comprehensive income.

The following table provides pro forma information for the results of operations for the three and nine months ended September 30, 2015 and 2014, as if the merger had occurred on January 1 of each year. These unaudited pro forma results are presented for illustrative purposes only and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of each period presented, nor are they intended to represent or be indicative of future results of the Company.

|                              | Three Months<br>Ended<br>September 30,<br>2015 |         | Nine Months<br>Ended<br>September 30,<br>2015 |         |
|------------------------------|--|---------|---|---------|
|                              | 2014   |         | 2014  |         |
| Net interest income          | \$2,343  | \$2,413 | \$7,006                                       | \$7,217 |
| Non-interest expense         | 2,578  | 2,852   | 7,508   | 7,921   |
| Net income                   | 1,887  | 1,709   | 2,623   | 1,997   |
| Net income per diluted share | 0.51   | 0.46    | 0.70  | 0.54    |

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

The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired"), and loans that do not meet the criteria, which are accounted for under ASC 310-20 ("acquired non-impaired"). In addition, the loans are further categorized into different pools based primarily on the type and purpose of the loan.



The fair value of loans as of the Merger Date is presented in the following table:

|                                 | Acquired<br>Impaired | Acquired<br>Non-Impaired | Acquired<br>Total |
|---------------------------------|----------------------|--------------------------|-------------------|
| Real estate loans:              |                      |                          |                   |
| Residential mortgages           | \$ 397               | \$ 6,992                 | \$7,389           |
| Commercial Loans:               |                      |                          |                   |
| Construction                    | —                    | 109                      | 109               |
| Secured by real estate          | 3,070                | 14,721                   | 17,791            |
| Other                           | 1,201                | 4,213                    | 5,414             |
| Total commercial loans          | 4,271                | 19,043                   | 23,314            |
| Consumer loans:                 |                      |                          |                   |
| Secured by real state           | 30                   | 1,568                    | 1,598             |
| Other                           | —                    | 750                      | 750               |
| Total consumer loans            | 30                   | 2,318                    | 2,348             |
| Total loans at acquisition date | \$ 4,698             | \$ 28,353                | \$33,051          |

The following table presents data on acquired impaired loans at the Merger Date:

|   | Acquired<br>Impaired | Acquired<br>Non-Impaired | Acquired<br>Total |
|---|----------------------|--------------------------|-------------------|
| Loans acquired- contractual required payments | \$5,930              | \$ 28,587                | \$34,517          |
| Non accretable yield                          | (1,232)              | —                        | (1,232 )          |
| Expected cash flows                           | 4,698                | 28,587                   | 33,285            |
| Accretable yield                              | —                    | (234 )                   | (234 )            |
| Carrying balance at acquisition date          | \$4,698              | \$ 28,353                | \$33,051          |

#### Note 4—SECURITIES

Investment securities have been classified according to management's intent. The carrying value and estimated fair value of securities are as follows:

September 30, 2015

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|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses   | Market Value |
|---|----------------|------------------------|---------------------------|--------------|
|   | (in thousands) |                        |                           |              |
| Securities Available for Sale   |                |                        |                           |              |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$34,339       | \$ 271                 | \$ (9 )                   | \$34,601     |
| Municipal obligations   | 28,243         | 407                    | (31 )                     | 28,619       |
| Corporate bonds & other obligations   | —              | —                      | —                         | —            |
| Mortgage-backed securities  | 67,415         | 408                    | (125 )                    | 67,698       |
| Equity securities   | 2              | 3                      | —                         | 5            |
| Total   | \$129,999      | \$ 1,089               | \$ (165 )                 | \$130,923    |
| Securities Held to Maturity   |                |                        |                           |              |
| Municipal obligations   | \$745          | \$ 1                   | \$ —                      | \$746        |
| December 31, 2014   |                |                        |                           |              |
|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Market Value |
|   | (in thousands) |                        |                           |              |
| Securities Available for Sale   |                |                        |                           |              |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$31,221       | \$ 58                  | \$ (57 )                  | 31,222       |
| Municipal obligations   | 22,894         | 369                    | (129 )                    | 23,134       |
| Corporate bonds & other obligations   | 1,549          | 12                     | —                         | 1,561        |
| Mortgage-backed securities  | 63,648         | 515                    | (117 )                    | 64,046       |
| Equity securities   | 3              | 2                      | —                         | 5            |
| Total   | \$119,315      | \$ 956                 | \$ (303 )                 | \$119,968    |
| Securities Held to Maturity   |                |                        |                           |              |
| Municipal obligations   | \$790          | \$ 118                 | \$ —                      | \$908        |

The amortized cost and estimated market value of securities at September 30, 2015, by contract maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities with no specified maturity date are separately stated.

|                                       | September 30, 2015 |           |
|---------------------------------------|--------------------|-----------|
|                                       | Amortized Market   |           |
|                                       | Cost               | Value     |
|                                       | (in thousands)     |           |
| Available For Sale:                   |                    |           |
| Due in one year or less               | \$1,853            | \$1,864   |
| Due after one year through five years | 41,243             | 41,625    |
| Due in five year through ten years    | 18,302             | 18,461    |
| Due after ten years                   | 1,184              | 1,270     |
| Subtotal                              | 62,582             | 63,220    |
| Equity securities                     | 2                  | 5         |
| Mortgage-backed securities            | 67,415             | 67,698    |
| Total                                 | \$130,000          | \$130,923 |
| Held To Maturity:                     |                    |           |
| Due in one year or less               | \$45               | \$45      |
| Due after one year through five years | 210                | 210       |
| Due in five year through ten years    | 335                | 335       |
| Due after ten years                   | 155                | 155       |
| Total                                 | \$745              | \$746     |

At September 30, 2015 and December 31, 2014, securities with a carrying value and fair value of \$26.3 million and \$35.0 million, respectively, were pledged to certain deposit accounts, FHLB advances and our line of credit at the Federal Reserve.

Gross proceeds from the sale of securities for the nine-months ended September 30, 2015 and 2014 were \$1.8 million and \$218,000, respectively, resulting in gross gains of \$4,000 and \$646 respectively and gross losses of \$0 and \$0, respectively.

The following is a summary of temporarily impaired investments that have been impaired for less than and more than twelve months as of September 30, 2015 and December 31, 2014:

| September 30, 2015            |                               |
|-------------------------------|-------------------------------|
| Gross<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses |

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|   | Fair<br>Value<br>(in thousands) | <12<br>months                                  | Fair<br>Value | > 12<br>months                                  |
|---|---------------------------------|--|---------------|---|
| Available For Sale:   |                                 |  |               |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$1,998                         | \$ 0   | \$990         | \$ (9 )   |
| Corporate bonds & other obligations   | —                               | —  | —             | —   |
| Municipal obligations   | 2,603                           | (20 )  | 1,963         | (11 )   |
| Mortgage-backed securities  | 13,891                          | (49 )  | 3,854         | (76 )   |
| Equity securities   | —                               | —  | —             | —   |
| Total   | \$18,492                        | \$ (69 )                                       | \$6,807       | \$ (96 )  |
| Held to Maturity:   |                                 |  |               |   |
| Municipal obligations   | \$—                             | \$ —   | \$—           | \$ —  |
| December 31, 2014   |                                 |  |               |   |
|   | Fair<br>Value<br>(in thousands) | Gross<br>Unrealized<br>Losses<br><12<br>months | Fair<br>Value | Gross<br>Unrealized<br>Losses<br>> 12<br>months |
| Available For Sale:   |                                 |  |               |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$13,672                        | \$ (28 )                                       | \$971         | \$ (29 )  |
| Municipal obligations   | 9,506                           | (54 )  | 4,039         | (75 )   |
| Mortgage-backed securities  | 9,923                           | (31 )  | 4,666         | (86 )   |
| Equity securities   | —                               | —  | —             | —   |
| Total   | \$33,101                        | \$ (113 )                                      | \$9,676       | \$ (190 )                                       |
| Held to Maturity:   |                                 |  |               |   |
| Municipal obligations   | \$—                             | \$ —   | \$—           | \$ —  |

As of September 30, 2015, there were 27 securities with unrealized losses totaling \$165,000 compared to 72 securities with unrealized losses totaling \$303,000 at December 31, 2014.

The unrealized losses on the securities held in the portfolio are not considered other than temporary and have not been recognized into income. This decision is based on the Company's ability and intent to hold any potentially impaired security until maturity. The performance of the security is based on the contractual terms of the agreement, the extent of the impairment and the financial condition and credit quality of the issuer. The decline in market value is considered temporary and a result of changes in interest rates and other market variables.

## **Note 5—LOANS**

Originated loans are reported at their principal amount outstanding adjusted for partial charge-offs, the allowance, and net deferred loan fees and costs. Interest income on loans is accrued over the term of the loans primarily using the simple interest method based on the principal balance outstanding. Interest is not accrued on loans where collectability is uncertain. Accrued interest is presented separately in the consolidated balance sheet. Loan origination fees and certain direct costs incurred to extend credit are deferred and amortized over the term of the loan or loan commitment period as an adjustment to the related loan yield.

Acquired loans are those obtained in the Merger (See Note 3 – Business Combination for further information). These loans were recorded at estimated fair value at the Acquisition Date with no carryover of the related allowance. The acquired loans were segregated between those considered to be performing ("acquired non-impaired loans") and those with evidence of credit deterioration ("acquired impaired loans"). Acquired loans are considered impaired if there is evidence of credit deterioration and if it is probable, at acquisition, that all contractually required payments will not be collected. Acquired loans restructured after acquisition are not considered or reported as troubled debt restructurings if the loans evidenced credit deterioration as of the Acquisition Date and are accounted for in pools. As of September 30, 2015, no acquired loans were modified as troubled debt restructurings after the Acquisition Date.

The fair value estimates for acquired loans are based on expected prepayments and the amount and timing of discounted expected principal, interest and other cash flows. Credit discounts representing the principal losses expected over the life of the loan are also a component of the initial fair value. In determining the Acquisition Date fair value of acquired impaired loans, and in subsequent accounting, we have generally aggregated acquired mortgage, commercial and consumer loans into pools of loans with common risk characteristics.

The difference between the fair value of an acquired non-impaired loan and contractual amounts due at the Acquisition Date is accreted into income over the estimated life of the loan. Contractually required payments represent the total undiscounted amount of all uncollected principal and interest payments. Acquired non-impaired loans are

placed on nonaccrual status and reported as nonperforming or past due using the same criteria applied to the originated loan portfolio.

The excess of an acquired impaired loan's contractually required payments over the amount of its undiscounted cash flows expected to be collected is referred to as the non-accretable difference. The non-accretable difference, which is neither accreted into income nor recorded on the consolidated balance sheet, reflects estimated future credit losses and uncollectible contractual interest expected to be incurred over the life of the acquired impaired loan. The excess cash flows expected to be collected over the carrying amount of the acquired loan is referred to as the accretable yield. This amount is accreted into interest income over the remaining life of the acquired loans or pools using the level yield method. The accretable yield is affected by changes in interest rate indices for variable rate loans, changes in prepayment speed assumptions and changes in expected principal and interest payments over the estimated lives of the acquired impaired loans.

We evaluate quarterly the remaining contractual required payments receivable and estimate cash flows expected to be collected over the life of the impaired loans. Contractually required payments receivable may increase or decrease for a variety of reasons, for example, when the contractual terms of the loan agreement are modified, when interest rates on variable rate loans change, or when principal and/or interest payments are received. Cash flows expected to be collected on acquired impaired loans are estimated by incorporating several key assumptions similar to the initial estimate of fair value. These key assumptions include probability of default, loss given default, and the amount of actual prepayments after the Acquisition Date. Prepayments affect the estimated lives of loans and could change the amount of interest income, and possibly principal, expected to be collected. In re-forecasting future estimated cash flows, credit loss expectations are adjusted as necessary. The adjustments are based, in part, on actual loss severities recognized for each loan type, as well as changes in the probability of default. For periods in which estimated cash flows are not re-forecasted, the prior reporting period's estimated cash flows are adjusted to reflect the actual cash received and credit events that transpired during the current reporting period.

Increases in expected cash flows of acquired impaired loans subsequent to the Acquisition Date are recognized prospectively through adjustments of the yield on the loans or pools over their remaining lives, while decreases in expected cash flows are recognized as impairment through a provision for loan losses and an increase in the allowance.

The following table sets forth the composition of our loan portfolio by loan type at the dates indicated.

|                            | At<br>September<br>30,<br>2015<br>(in thousands) | At<br>December<br>31,<br>2014 |
|----------------------------|--|-------------------------------|
| Real estate loans:         |  |                               |
| Residential mortgage       | \$76,458   | \$71,828                      |
| Commercial loans:          |  |                               |
| Construction - real estate | 257  | 1,443                         |
| Secured by real estate     | 59,096   | 62,163                        |
| Other                      | 23,387   | 19,000                        |
| Total commercial loans     | 82,740   | 82,606                        |
| Consumer loans:            |  |                               |
| Secured by real estate     | 9,063  | 9,502                         |
| Other                      | 1,557  | 1,403                         |
| Total consumer loans       | 10,620   | 10,905                        |
| Total gross loans          | \$169,818  | \$165,339                     |
| Less:                      |  |                               |
| Net deferred loan fees     | (241 )   | (263 )                        |
| Allowance for loan losses  | (1,514 )   | (1,429 )                      |
| Total loans, net           | \$168,063  | \$163,647                     |

Total outstanding balance and carrying value of acquired impaired loans was \$4.2 million and \$3.1 million, respectively, as of September 30, 2015. Changes in the accretable yield for acquired impaired loans for the nine months ended September 30, 2015 were as follows:

|  |  |                   |
|--|--|-------------------|
| Acquired<br>Impaired<br>Non-<br>Accretable | Acquired<br>Non-<br>Impaired<br>Accretable | Acquired<br>Total |
|--|--|-------------------|

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|  |             |           |             |
|--|-------------|-----------|-------------|
| December 31, 2014 balance                    | \$ (1,232 ) | \$ (208 ) | \$ (1,440 ) |
| Net discount associated with acquired loans  | —           | —         | —           |
| Accretion of discount for credit spread      | —           | 57        | 57          |
| Transfer from non-accretable to accretable   | 25          | (25 )     | —           |
| Loans paid off through September 30, 2015    | 6           | —         | 6           |
| Loans charged off through September 30, 2015 | 113         | —         | 113         |
| Total  | \$ (1,088 ) | \$ (176 ) | \$ (1,264 ) |

The following table illustrates the contractual aging of the recorded investment in past due loans by class of loans as of September 30, 2015 and December 31, 2014:

As of September 30, 2015

|                                       | 30 -<br>59<br>Days<br>Past<br>Due | 60 -<br>89<br>Days<br>Past<br>Due | Greater<br>than<br>90 Days<br>Past<br>Due | Total<br>Past<br>Due | Current   | Total<br>Loans | Recorded<br>Investment<br>> 90<br>Days and<br>Accruing |
|---------------------------------------|-----------------------------------|-----------------------------------|---|----------------------|-----------|----------------|--|
| (dollars in thousands)                |                                   |                                   |   |                      |           |                |  |
| Originated Loans:                     |                                   |                                   |   |                      |           |                |  |
| Commercial Real Estate:               |                                   |                                   |   |                      |           |                |  |
| Commercial Real Estate - construction | \$—                               | \$—                               | \$ —                                      | \$—                  | \$257     | \$257          | \$ —   |
| Commercial Real Estate - other        | 640                               | —                                 | —   | 640                  | 44,577    | 45,217         | —  |
| Commercial - non real estate          | 29                                | 11                                | —   | 40                   | 20,887    | 20,927         | —  |
| Consumer:                             |                                   |                                   |   |                      |           |                |  |
| Consumer - Real Estate                | 137                               | —                                 | —   | 137                  | 7,353     | 7,490          | —  |
| Consumer - Other                      | —                                 | —                                 | 4   | 4                    | 1,433     | 1,437          | —  |
| Residential:                          |                                   |                                   |   |                      |           |                |  |
| Residential                           | 1,273                             | 481                               | 231                                       | 1,985                | 68,906    | 70,891         | 125  |
| Total                                 | \$2,079                           | \$492                             | \$ 235                                    | \$2,806              | \$143,413 | \$146,219      | \$ 125   |



As of September 30, 2015

|                                       | 30 -<br>59<br>Days<br>Past<br>Due | 60 -<br>89<br>Days<br>Past<br>Due | Greater<br>than<br>90 Days<br>Past<br>Due | Total<br>Past<br>Due | Current  | Total<br>Loans | Recorded<br>Investment<br>> 90<br>Days and<br>Accruing |
|---------------------------------------|-----------------------------------|-----------------------------------|---|----------------------|----------|----------------|--|
| (dollars in thousands)                |                                   |                                   |   |                      |          |                |  |
| <b>Acquired Loans:</b>                |                                   |                                   |   |                      |          |                |  |
| <b>Commercial Real Estate:</b>        |                                   |                                   |   |                      |          |                |  |
| Commercial Real Estate - construction | \$—                               | \$—                               | \$—                                       | \$—                  | \$—      | \$—            | \$—  |
| Commercial Real Estate - other        | 222                               | 176                               | 259                                       | 657                  | 13,222   | 13,879         | 97   |
| Commercial - non real estate          | 17                                | 359                               | 451                                       | 827                  | 1,633    | 2,460          | 300  |
| <b>Consumer:</b>                      |                                   |                                   |   |                      |          |                |  |
| Consumer - Real Estate                | —                                 | —                                 | 4   | 4                    | 1,569    | 1,573          | —  |
| Consumer - Other                      | —                                 | —                                 | —   | —                    | 120      | 120            | —  |
| <b>Residential:</b>                   |                                   |                                   |   |                      |          |                |  |
| Residential                           | 306                               | —                                 | 265                                       | 571                  | 4,996    | 5,567          | —  |
| Total                                 | \$545                             | \$535                             | \$ 979                                    | \$2,059              | \$21,540 | \$23,599       | \$ 397   |

As of December 31, 2014

|                                       | 30 -<br>59<br>Days<br>Past<br>Due | 60 -<br>89<br>Days<br>Past<br>Due | Greater<br>than<br>90 Days<br>Past<br>Due | Total<br>Past<br>Due | Current   | Total<br>Loans | Recorded<br>Investment<br>> 90<br>Days and<br>Accruing |
|---------------------------------------|-----------------------------------|-----------------------------------|---|----------------------|-----------|----------------|--|
| <b>Originated Loans:</b>              |                                   |                                   |   |                      |           |                |  |
| (dollars in thousands)                |                                   |                                   |   |                      |           |                |  |
| <b>Commercial Real Estate:</b>        |                                   |                                   |   |                      |           |                |  |
| Commercial Real Estate - construction | \$—                               | \$—                               | \$—                                       | \$—                  | \$1,443   | \$1,443        | \$—  |
| Commercial Real Estate - other        | 10                                | 195                               | —   | 205                  | 46,103    | 46,308         | —  |
| Commercial - non real estate          | —                                 | —                                 | —   | —                    | 14,544    | 14,544         | —  |
| <b>Consumer:</b>                      |                                   |                                   |   |                      |           |                |  |
| Consumer - Real Estate                | 107                               | 4                                 | 7   | 118                  | 7,684     | 7,802          | —  |
| Consumer - Other                      | 3                                 | —                                 | 3   | 6                    | 1,152     | 1,158          | 3  |
| <b>Residential:</b>                   |                                   |                                   |   |                      |           |                |  |
| Residential                           | 1,484                             | 746                               | 386                                       | 2,616                | 62,326    | 64,942         | 87   |
| Total                                 | \$1,604                           | \$945                             | \$ 396                                    | \$2,945              | \$133,252 | \$136,197      | \$ 90  |

As of December 31, 2014

| <b>Acquired Loans:</b>                | 30 -<br>59<br>Days<br>Past<br>Due | 60 -<br>89<br>Days<br>Past<br>Due | Greater<br>than<br>90 Days<br>Past<br>Due | Total<br>Past<br>Due | Current  | Total<br>Loans | Recorded<br>Investment<br>> 90<br>Days and<br>Accruing |
|---------------------------------------|-----------------------------------|-----------------------------------|---|----------------------|----------|----------------|--|
|                                       | (dollars in thousands)            |                                   |   |                      |          |                |  |
| Commercial Real Estate - construction | \$—                               | \$—                               | \$—                                       | \$—                  | \$—      | \$—            | \$ —   |
| Commercial Real Estate - other        | 125                               | 128                               | 93  | 346                  | 15,604   | 15,950         | —  |
| Commercial - non real estate          | —                                 | 40                                | 104                                       | 144                  | 4,217    | 4,361          | —  |
| Consumer:                             |                                   |                                   |   |                      |          |                |  |
| Consumer - Real Estate                | 123                               | —                                 | —   | 123                  | 1,609    | 1,732          | —  |
| Consumer - Other                      | —                                 | —                                 | —   | —                    | 213      | 213            | —  |
| Residential:                          |                                   |                                   |   |                      |          |                |  |
| Residential                           | 147                               | 56                                | 461                                       | 664                  | 6,222    | 6,886          | 225  |
| Total                                 | \$395                             | \$224                             | \$ 658                                    | \$1,277              | \$27,865 | \$29,142       | \$ 225   |

The Bank uses an eight tier risk rating system to grade its commercial loans. The grade of a loan may change during the life of the loan. The risk ratings are described as follows:

**Risk Grade 1 (Excellent):**

Demonstrates exceptional credit fundamentals, including stable and predictable profit margins and cash flows, strong liquidity, and a conservative balance sheet.

Significant cash flow coverage of existing and pro forma debt service.

Industry leader with a diversified product mix and broad geographical market distribution.

Obligations secured by cash (“on us” deposits) and U.S. Government securities within policy advance rates.

**Risk Grade 2 (Superior):**

The difference between this rating and Class 1 is generally in degree and size. Credit quality is slightly less dominant, with less predictability in earnings and cash flow.

Customer may be one of the stronger and larger privately held companies. Balance sheet is conservative with excellent liquidity.

Obligations secured by liquid financial instruments within policy advance rates.

**Risk Grade 3 (Satisfactory):**

Obligor may also be a privately held, middle market company with a strong balance sheet, consistent earnings, and worthy of unsecured credit.

Leverage, liquidity and coverage average to slightly better than average within industry. Balance sheet may contain some intangibles.

History of profitable operations, but conditions exist that would suggest obligor's earnings could temporarily decline due to market or economic conditions.

Cash flow is adequate and profit margins are slightly above average within the industry.

Obligor's product mix may lack diversity or geographic distribution, but is usually not confined to a single product or service.

Bank borrowings will tend not to be constant; obligor's debt instruments would be attractive to other lenders. Most likely would have access to alternative sources of funding (public or private).

**Risk Grade 4 (Acceptable):**

Subject to normal degree of risk.

Cash flow is adequate to service debt, but is susceptible to some deterioration due to cyclical, seasonal or economic fluctuations.

Balance sheet contains some leverage; liquidity could be temporarily tight. There could be some asset concentration.

Access to financial markets could be limited or expensive.

Management is experienced but may be concentrated in a few "key" people.

Some unfavorable characteristics may exist:

- Reliance on single product or major customer concentration
- Volatility of earnings or earnings weakness due to competition
- Leverage is increasing, but is still within normal industry parameters
- Management is capable but would be tested in an adverse business environment
- High leverage offset by stable or predictable cash flow

Borrowings would usually be on a secured basis, with some inventory reliance and fairly steady outstandings. Borrowing base may be fully utilized from time to time.

**4.5 - Acceptable Risk Monitored:**

This rating category is a subset of a Risk Grade 4-Acceptable and serves primarily as an early warning indicator to management to avoid surprises to Special Mention or worse credits. The loans in this category may have several characteristics of a Risk Grade 4 loan, but have negative results and trending that warrant monitoring.

More unpredictability in earnings and cash flow. Obligor may have experienced modest and presumably temporary losses; resulting in a temporary negative cash flow.

Current financial statements have not been provided by the borrower.

Leverage ratios and liquidity are below normal industry standards, but may be deliberate financial restructuring, testing the limits of acceptable capitalization.

Secondary source of repayment may be limited.

Grade 4.5 risk rated credits are acceptable, but if the weakness is not checked or corrected the asset may further weaken or inadequately protect the Bank's credit exposure at some future date.

**Risk Grade 5 (Special Mention):**

A Special Mention asset is not considered criticized for regulatory purposes. A Special Mention obligor may exhibit a potential weakness that may result in the deterioration of the repayment prospects for the credit or in the Bank's credit position in the future; however, there must also be a well-defined plan of corrective action that is believed to be credible.

The obligor will generally have exhibited a sudden but modest and temporary deterioration, often related to a specific event.

Protracted gradual deterioration that appears to represent a trend or sudden deterioration of a more significant magnitude would warrant a more severe risk rating.

The action plan may include certain kinds of bridging events (for example, a capital injection) that could resolve the issue.

Special Mention asset may also have a single event of uncertainty associated with it, which should generally be resolved within 120 days (for example, management succession, litigation or turnaround acquisition).

**Risk Grade 6 (Substandard):**

A Substandard asset has well defined weakness(es) where a payment default is possible and a loss is possible, but not yet probable. Assets so classified are inadequately protected by current net worth and repayment capacity or there is a likelihood that collateral will have to be liquidated to repay the debt.

Cash flow from operations may be insufficient to meet principal reductions as expected, with the prospect that this condition may not be temporary.

Restructure not in the ordinary course of business has occurred or is anticipated.

A payment default is possible (at least 20% probability but less than 50%) and there is a dependence upon favorable business, financial, and economic conditions to meet timely payment of interest and repayment of principal.

If deficiencies are not corrected, there is a possibility of loss (less than 25% probability) and a question regarding the company's ability to operate as a going concern.

Generally, the asset/loan is considered collectible as to both principal and interest, primarily because of collateral coverage or enterprise value. Loss of principal is not at question, unless current trends were to continue.

**Risk Grade 7 (Doubtful):**

A Doubtful asset/loan has characteristics of Substandard, but available information suggests it is unlikely that the asset/loan will be repaid in its entirety. A loan/asset with a grade 7 is reported in the Bank's financial records on a non-accrual basis. The entire asset/loan should be rated Doubtful when any portion is considered Doubtful.

**Risk Grade 8 (Loss):**

Assets/loans or portions of assets/loans classified as Loss are determined to be uncollectible and are of such little value that their continuing classification as bankable is unwarranted. Accordingly, that portion of an asset/loan with a 75% or greater probability of being uncollectible should be classified Loss and promptly charged off. The remaining portion of the asset/loan may be classified Doubtful, depending on the circumstances. This does not suggest, however, that there is no possibility of a recovery of a portion or all of the charged-off asset/loan at some future time.

The following table presents the risk category of loans by class of loans based on the most recent analysis performed as of September 30, 2015 and December 31, 2014:

As of September 30, 2015

Originated

Loans:

| Loan Grade | Commercial Real Estate | Construction | Commercial Real Estate Other | Commercial |
|------------|------------------------|--------------|------------------------------|------------|
| 1-2        | \$—                    |              | \$658                        | \$ 342     |
| 3          | —                      |              | 12,364                       | 10,852     |
| 4          | 237                    |              | 21,701                       | 7,336      |
| 4.5        | 20                     |              | 3,268                        | 357        |
| 5          | —                      |              | 2,595                        | 224        |
| 6          | —                      |              | 4,631                        | 1,816      |
| 7          | —                      |              | —                            | —          |
| 8          | —                      |              | —                            | —          |
| Total      | \$257                  |              | \$45,217                     | \$ 20,927  |

Acquired

Loans:

| Loan Grade | Commercial Real Estate | Construction | Commercial Real Estate Other | Commercial |
|------------|------------------------|--------------|------------------------------|------------|
| 1-2        | \$—                    |              | \$236                        | \$ 690     |
| 3          | —                      |              | 2,128                        | 392        |
| 4          | —                      |              | 9,598                        | 545        |
| 4.5        | —                      |              | 461                          | 7          |
| 5          | —                      |              | 694                          | 375        |
| 6          | —                      |              | 761                          | 451        |
| 7          | —                      |              | 0                            | 0          |
| 8          | —                      |              | 0                            | 0          |
| Total      | \$—                    |              | \$13,878                     | \$ 2,460   |

As of December 31, 2014

Originated

Loans:

| Loan Grade | Commercial Real Estate Construction | Commercial Real Estate Other | Commercial |
|------------|-------------------------------------|------------------------------|------------|
| 1-2        | \$—                                 | \$—                          | \$ 31      |
| 3          | —                                   | 13,565                       | 6,088      |
| 4          | 1,443                               | 21,757                       | 7,538      |
| 4.5        | —                                   | 3,553                        | 252        |
| 5          | —                                   | 6,040                        | 635        |
| 6          | —                                   | 1,393                        | —          |
| 7          | —                                   | —                            | —          |
| 8          | —                                   | —                            | —          |
| Total      | \$1,443                             | \$46,308                     | \$ 14,544  |

Acquired

Loans:

| Loan Grade | Commercial Real Estate Construction | Commercial Real Estate Other | Commercial |
|------------|-------------------------------------|------------------------------|------------|
| 1-2        | \$—                                 | \$280                        | \$ 1,188   |
| 3          | —                                   | 2,696                        | 876        |
| 4          | —                                   | 10,905                       | 970        |
| 4.5        | —                                   | 337                          | 21         |
| 5          | —                                   | 1,176                        | 1,150      |
| 6          | —                                   | 547                          | 156        |
| 7          | —                                   | 9                            | 0          |
| 8          | —                                   | —                            | 0          |
| Total      | \$—                                 | \$15,950                     | \$ 4,361   |

For residential real estate and other consumer credit the Company also evaluates credit quality based on the aging status of the loan and by payment activity. Loans 60 or more days past due are monitored by the collection committee.

The following tables present the risk category of loans by class based on the most recent analysis performed as of September 30, 2015 and December 31, 2014:

As of September 30, 2015

|             |               |          |
|-------------|---------------|----------|
|             | Consumer      | Consumer |
| Residential | - Real Estate | - Other  |

Originated Loans:

Loan Grade:

|                 |           |          |          |
|-----------------|-----------|----------|----------|
| Pass            | \$ 70,350 | \$ 7,462 | \$ 1,432 |
| Special Mention | —         | —        | —        |
| Substandard     | 541       | 28       | 4        |
| Total           | \$ 70,891 | \$ 7,490 | \$ 1,436 |

Consumer

|             |               |                  |
|-------------|---------------|------------------|
| Residential | - Real Estate | Consumer - Other |
|-------------|---------------|------------------|

Acquired Loans:

Loan Grade:

|                 |          |          |        |
|-----------------|----------|----------|--------|
| Pass            | \$ 5,294 | \$ 1,565 | \$ 120 |
| Special Mention | —        | —        | —      |
| Substandard     | 273      | 9        | —      |
| Total           | \$ 5,567 | \$ 1,574 | \$ 120 |

As of December 31, 2014

Consumer

|             |               |                  |
|-------------|---------------|------------------|
| Residential | - Real Estate | Consumer - Other |
|-------------|---------------|------------------|

Originated Loans:

Loan Grade:

|                 |           |          |          |
|-----------------|-----------|----------|----------|
| Pass            | \$ 64,397 | \$ 7,778 | \$ 1,155 |
| Special Mention | —         | —        | —        |
| Substandard     | 545       | 24       | 3        |
| Total           | \$ 64,942 | \$ 7,802 | \$ 1,158 |

Consumer

|             |               |                  |
|-------------|---------------|------------------|
| Residential | - Real Estate | Consumer - Other |
|-------------|---------------|------------------|

Acquired Loans:

Loan Grade:

|                 |          |          |        |
|-----------------|----------|----------|--------|
| Pass            | \$ 6,335 | \$ 1,731 | \$ 213 |
| Special Mention | —        | —        | —      |
| Substandard     | 551      | 1        | —      |
| Total           | \$ 6,886 | \$ 1,732 | \$ 213 |



The following table presents the recorded investment in non-accrual loans by class as of September 30, 2015 and December 31, 2014:

|                                       | As of                    |                      |
|---------------------------------------|--------------------------|----------------------|
|                                       | September<br>30,<br>2015 | December<br>31, 2014 |
|                                       | (in thousands)           |                      |
| Commercial Real Estate:               |                          |                      |
| Commercial Real Estate - construction | \$ —                     | \$ —                 |
| Commercial Real Estate - other        | 370                      | 486                  |
| Commercial                            | 151                      | 77                   |
| Consumer:                             |                          |                      |
| Consumer - real estate                | 35                       | 25                   |
| Consumer - other                      | 4                        | —                    |
| Residential:                          |                          |                      |
| Residential                           | 681                      | 750                  |
| Total                                 | \$ 1,241                 | \$ 1,338             |

Acquired impaired loans are not subject to individual evaluation for impairment and are not reported as non-performing loans based on acquired impaired loan accounting. Acquired non-impaired loans are placed on non-accrual status and reported as past due or non-performing using the same criteria that is applied to the originated loan portfolio.

The key features of the Company's loan modifications are determined on a loan-by-loan basis. Generally, our restructurings have related to interest rate reductions and loan term extensions. In the past the Company has granted reductions in interest rates, payment extensions and short-term payment forbearances as a means to maximize collectability of troubled credits. The Company has not forgiven principal to date, although this would be considered if necessary to ensure the long-term collectability of the loan. The Company's loan modifications are typically short-term in nature, although the Company would consider a long-term modification to ensure the long-term collectability of the credit. At a minimum, a borrower must make at least six consecutive timely payments before the Company would consider a return of a restructured loan to accruing status in accordance with Federal Deposit Insurance Corporation guidelines regarding restoration of credits to accrual status.

The Bank has classified approximately \$3.1 million of its impaired loans as troubled debt restructurings ("TDRs") as of September 30, 2015. There were no commitments to extend credit to borrowers with loans classified as TDRs as of September 30, 2015 and December 31, 2014.

TDR loans are classified as being in default on a case by case basis when they fail to be in compliance with the modified terms. For the three and nine months ended September 30, 2015 and 2014 the Company did not have any new TDRs or TDRs that subsequently defaulted.

For the majority of the Bank's impaired loans, the Bank will apply the market value of collateral methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine observable market price, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated evaluations are received, the Bank may discount the collateral value used.

The Bank uses the following guidelines, as stated in policy, to determine when to realize a charge-off, whether a partial or full loan balance. A charge down in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquency, secured consumer loans are charged down to the value of collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial credits are charged down at 90 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-offs may be realized as further unsecured positions are recognized.

The following tables present loans individually evaluated for impairment by class of loans as of September 30, 2015 and December 31, 2014:

| Impaired Loans<br>As of September 30, 2015 | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | For the Three<br>Months Ended<br>September 30,<br>2015 |  | For the Nine<br>Months Ended<br>September 30,<br>2015 |  |
|--|--------------------------------|------------------------|----------------------|--|--|---|--|
|  | (dollars in thousands)         |                        |                      | Average Interest<br>Recorded<br>Investment             | Average Interest<br>Income<br>Recognized | Average Interest<br>Recorded<br>Investment            | Average Interest<br>Income<br>Recognized |
| With no specific allowance recorded:       |                                |                        |                      |  |  |   |  |
| Commercial Real Estate - Construction      | \$—                            | \$ —                   | \$ —                 | \$—  | \$ —                                     | \$—   | \$ —                                     |
| Commercial Real Estate - Other             | 728                            | 728                    | —                    | 756  | 11                                       | 796   | 36                                       |
| Commercial - Other                         | —                              | —                      | —                    | —  | —  | —   | —  |
| Consumer - Real Estate                     | 14                             | 12                     | —                    | 12   | —  | 12  | —  |
| Consumer - Other                           | 6                              | 4                      | —                    | 5  | —  | 4   | —  |
| Residential                                | 526                            | 435                    | —                    | 442  | 5  | 449   | 10                                       |
| With a specific allowance recorded:        |                                |                        |                      |  |  |   |  |
| Commercial Real Estate - Construction      | —                              | —                      | —                    | —  | —  | —   | —  |
| Commercial Real Estate - Other             | 935                            | 935                    | 11                   | 940  | 12                                       | 949   | 36                                       |
| Commercial - Other                         | —                              | —                      | —                    | —  | —  | —   | —  |
| Consumer - Real Estate                     | 18                             | 16                     | 16                   | 17   | —  | 17  | —  |
| Consumer - Other                           | —                              | —                      | —                    | —  | —  | —   | —  |
| Residential                                | 185                            | 176                    | 38                   | 178  | —  | 178   | 1  |
| Totals:                                    |                                |                        |                      |  |  |   |  |
| Commercial Real Estate - Construction      | \$—                            | \$ —                   | \$ —                 | \$—  | \$ —                                     | \$—   | \$ —                                     |
| Commercial Real Estate - Other             | \$1,663                        | \$ 1,663               | \$ 11                | \$1,696  | \$ 23                                    | \$1,745   | \$ 72                                    |
| Commercial - Other                         | \$—                            | \$ —                   | \$ —                 | \$—  | \$ —                                     | \$—   | \$ —                                     |
| Consumer - Real Estate                     | \$32                           | \$ 28                  | \$ 16                | \$29   | \$ —                                     | \$29  | \$ —                                     |
| Consumer - Other                           | \$6                            | \$ 4                   | \$ —                 | \$5  | \$ —                                     | \$4   | \$ —                                     |
| Residential                                | \$711                          | \$ 611                 | \$ 38                | \$620  | \$ 5                                     | \$627   | \$ 11                                    |

| Impaired Loans<br>As of December 31, 2014 | Unpaid<br>Principal<br>Balance<br>(dollars in thousands) | Recorded<br>Investment | Related<br>Allowance | For the Three  | For the Nine   |
|---|--|------------------------|----------------------|--|--|
|   |  |                        |                      | Months Ended   | Months Ended   |
|   |  |                        |                      | September 30,  | September 30,  |
|   |  |                        |                      | 2014   | 2014   |
|   |  |                        |                      | Average Interest<br>Recorded Income<br>Investment Recognized | Average Interest<br>Recorded Income<br>Investment Recognized |

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|                                       |         |          |       |         |       |          |       |
|---------------------------------------|---------|----------|-------|---------|-------|----------|-------|
| Commercial Real Estate - Construction | \$—     | \$ —     | \$ —  | \$—     | \$ —  | \$ —     | \$ —  |
| Commercial Real Estate - Other        | —       | —        | —     | —       | —     | —        | —     |
| Commercial - Other                    | 1,431   | 1,430    | —     | 1,444   | 21    | 1,499    | 63    |
| Consumer - Real Estate                | 26      | 24       | —     | —       | —     | —        | —     |
| Consumer - Other                      | —       | —        | —     | 27      | —     | 27       | —     |
| Residential                           | 781     | 618      | —     | —       | —     | —        | —     |
|                                       |         |          |       | 528     | 1     | 534      | 4     |
| With a specific allowance recorded:   |         |          |       |         |       |          |       |
| Commercial Real Estate - Construction | —       | —        | —     | 173     | —     | 173      | —     |
| Commercial Real Estate - Other        | —       | —        | —     | 392     | 5     | 396      | 13    |
| Commercial - Other                    | 386     | 386      | 10    | —       | —     | —        | —     |
| Consumer - Real Estate                | —       | —        | —     | —       | —     | —        | —     |
| Consumer - Other                      | —       | —        | —     | —       | —     | —        | —     |
| Residential                           | —       | —        | —     | 179     | —     | 179      | 1     |
| Totals:                               |         |          |       |         |       |          |       |
| Commercial Real Estate - Construction | \$—     | \$ —     | \$ —  | \$173   | \$ —  | \$ 173   | \$ —  |
| Commercial Real Estate - Other        | \$—     | \$ —     | \$ —  | \$1,836 | \$ 26 | \$ 1,895 | \$ 76 |
| Commercial - Other                    | \$1,817 | \$ 1,816 | \$ 10 | \$—     | \$ —  | \$ —     | \$ —  |
| Consumer - Real Estate                | \$26    | \$ 24    | \$ —  | \$27    | \$ —  | \$ 27    | \$ —  |
| Consumer - Other                      | \$—     | \$ —     | \$ —  | \$—     | \$ —  | \$ —     | \$ —  |
| Residential                           | \$781   | \$ 618   | \$ —  | \$707   | \$ 1  | \$ 713   | \$ 5  |

Acquired loans are not subject to individual evaluation for impairment and are not reported as impaired loans based on acquired impaired loan accounting. Acquired non-impaired loans are placed on nonaccrual status and reported as impaired using the same criteria applied to the originated loan portfolio. In accordance with purchase accounting rules, acquired loans were recorded at fair value at the acquisition date and the prior allowance was eliminated. No allowance for loan loss has been established on these acquired loans through September 30, 2015.

The ALLL has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense.

Activity in the allowance for loan and lease losses was as follows for the three and nine months ended September 30, 2015 and September 30, 2014, respectively:

# Allowance for Credit Losses

For the Three Months Ended September 30, 2015

|                              | Commercial Construction | Commercial Real Estate | Commercial Real Estate | Consumer Real Estate | Consumer Residential | Unallocated | Total |         |
|------------------------------|-------------------------|------------------------|------------------------|----------------------|----------------------|-------------|-------|---------|
|                              | (dollars in thousands)  |                        |                        |                      |                      |             |       |         |
| Allowance for credit losses: |                         |                        |                        |                      |                      |             |       |         |
| Beginning Balance            | \$—                     | \$ 492                 | \$ 140                 | \$ 42                | \$ 18                | \$ 721      | \$ 75 | \$1,488 |
| Charge-offs                  | —                       | —                      | —                      | (7 )                 | (3 )                 | (5 )        | —     | (15 )   |
| Recoveries                   | 1                       | 9                      | —                      | 8                    | 15                   | 13          | —     | 46      |
| Provision                    | —                       | (1 )                   | 55                     | (7 )                 | (15 )                | (52 )       | 15    | (5 )    |
| Ending Balance               | \$1                     | \$ 500                 | \$ 195                 | \$ 36                | \$ 15                | \$ 677      | \$ 90 | \$1,514 |

For the Nine Months Ended September 30, 2015

|                              | Commercial Construction | Commercial Real Estate | Commercial | Consumer Real Estate | Consumer | Residential | Unallocated | Total   |
|------------------------------|-------------------------|------------------------|------------|----------------------|----------|-------------|-------------|---------|
|                              | (dollars in thousands)  |                        |            |                      |          |             |             |         |
| Allowance for credit losses: |                         |                        |            |                      |          |             |             |         |
| Beginning Balance            | \$ 8                    | \$ 307                 | \$ 94      | \$ 33                | \$ 19    | \$ 869      | \$ 99       | \$1,429 |
| Charge-offs                  | —                       | (3 )                   | —          | (11 )                | (15 )    | (42 )       | —           | (71 )   |
| Recoveries                   | 13                      | 74                     | 5          | 28                   | 16       | 46          | —           | 182     |
| Provision                    | (20)                    | 122                    | 96         | (14 )                | (5 )     | (196 )      | (9 )        | (26 )   |
| Ending Balance               | \$1                     | \$ 500                 | \$ 195     | \$ 36                | \$ 15    | \$ 677      | \$ 90       | \$1,514 |

Loan Balances Evaluated for Impairment  
As of September 30, 2015

|  | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real Estate | Consumer | Residential | Unallocated | Total      |
|--|----------------------------|---------------------------|------------|-------------------------|----------|-------------|-------------|------------|
|  | (dollars in thousands)     |                           |            |                         |          |             |             |            |
| Allowance for loan losses as of September 30, 2015                               |                            |                           |            |                         |          |             |             |            |
| Ending balance: individually evaluated for impairment                            | \$ —                       | \$ 11                     | \$ —       | \$ 16                   | \$ —     | \$ 38       | \$ —        | \$ 65      |
| Ending balance: loans collectively evaluated for impairment                      | \$ 1                       | \$ 489                    | \$ 195     | \$ 20                   | \$ 15    | \$ 639      | \$ 90       | \$ 1,449   |
| Loans as of September 30, 2015   |                            |                           |            |                         |          |             |             |            |
| Loans:   |                            |                           |            |                         |          |             |             |            |
| Ending Balance   | \$ 257                     | \$ 59,096                 | \$ 23,387  | \$ 9,063                | \$ 1,557 | \$ 76,458   | \$ —        | \$ 169,818 |
| Ending balance: individually evaluated for impairment                            | \$ —                       | \$ 1,663                  | \$ —       | \$ 28                   |          | \$ 611      | \$ —        | \$ 2,302   |
| Ending balance: loans collectively evaluated for impairment                      | \$ 257                     | \$ 43,554                 | \$ 20,927  | \$ 7,462                | \$ 1,436 | \$ 70,280   | \$ —        | \$ 143,916 |
| Acquired loans with deteriorated credit quality not subject to loan loss reserve | \$ —                       | \$ 1,892                  | \$ 810     | \$ 11                   | \$ —     | \$ 401      | \$ —        | \$ 3,114   |
| Other acquired loans not subject to loan loss reserve                            | \$ —                       | \$ 11,987                 | \$ 1,650   | \$ 1,563                | \$ 120   | \$ 5,166    | \$ —        | \$ 20,486  |

Allowance for Credit Losses  
For the Three Months Ended September 30, 2014

|                              | Commercial Construction | Commercial Real Estate | Commercial | Consumer Real Estate | Consumer | Residential | Unallocated | Total   |
|------------------------------|-------------------------|------------------------|------------|----------------------|----------|-------------|-------------|---------|
|                              | (dollars in thousands)  |                        |            |                      |          |             |             |         |
| Allowance for credit losses: |                         |                        |            |                      |          |             |             |         |
| Beginning Balance            | \$48                    | \$ 426                 | \$ 72      | \$ 38                | \$ 16    | \$ 783      | \$ 104      | \$1,487 |
| Charge-offs                  | —                       | (225 )                 | —          | (2 )                 | (17 )    | (66 )       | —           | (310 )  |
| Recoveries                   | —                       | 14                     | 1          | 3                    | —        | 12          | —           | 30      |

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|                |      |        |       |       |      |        |        |         |
|----------------|------|--------|-------|-------|------|--------|--------|---------|
| Provision      | 2    | 18     | (14 ) | (1 )  | 6    | 211    | 35     | 257     |
| Ending Balance | \$50 | \$ 233 | \$ 59 | \$ 38 | \$ 5 | \$ 940 | \$ 139 | \$1,464 |

For the Nine Months Ended September 30, 2014

|                        | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer | Residential | Unallocated | Total |
|------------------------|----------------------------|---------------------------|------------|----------------------------|----------|-------------|-------------|-------|
| (dollars in thousands) |                            |                           |            |                            |          |             |             |       |

Allowance for credit losses:

|                   |      |        |       |       |       |        |        |         |
|-------------------|------|--------|-------|-------|-------|--------|--------|---------|
| Beginning Balance | \$48 | \$ 444 | \$ 63 | \$ 62 | \$ 21 | \$ 784 | \$ 50  | \$1,472 |
| Charge-offs       | —    | (241 ) | —     | (15 ) | (23 ) | (111 ) | —      | (390 )  |
| Recoveries        | —    | 45     | 1     | 26    | —     | 37     | —      | 109     |
| Provision         | 2    | (15 )  | (5 )  | (35 ) | 7     | 230    | 89     | 273     |
| Ending Balance    | \$50 | \$ 233 | \$ 59 | \$ 38 | \$ 5  | \$ 940 | \$ 139 | \$1,464 |

Loan Balances Individually Evaluated for Impairment  
As of September 30, 2014

|   | Commercial<br>Construction<br>Estate |           | Commercial | Consumer<br>Real Estate |          | Consumer  | Residential | Unallocated | Total |
|---|--------------------------------------|-----------|------------|-------------------------|----------|-----------|-------------|-------------|-------|
|   | (dollars in thousands)               |           |            |                         |          |           |             |             |       |
| Allowance for loan losses as of September 30, 2014          |                                      |           |            |                         |          |           |             |             |       |
| Ending balance: individually evaluated for impairment       | \$48                                 | \$ 11     | \$ —       | \$ —                    | \$ —     | \$ 39     | \$ —        | \$98        |       |
| Ending balance: loans collectively evaluated for impairment | \$2                                  | \$ 222    | \$ 59      | \$ 38                   | \$ 5     | \$ 901    | \$ 139      | \$1,366     |       |
| Loans as of September 30, 2014                              |                                      |           |            |                         |          |           |             |             |       |
| Loans:  |                                      |           |            |                         |          |           |             |             |       |
| Ending Balance  | \$634                                | \$ 45,697 | \$ 12,578  | \$ 7,905                | \$ 1,098 | \$ 65,526 | \$ —        | \$133,438   |       |
| Ending balance: individually evaluated for impairment       | \$173                                | \$ 1,620  | \$ 202     | \$ 39                   | \$ —     | \$ 1,370  | \$ —        | \$3,404     |       |
| Ending balance: loans collectively evaluated for impairment | \$461                                | \$ 44,077 | \$ 12,376  | \$ 7,866                | \$ 1,098 | \$ 64,156 | \$ —        | \$130,034   |       |

**Note 6—DIVIDENDS**

We are dependent primarily upon the Bank for our earnings and funds to pay dividends on common stock. The payment of dividends also is subject to legal and regulatory restrictions. Any payment of dividends in the future will depend, in large part, on the Bank's earnings, capital requirements, financial condition and other factors considered by the Board of Directors.

**Note 7—STOCK-BASED COMPENSATION**

Effective January 1, 2006, the Company adopted FASB ASC 718-10, "Shareholder Based Payments", which requires that the grant-date fair value of awarded stock options be expensed over the requisite service period. The Company's 1996 Stock Option Plan (the "1996 Plan"), which was approved by shareholders, permits the grant of options to purchase shares of common stock to its employees and directors for up to 127,491 shares of common stock (retroactively adjusted for the exchange ratio applied in the Company's 2005 stock offering and related second-step conversion). The Company's 2006 Stock-Based Incentive Plan (the "2006 Plan"), which was approved by shareholders, permits the award of up to 242,740 shares of common stock of which the maximum number to be granted as stock



options is 173,386 and the maximum to be granted as restricted stock awards is 69,354. Option awards are granted with an exercise price equal to the market price of the Company's stock at the date of grant. These option awards generally vest based on five years of continual service and have ten-year contractual terms. Certain options provide for accelerated vesting if there is a change in control (as defined in the Plans).

During the nine months ended September 30, 2015 the Company awarded no shares under either the 2006 Plan or the 1996 Plan. Shares issued under the plans and exercised pursuant to the exercise of stock options may be either authorized but unissued shares or reacquired shares held by the Company as treasury stock.

**Stock Options** - A summary of option activity under the Plan during the nine months ended September 30, 2015 is presented below:

| Options                                   | Shares    | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual Term<br>(Years) | Aggregate<br>Intrinsic<br>Value |
|---|-----------|------------------------------------|--|---------------------------------|
| Outstanding at January 1, 2015            | 136,030   | \$ 9.54                            | 1.4  | \$ —                            |
| Granted                                   | —         | N/A                                |  |                                 |
| Exercised                                 | —         | N/A                                |  |                                 |
| Forfeited or expired                      | (14,400 ) | \$ 9.35                            |  |                                 |
| Outstanding at September 30, 2015         | 121,630   | \$ 9.57                            | 0.6  | \$ —                            |
| Options Exercisable at September 30, 2015 | 121,630   | \$ 9.57                            | 0.6  | \$ —                            |

The aggregate intrinsic value of outstanding options shown in the table above represents the total pretax intrinsic value (i.e. the difference between the Company's closing stock price of \$6.29 on September 30, 2015 and the exercise price times the number of shares) that would have been received by the option holder had all option holders exercised their options on September 30, 2015. This amount changes based on the fair market value of the stock.

As of September 30, 2015 the Company had no unrecognized compensation cost related to nonvested options under the Plan. There were no shares which vested during the quarter ended September 30, 2015. In addition, there were no non-vested options as of September 30, 2015.

**Restricted Stock Awards** – As of September 30, 2015 all restricted stock awards have vested, therefore the Company had no unrecognized compensation costs under the 2006 Plan. There were 5,304 shares available for future stock award grants as of September 30, 2015.

**Note 8—COMMITMENTS TO EXTEND CREDIT**

The Company is a party to credit-related 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, standby letters of credit, and commercial lines of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheet. The Company's exposure to credit loss is represented by the contracted amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At September 30, 2015, the Company had outstanding commitments to originate loans of \$23.5 million. These commitments include the following:

|  | As of<br>September<br>30, 2015<br>(in<br>thousands) |
|--|---|
| Commitments to grant loans                 | \$ 6,373  |
| Unfunded commitments under lines of credit | 16,939  |
| Commercial and standby letters of credit   | 130   |

## Note 9—FAIR VALUE MEASUREMENTS

The fair value of financial assets and liabilities recorded at fair value is categorized in three levels. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. These levels are as follows:

Level 1 — Valuations based on quoted prices in active markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 — Valuations of assets and liabilities traded in less active dealer or broker markets. Valuations include quoted prices for similar assets and liabilities traded in the same market; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable. Valuations may be obtained from, or corroborated by, third-party pricing services.

Level 3 — Assets and liabilities with valuations that include methodologies and assumptions that may not be readily observable, including option pricing models, discounted cash flow models, yield curves and similar techniques. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities, but in all cases are corroborated by external data, which may include third-party pricing services.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014, and the valuation techniques used by the Company to determine those fair values.

### Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2015

|   |   |  |  |
|---|---|--|--|
| Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance at<br>September<br>30,<br>2015 |
|---|---|--|--|

(dollars in thousands)

## Assets

## Investment securities- available-for-sale:

|   |          |            |          |            |
|---|----------|------------|----------|------------|
| US Treasury securities and obligations of U.S. government corporations and agencies | \$ 1,282 | \$ 33,319  | \$ —     | \$ 34,601  |
| Municipal obligations   | —        | 26,781     | 1,838    | 28,619     |
| Corporate bonds & other obligations   | —        | —          | —        | —          |
| Mortgage-backed securities  | —        | 67,698     | —        | 67,698     |
| Equity securities   | 5        | —          | —        | 5          |
| Total investment securities - available-for-sale                                    | \$ 1,287 | \$ 127,798 | \$ 1,838 | \$ 130,923 |

**Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2014**

|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Fair Value<br>as of<br>December<br>31,<br>2014 |
|---|---|---|--|--|
| (dollars in thousands)  |   |   |  |  |
| Assets  |   |   |  |  |
| Investment securities - available-for-sale:   |   |   |  |  |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 1,279  | \$ 29,943   | \$ —   | \$ 31,222                                      |
| Municipal obligations   | —   | 20,872  | 2,262  | 23,134   |
| Corporate bonds & other obligations   | —   | 1,561   | —  | 1,561  |
| Mortgage-backed securities  | —   | 64,046  | —  | 64,046   |
| Equity securities   | 5   | —   | —  | 5  |
| Total investment securities - available-for-sale                                      | \$ 1,284  | \$ 116,422  | \$ 2,262   | \$ 119,968                                     |

Fair value measurements of U.S. Government agencies and mortgage backed securities use pricing models that vary and may consider various assumptions, including time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures.

There were no transfers between Levels 1 and 2 of the fair value hierarchy from December 31, 2014 to September 30, 2015. For the available for sale securities, the Company obtains fair value measurements from an independent third-party service.



The following table presents the changes in Level 3 assets measured at fair value on a recurring basis.

|                              | Three Months<br>Ended<br>September 30,<br>2015<br>Available-for-Sale<br>Securities | Nine Months<br>Ended<br>September 30,<br>2015<br>Available-for-Sale<br>Securities |
|------------------------------|--|---|
| Balance, beginning of period | \$ 1,984   | \$ 2,292  |
| Purchases                    | —  | —   |
| Sales or maturities          | (117 )   | (275 )  |
| Unrealized gain (loss)       | (29 )  | (179 )  |
| Balance, end of period       | \$ 1,838   | \$ 1,838  |
|                              | Three Months<br>Ended<br>September 30,<br>2014<br>Available-for-Sale<br>Securities | Nine Months<br>Ended<br>September 30,<br>2014<br>Available-for-Sale<br>Securities |
| Balance, beginning of period | \$ 1,905   | \$ 1,941  |
| Purchases                    | 360  | 360   |
| Sales or maturities          | (122 )   | (100 )  |
| Unrealized gain (loss)       | 119  | 61  |
| Balance, end of period       | \$ 2,262   | \$ 2,262  |

The Company has assets that, under certain conditions, are subject to measurement at fair value on a nonrecurring basis. At September 30, 2015 and December 31, 2014, such assets consist primarily of impaired loans and other real estate owned. The Company has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

#### Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2015

| Balance at September 30, | Quoted Prices in Active Markets | Significant Other Observable Inputs | Significant Unobservable Inputs (Level 3) |
|--------------------------|---------------------------------|-------------------------------------|---|
|--------------------------|---------------------------------|-------------------------------------|---|

|   | 2015                   | for       | (Level 2) |          |
|---|------------------------|-----------|-----------|----------|
|   |                        | Identical |           |          |
|   |                        | Assets    |           |          |
|   |                        | (Level 1) |           |          |
|   | (dollars in thousands) |           |           |          |
| Originated Assets:                                  |                        |           |           |          |
| Impaired loans accounted for under FASB ASC 310-10  | \$ 1,663               | \$ —      | \$ —      | \$ 1,663 |
| Other real estate owned -residential mortgages      | 527                    | —         | —         | 527      |
| Other Real estate owned - commercial                | 1,721                  | —         | —         | 1,721    |
| Other repossessed assets                            | 774                    | —         | —         | 774      |
| Total assets at fair value on a non-recurring basis |                        |           |           | \$ 4,685 |
| Acquired Assets:                                    |                        |           |           |          |
| Impaired loans accounted for under FASB ASC 310-10  | \$ 540                 | \$ —      | \$ —      | \$ 540   |
| Other real estate owned -residential mortgages      | —                      | —         | —         | —        |
| Other real estate owned - commercial                | —                      | —         | —         | —        |
| Other repossessed assets                            | —                      | —         | —         | —        |
| Total assets at fair value on a non-recurring basis |                        |           |           | \$ 540   |



**Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2014**

|   | Balance<br>at<br>December<br>31,<br>2014 | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|--|---|---|--|
| (dollars in thousands)                              |  |   |   |  |
| <b>Originated Assets:</b>                           |  |   |   |  |
| Impaired loans accounted for under FASB ASC 310-10  | \$1,806                                  | \$ —  | \$ —  | \$ 1,806   |
| Other real estate owned -residential mortgages      | 336                                      | —   | —   | 336  |
| Other real estate owned - commercial                | 1,628                                    | —   | —   | 1,628  |
| Other repossessed assets                            | 860                                      | —   | —   | 860  |
| Total assets at fair value on a non-recurring basis |  |   |   | \$ 4,630   |
| <b>Acquired Assets:</b>                             |  |   |   |  |
| Impaired loans accounted for under FASB ASC 310-10  | \$396                                    | \$ —  | \$ —  | \$ 396   |
| Other real estate owned -residential mortgages      | —  | —   | —   | —  |
| Other real estate owned - commercial                | —  | —   | —   | —  |
| Other repossessed assets                            | —  | —   | —   | —  |
| Total assets at fair value on a non-recurring basis |  |   |   | \$ 396   |

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

**Cash and Cash Equivalents** - The carrying amounts of cash and short-term instruments approximate fair values.

**Deposits Held in Other Financial Institutions** - Fair value for the Bank's deposits held in other financial institutions was determined using the market value in active markets, where available. When not available, fair values are estimated using the fair value hierarchy. In the fair value hierarchy, Level 2 fair values are determined using observable inputs other than Level 1 market prices, such as quoted prices for similar assets. Level 3 values are

determined using unobservable inputs, such as discounted cash flow projections.

**Investment Securities** - Fair value for the Bank's investment securities was determined using the market value in active markets, where available. When not available, fair values are estimated using the fair value hierarchy. In the fair value hierarchy, Level 2 fair values are determined using observable inputs other than Level 1 market prices, such as quoted prices for similar assets. Level 3 values are determined using unobservable inputs, such as discounted cash flow projections.

**Loans Receivable** - For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (e.g., one- to four-family residential), credit card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans, commercial, and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

**Loans Held For Sale** - Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.

**Federal Home Loan Bank Stock** - The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

**Deposit Liabilities** - The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

**Federal Home Loan Bank Advances** - The estimated fair value of the fixed and variable rate Federal Home Loan Bank advances are estimated by discounting the related cash flows using the rates currently available for similarly structured borrowings with similar maturities.

**Accrued Interest** - The carrying amounts of accrued interest approximate fair value.

The estimated fair values, related carrying or notional amounts, and level of the Company's financial instruments are as follows:

| September 30, 2015                            | Carrying Value | Level 1  | Level 2 | Level 3 | Total Estimated Fair Value |
|---|----------------|----------|---------|---------|----------------------------|
|   | (in thousands) |          |         |         |                            |
| Financial assets:                             |                |          |         |         |                            |
| Cash and cash equivalents                     | \$8,518        | \$8,518  | \$—     | \$—     | \$8,518                    |
| Deposits held at other financial institutions | 8,924          | —        | 8,924   | —       | 8,924                      |
| Securities available for sale                 | 130,923        | 1,287    | 127,798 | 1,838   | 130,923                    |
| Securities held to maturity                   | 745            | —        | 746     | —       | 746                        |
| Loans held for sale                           | 132            | —        | —       | 147     | 147                        |
| Loans receivable - net                        | 168,063        | —        | —       | 167,238 | 167,238                    |
| Federal Home Loan Bank stock                  | 1,636          | —        | 1,636   | —       | 1,636                      |
| Accrued interest receivable                   | 1,065          | —        | —       | 1,065   | 1,065                      |
| Financial liabilities:                        |                |          |         |         |                            |
| Customer deposits                             | 279,297        | —        | 279,851 | —       | 279,851                    |
| Federal Home Loan Bank advances               | 25,072         | —        | 25,036  | —       | 25,036                     |
| Accrued interest payable                      | 101            | —        | —       | 101     | 101                        |
| December 31, 2014                             | Carrying Value | Level 1  | Level 2 | Level 3 | Total Estimated Fair Value |
|   | (in thousands) |          |         |         |                            |
| Financial assets:                             |                |          |         |         |                            |
| Cash and cash equivalents                     | \$11,472       | \$11,472 | \$—     | \$—     | \$11,472                   |
| Deposits held at other financial institutions | 8,429          | —        | 8,429   | —       | 8,429                      |
| Securities available for sale                 | 119,968        | 1,284    | 116,392 | 2,292   | 119,968                    |
| Securities held to maturity                   | 790            | —        | 908     | —       | 908                        |
| Loans held for sale                           | 88             | —        | —       | 90      | 90                         |
| Loans receivable - net                        | 163,647        | —        | —       | 163,690 | 163,690                    |
| Federal Home Loan Bank stock                  | 2,591          | —        | 2,591   | —       | 2,591                      |

|                                 |         |   |         |     |         |
|---------------------------------|---------|---|---------|-----|---------|
| Accrued interest receivable     | 986     | — | —       | 986 | 986     |
| Financial liabilities:          |         |   |         |     |         |
| Customer deposits               | 270,734 | — | 271,200 | —   | 271,200 |
| Federal Home Loan Bank advances | 22,885  | — | 22,696  | —   | 22,696  |
| Accrued interest payable        | 101     | — | —       | 101 | 101     |

**Note 10—RECENT ACCOUNTING PRONOUNCEMENT**

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (ASU 2014-09), “Revenue from Contracts with Customers (Topic 606)”. ASU 2014-09 adopts a standardized approach for revenue recognition and was a joint effort with the International Accounting Standards Board (IASB). The new revenue recognition standard is based on a core principle of recognizing revenue to 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. ASU 2014-09 does not apply to financial instruments. ASU 2014-09 is effective for public entities for reporting periods beginning after December 15, 2016 (therefore, for the year ending December 31, 2017 for the Corporation). Early implementation is not allowed for public companies. Management is currently assessing the impact to the Corporation’s consolidated financial statements.

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.  
AND SUBSIDIARIES**

**PART - FINANCIAL INFORMATION**

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

The following discussion compares the consolidated financial condition of the Company at September 30, 2015 and December 31, 2014, and the results of operations for the three- and nine-month periods ended September 30, 2015 and 2014. This discussion should be read in conjunction with the interim financial statements and footnotes included herein.

When used in this Form 10-Q or future filings by First Federal of Northern Michigan Bancorp, Inc. (the "Company") with the Securities and Exchange Commission ("SEC"), in the Company's press releases or other public or stockholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases "would be," "will allow," "intends to," "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "pro" similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995.

The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made, and to advise readers that various factors, including regional and national economic conditions, changes in levels of market interest rates, credit and other risks of lending and investment activities and competitive and regulatory factors, could affect the Company's financial performance and could cause the Company's actual results for future periods to differ materially from those anticipated or projected.

The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

**OVERVIEW**

The Company operates as a community-oriented financial institution that accepts deposits from the general public in the communities surrounding its 8 full-service banking centers. The deposited funds, together with funds generated from operations and borrowings, are used by the Company to originate loans. The Company's principal lending activity is the origination of mortgage loans for the purchase or refinancing of one-to-four family residential properties. The Company also originates commercial and multi-family real estate loans, construction loans, commercial loans, automobile loans, home equity loans and lines of credit, and a variety of other consumer loans.

For the quarter ended September 30, 2015, the Company reported net income of \$1.9 million, or \$0.51 per basic and diluted share, compared to \$1.8 million, or \$0.53 per basic and diluted share, for the quarter ended September 30, 2014, an increase of \$107,000. For the nine months ended September 30, 2015 net income was \$2.6 million, or \$0.70 per basic and diluted share as compared to \$2.1 million, or \$0.69 per share, for the same period ended September 30, 2014. Net income results for the three and nine months ended September 30, 2015 and September 30, 2014 include the recovery of \$1.7 million of the valuation reserve on our deferred tax asset and the bargain purchase gain of \$2.0 million related to our merger with Alpena, respectively.

Total assets increased \$13.0 million, or 4.0%, to \$338.8 million as of September 30, 2015 from \$325.9 million as of December 31, 2014. Investment securities available-for-sale increased \$11.0 million, or 9.1%, from December 31, 2014 to September 30, 2015. Cash and cash equivalents decreased \$3.0 million and net loans receivable increased \$4.4 million during this time period. Total deposits increased \$8.6 million from December 31, 2014 to September 30, 2015, while Federal Home Loan Bank advances increased \$2.2 million and equity increased \$2.5 million.

## CRITICAL ACCOUNTING POLICIES

As of September 30, 2015, there have been no changes in the critical accounting policies as disclosed in the Company's Form 10-K for the year ended December 31, 2014. The Company's critical accounting policies are described in the Management's Discussion and Analysis and financial sections of its 2014 Annual Report. Management believes its critical accounting policies relate to the Company's allowance for loan losses, real estate owned, mortgage servicing rights, valuation of deferred tax assets and impairment of intangible assets.

## MERGER

We completed the merger with Alpena Banking Corporation and its wholly owned subsidiary Bank of Alpena ("Alpena"), as of August 8, 2014. Alpena had one branch office and assets with a fair value of \$102.6 million as of August 8, 2014. The merger was effected by the issuance of shares of the Company's common stock to Alpena Banking Corporation shareholders. Each share of Alpena's common stock was converted into the right to receive 1.549 shares of the Company's common stock, with cash paid in lieu of fractional shares. The conversion of Alpena's shares resulted in the issuance of 842,965 share of the Company's common stock.

The merger transaction was recorded using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair values on the Merger Date. The fair value measurements, based on third-party valuations, have been retrospectively reflected and the following table provides the purchase price calculation as of the Merger Date and the identifiable assets acquired and liabilities assumed at their estimated fair values.

In most instances, determining the fair value of the acquired assets and assumed liabilities required the Company to estimate the cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations related to the valuation of acquired loans. For such loans, the excess cash flows expected at merger over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at merger and the cash flows expected to be collected at merger reflects the impact of estimated credit losses and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of Alpena's previously established allowance for loan losses. The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired"), and loans that do not meet the criteria, which are accounted for under ACC 310-20 ("acquired non-impaired"). In addition, the loans are further categorized into different pools based primarily on the type and purpose of the loan.

The results of operations for the three and nine months ended September 30, 2014 include the operating results of the acquired assets and assumed liabilities for the 51 days subsequent to the Merger Date.

We recorded merger related expenses of \$140,000 and \$264,000 during the three and nine months ended September 30, 2014. These expenses were for professional services such as legal, accounting and contractual arrangements for consulting services. Alpena's entire operating system has been integrated with the Company's.

In conjunction with the Merger the Company has closed one branch location and an operations center. The operations center was sold in January of 2015 and the Company has received a market value assessment on the branch location and has classified the building as an asset held for sale as of September 30, 2015.

#### **COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2015 AND DECEMBER 31, 2014**

**Assets:** Total assets increased \$13.0 million, or 4.0%, to \$338.8 million at September 30, 2015 from \$325.9 million at December 31, 2014. During the nine-month period the following changes occurred: investment securities available for sale increased \$11.0 million, or 9.1% and net loans receivable increased \$4.4 million, or 2.7%, to \$168.1 million at September 30, 2015 from \$163.6 million at December 31, 2014. Mortgage loans increased \$4.6 million as a result of our continued effort to grow this portfolio by retaining certain high-quality adjustable rate mortgages and 10- and 15-year fixed rate residential mortgages as opposed to selling them.



**Liabilities:** Deposits increased \$8.6 million, to \$279.3 million at September 30, 2015 from \$270.7 million at December 31, 2014. During the nine months ended September 30, 2015 we experienced increases of \$172,000 in statement savings accounts and \$16.6 million in non-interest bearing demand deposit accounts. Partially offsetting these increases were decreases of \$3.9 million in NOW demand deposit accounts, \$936,000 in money market deposit accounts, \$2.3 million in our traditional certificates of deposit and \$1.1 million in our liquid certificates of deposit (from which customers can take a penalty-free withdrawal with seven days advance written notice) as, in general, we were not the market leader in rates on this product during this time period. FHLB advances increased \$2.2 million to \$25.1 million at September 30, 2015 from \$22.3 million at December 31, 2014.

**Equity:** Stockholders' equity increased \$2.5 million to \$33.1 million at September 30, 2015 from \$30.5 million at December 31, 2014. The increase in stockholders' equity was mainly attributable to net income reported for the nine month period of \$2.6 million which includes the reserve recovery of our deferred tax asset of \$1.7 million and \$179,000 in unrealized gains on available for sale securities net of tax.

## RESULTS OF OPERATIONS

### *Three Months Ended September 30, 2015 Compared to Three Months Ended September 30, 2014*

**General:** Net income increased \$107,000 to \$1.9 million for the three months ended September 30, 2015 from \$1.8 million for the same period ended September 30, 2014.

**Interest Income:** Interest income was \$2.7 million for the three months ended September 30, 2015, compared to \$2.4 million for the comparable period in 2014. The increase in interest income was due to an increase of \$45.0 million in the average balance of our interest-earning assets that resulted from the bonds purchased subsequent to the merger with Alpena during the three months ended September 30, 2014. We experienced the following quarter over quarter average balance increases: \$6.3 million in mortgage loans, \$4.5 in non-mortgage loans and \$34.2 million in available for sale securities. We experienced a decrease of \$3.0 million in cash and cash equivalents for the three months ended September 30, 2015 when compared to the same period in 2014. In spite of the increases in our loan portfolios, the average yield on our interest-earning assets declined 16 basis points to 3.37% for the three-month period ended September 30, 2015 from 3.53% for the same period in 2014. The decrease in asset yields is primarily a function of the increased level of lower yielding available-for-sale securities, as of September 30, 2015.

**Interest Expense:** Interest expense was \$317,000 for the three-month period ended September 30, 2015, compared to \$270,000 for the same period in 2014. The increase in interest expense for the three-month period was due in part to a 22 basis point increase in the cost of our Federal Home Loan Bank advances to 1.34% as of September 30, 2015 from 1.12% for same period a year ago.

The following table sets forth information regarding the changes in interest income and interest expense of the Bank during the periods indicated.

|                                    | Quarter ended<br>September 30, 2015<br>Compared to<br>Quarter ended<br>September 30, 2014<br>Increase (Decrease)<br>Due to:<br>VolumeRate Total<br>(in thousands) |        |         |
|------------------------------------|---|--------|---------|
| Interest-earning assets:           |   |        |         |
| Loans receivable                   | \$128   | \$(6 ) | \$122   |
| Investment securities              | 206   | (35)   | \$171   |
| Other investments                  | (23 )   | 3      | \$(20 ) |
| Total interest-earning assets      | 311   | (38)   | 273     |
| Interest-bearing liabilities:      |   |        |         |
| Savings Deposits                   | —   | —      | —       |
| Money Market/NOW accounts          | 17  | —      | 17      |
| Certificates of Deposit            | 5   | 7      | 12      |
| Deposits                           | 22  | 7      | 29      |
| Borrowed funds                     | 4   | 14     | 18      |
| Total interest-bearing liabilities | 26  | 21     | 47      |
| Change in net interest income      | \$285   | \$(59) | \$226   |

**Net Interest Income:** Net interest income increased \$226,000 to \$2.3 million for the three-month period ended September 30, 2015 as compared to \$2.1 million for the same period in 2014. For the three months ended September 30, 2015, average interest-earning assets increased \$45.0 million, or 16.7%, to \$314.3 million when compared to the same period in 2014. Average interest-bearing liabilities increased \$36.9 million, or 18.9%, to \$232.3 million for the quarter ended September 30, 2015 from \$195.5 million for the quarter ended September 30, 2014. The yield on average interest-earning assets decreased to 3.37% for the three month period ended September 30, 2015 from 3.53% for the same period ended in 2014. The cost of average interest-bearing liabilities decreased to 0.54% from 0.55% for the three-month periods ended September 30, 2015 and September 30, 2014, respectively. The net interest margin decreased 17 basis points to 2.97% for the three-month period ended September 30, 2015 from 3.14% for same period in 2014.

**Provision for Loan Losses:** The allowance for loan losses is established through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The provision for loan losses for the three month period ended September 30, 2015 was a recovery of \$4,000 compared to provision of \$257,000 for the prior year period. Our provision for loan losses is based on a twelve-quarter rolling average of actual net charge-offs adjusted for various environmental factors for each pool of loans in our portfolio. During the three months ended September 30, 2015, we experienced net recoveries of \$9,000 compared to net-charge offs of \$280,000 for the prior year period. The direct effect of the decreased charge-offs quarter over quarter resulted in a decrease in the general reserve factor applied to each pool of loans in our portfolio for the quarter ended September 30, 2015, which in turn was a main cause of the decrease in provision period over period. The provision was based on management's review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

**Non-Interest Income:** Non-interest income decreased to \$468,000 for the three months ended September 30, 2015 from \$2.4 million for the three months ended September 30, 2014, related primarily to the bargain purchase gain of \$2.0 million that was recorded as a result of the merger with Alpena during the three months ended September 30, 2014. Service charges and fee income increased \$36,000 when compared to the same period in 2014.

**Non-Interest Expense:** Non-interest expense was \$2.6 million for the three months ended September 30, 2015 as compared to \$2.5 million for the same period in 2014. Professional services increased \$91,000, related to legal and

accounting services, when compared to the 2014 quarter. In addition, we experienced an increase in real estate owned expenses of \$160,000 during the three month period ended September 30, 2015 as a result of a valuation reserve expense on our largest piece of Bank-owned property. Partially offsetting these increases was a decrease in merger related expenses of \$140,000 when compared to the three months ended September 30, 2014.

**Income Taxes:** The Company recorded an income tax benefit of \$1.7 million the three months ended September 30, 2015 and no federal income taxes for the three months ended September 30, 2014. During the three months ended September 30, 2015 management evaluated the deferred tax asset and, as a result of that evaluation, a valuation reserve recovery of \$1.7 million was recorded as it was determined that it is “more likely than not” that the future tax assets will be recognized before their expiration. A valuation allowance of \$1.1 million remains on our current deferred tax asset as of September 30, 2015.

***Nine Months Ended September 30, 2015 Compared to Nine Months Ended September 30, 2014***

**General:** Net income increased \$527,000 to \$2.6 million for the nine months ended September 30, 2015 from \$1.9 million for the same period ended September 30, 2014. This increase is primarily attributed to the reserve recovery of the deferred tax asset that was recorded during the nine-month period ended September 30, 2015.

**Interest Income:** Interest income was \$7.9 million for the nine months ended September 30, 2015, compared to \$6.5 million for the comparable period in 2014. The increase of \$1.5 million, or 22.8%, in interest income was due in large part to an increase of \$90.3 million in average balances of interest earning assets for the nine months ended September 30, 2015. While we experienced an increase in average balances our yield on these assets declined 49 basis points to 3.39% for the nine-month period ended September 30, 2015 as compared to 3.88% for the same period in 2014. The decrease in yield is attributed to an increase of \$65.9 million in the average balance of our available-for-sale investment portfolio with a yield of 1.78% as of September 30, 2015 compared to a yield of 2.10% for the prior year period.

**Interest Expense:** Interest expense was \$926,000 for the nine-month period ended September 30, 2015 compared to \$778,000 for the same period in 2014. The increase in interest expense was due primarily to a period over period increase in the cost of funds on Federal Home Loan Bank advances of 18 basis points, to 1.27% compared to 1.09% for the same period in 2014. In addition, we experienced an increase of \$34.1 million in the average balance of core deposits, which serve as a low cost funding source for the Company.

The following table sets forth information regarding the changes in interest income and interest expense of the Bank during the periods indicated.

|                                    | Nine Months ended<br>September 30, 2015<br>Compared to<br>Nine Months ended<br>September 30, 2014<br>Increase (Decrease) Due<br>to:<br>Volume    Rate       Total<br>(in thousands) |          |         |
|------------------------------------|---|----------|---------|
| Interest-earning assets:           |   |          |         |
| Loans receivable                   | \$822   | \$(63 )  | \$759   |
| Investment securities              | 853   | (108 )   | 745     |
| Other investments                  | 20  | (49 )    | (29 )   |
| Total interest-earning assets      | 1,695   | (220 )   | 1,475   |
| Interest-bearing liabilities:      |   |          |         |
| Savings Deposits                   | 2   | —        | 2       |
| Money Market/NOW accounts          | 73  | (1 )     | 72      |
| Certificates of Deposit            | 53  | (1 )     | 52      |
| Deposits                           | 128   | (2 )     | 126     |
| Borrowed funds                     | (8 )  | 30       | 22      |
| Total interest-bearing liabilities | 120   | 28       | 148     |
| Change in net interest income      | \$1,575   | \$(248 ) | \$1,327 |

**Net Interest Income:** Net interest income increased \$1.3 million to \$7.0 million for the nine months ended September 30, 2015 compared to the year earlier period. For the nine months ended September 30, 2015, average interest-earning assets increased \$90.3 million, or 40.6%, and average interest-bearing liabilities increased \$60.2 million, or 39.5%, when compared to the year earlier period. The yield on average interest-earning assets decreased to 3.39% for the nine months ended September 30, 2015 from 3.88% for the same period ended in 2014. The average cost of interest-bearing liabilities decreased to 0.53% from 0.60% for the nine month periods ended September 30, 2015 and September 30, 2014, respectively. The net interest margin decreased 42 basis points to 2.99% for the nine-month period ended September 30, 2015, from 3.41% for the same period in 2014.

**Delinquent Loans and Nonperforming Assets:** Acquired impaired loans are not subject to individual evaluation for impairment and are not reported as non-performing loans based on acquired impaired loan accounting. Acquired non-impaired loans are placed on non-accrual status and reported as past due or non-performing using the same criteria that is applied to the originated loan portfolio.

|   | September<br>30,<br>2015<br>(in thousands) | December<br>31,<br>2014 |
|---|--|-------------------------|
| Total non-accrual loans   | \$1,241                                    | \$ 1,338                |
| Accrual loans delinquent 90 days or more:                       |  |                         |
| One- to four-family residential                                 | 125  | 312                     |
| Other real estate loans   | 97   | —                       |
| Construction  | —  | —                       |
| Purchased Out-of-State  | —  | —                       |
| Commerical  | 300  | —                       |
| Consumer & other  | —  | 3                       |
| Total accrual loans delinquent 90 days or more                  | \$522                                      | \$ 315                  |
| Total nonperforming loans (1)                                   | 1,763                                      | 1,653                   |
| Total real estate owned-residential mortgages (2)               | 375  | 356                     |
| Total real estate owned-Commercial (2)                          | 1,346                                      | 391                     |
| Total purchased mortgage out-of-state participation (2)         | —  | 1,216                   |
| Total real estate owned-Consumer & other repossessed assets (2) | 774  | 860                     |
| Total nonperforming assets                                      | \$4,258                                    | \$ 4,476                |
| Total nonperforming loans to loans receivable                   | 1.04 %                                     | 1.00 %                  |
| Total nonperforming loans to total assets                       | 0.52 %                                     | 0.51 %                  |
| Total nonperforming assets to total assets                      | 1.26 %                                     | 1.37 %                  |

(1) All of the Bank's loans delinquent more than 90 days are classified as nonperforming.

Represents the net book value of property acquired by the Bank through foreclosure or deed in lieu of foreclosure.

(2) Upon acquisition, this property is recorded at the lower of its fair market value or the principal balance of the related loan.

**Provision for Loan Losses:** The provision for loan losses was a recovery of \$26,000 for the nine-month period ended September 30, 2015 compared to provision of \$273,000 for the comparable period in 2014. As discussed above in the discussion for the three-month period ended September 30, 2015, our provision for loan losses is based on a twelve-quarter rolling average of actual net charge-offs adjusted for various environmental factors for each pool of loans in our portfolio. During the nine-months ended September 30, 2015, we experienced net recoveries on charged off loans of \$97,000. As a result of the decrease in charge-offs we decreased the reserve factors applied to the loan pools classified as substandard based on the inherent increased risk associated with those credits. The provision was based on management's review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

The following table sets forth our delinquent and non-accrual loans at the dates indicated:

|   | Portfolio<br>Balance | Delinquent<br>Loans<br>Over 90<br>Days | Non-Accrual<br>Loans |
|---|----------------------|--|----------------------|
| (in thousands)                            |                      |  |                      |
| At September 30, 2015                     |                      |  |                      |
| Real estate loans:                        |                      |  |                      |
| Construction                              | \$257                | \$ —                                   | \$ —                 |
| One - to four - family                    | 76,458               | 125                                    | 681                  |
| Commercial Mortgages                      | 59,096               | 97                                     | 370                  |
| Home equity lines of credit/ Junior liens | 9,063                | —                                      | 39                   |
| Commercial loans                          | 23,387               | 300                                    | 151                  |
| Consumer loans                            | 1,557                | —                                      | —                    |
| Total gross loans                         | \$169,818            | \$ 522                                 | \$ 1,241             |
| Less:                                     |                      |  |                      |
| Net deferred loan fees                    | (241 )               | —                                      | (1 )                 |
| Allowance for loan losses                 | (1,514 )             | (25 )                                  | (206 )               |
| Total loans, net                          | \$168,063            | \$ 497                                 | \$ 1,034             |
|   |                      |  |                      |
|   | Portfolio<br>Balance | Delinquent<br>Loans<br>Over 90<br>Days | Non-Accrual<br>Loans |
| (Dollars in thousands)                    |                      |  |                      |
| At December 31, 2014                      |                      |  |                      |
| Real estate loans:                        |                      |  |                      |
| Construction                              | \$1,443              | \$ —                                   | \$ —                 |
| One - to four - family                    | 71,828               | 312                                    | 750                  |
| Commercial Mortgages                      | 62,163               | —                                      | 486                  |

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|  |            |        |          |
|--|------------|--------|----------|
| Home equity lines of credit/Junior liens | 9,502      | —      | 25       |
| Commercial loans                         | 19,000     | —      | 77       |
| Consumer loans                           | 1,403      | 3      | —        |
| Total gross loans                        | \$ 165,339 | \$ 315 | \$ 1,338 |
| Less:                                    |            |        |          |
| Net deferred loan fees                   | (263 )     | —      | (2 )     |
| Allowance for loan losses                | (1,429 )   | —      | (130 )   |
| Total loans, net                         | \$ 163,647 | \$ 315 | \$ 1,206 |

**Non-Interest Income:** Non-interest income was \$1.4 million for the nine-month period ended September 30, 2015, a decrease of \$1.6 million from the prior year period. Most notably, the nine-month results in 2014 reflect the bargain purchase gain of \$2.0 million recorded as a result of the merger with Alpena. Partially offsetting this item are increases of \$120,000 in service charges and fees and \$109,000 in gain on sale of Bank-owned properties as we sold the former operations center building during the nine months ended September 30, 2015.

**Non-Interest Expense:** Non-interest expense increased to \$7.5 million for the nine months ended September 30, 2015 from \$6.4 million for the nine months ended September 30, 2014. We experienced increases of \$721,000 in salaries and benefits as a result of the merger with Alpena, \$103,000 in occupancy expenses, \$168,000 in other professional services, primarily associated with accounting and legal services and \$177,000 in real estate owned expenses related to a valuation reserve that was established on our largest piece of real estate owned. Partially offsetting these increases were decreases of \$264,000 in merger related expenses and \$52,000 in other expenses primarily related to commercial loan expenses.

**Income Taxes:** As stated in the three month comparison, the Company recorded an income tax benefit of \$1.7 million for the nine months ended September 30, 2015 and no federal income tax expense for the nine months ended September 30, 2014. The income tax benefit is related to the recovery of \$1.7 million of the valuation reserve on the deferred tax asset as management's evaluation of the asset reflected a "more likely than not" result that the future tax assets will be recognized before their expiration. A valuation allowance of \$1.1 million remains on our current deferred tax asset as of September 30, 2015.

The Company will continue to evaluate the future benefits from these carryforwards and at such time as it becomes "more likely than not" that they would be utilized prior to expiration, the Company will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will fully expire in the year 2033.



## LIQUIDITY

The Company's current liquidity position is more than adequate to fund expected asset growth. The Company's primary sources of funds are deposits, FHLB advances, proceeds from principal and interest payments, prepayments on loans and mortgage-backed and investment securities and sale of long-term fixed-rate mortgages into the secondary market. While maturities and scheduled amortization of loans and mortgage-backed securities are a predictable source of funds, deposit flows, mortgage prepayments and sale of mortgage loans into the secondary market are greatly influenced by general interest rates, economic conditions and competition.

Liquidity represents the amount of an institution's assets that can be quickly and easily converted into cash without significant loss. The most liquid assets are cash, short-term U.S. Government securities, U.S. Government agency securities and certificates of deposit. The Company is required to maintain sufficient levels of liquidity as defined by OCC regulations. This requirement may be varied at the direction of the OCC. Regulations currently in effect require that the Bank must maintain sufficient liquidity to ensure its safe and sound operation. The Company's objective for liquidity is to be above 20% of net deposits and short-term borrowings. Liquidity as of September 30, 2015 was \$157.3 million, or 65.6%, compared to \$146.5 million, or 62.9% at December 31, 2014. The levels of these assets are dependent on the Company's operating, financing, lending and investing activities during any given period. The liquidity calculated by the Company includes additional borrowing capacity available with the FHLB. This borrowing capacity is based on pledged collateral. As of September 30, 2015, the Bank had unused borrowing capacity totaling \$29.2 million at the FHLB based on the pledged collateral.

The Company intends to retain in its portfolio certain originated residential mortgage loans (primarily adjustable rate and shorter-term fixed-rate mortgage loans) and to generally sell the remainder in the secondary market. The Bank will from time to time participate in or originate commercial real estate loans, including real estate development loans. During the nine month period ended September 30, 2015 the Company originated \$27.3 million in residential mortgage loans, of which \$15.2 million were retained in portfolio while the remainder were sold or are being held for sale. This compares to \$17.8 million in originations during the first nine months of 2014 of which \$8.2 million were retained in portfolio. The Company also originated \$14.8 million of commercial loans and \$2.7 million of consumer loans in the first nine months of 2015 compared to \$11.8 million of commercial loans and \$1.9 million of consumer loans for the same period in 2014. Of total loans receivable, excluding loans held for sale, mortgage loans comprised 45.0% and 47.1%, commercial loans 48.8% and 45.9% and consumer loans 6.3% and 7.0% at September 30, 2015 and December 31, 2014, respectively.

Deposits are a primary source of funds for use in lending and for other general business purposes. At September 30, 2015 deposits funded 82.5% of the Company's total assets compared to 83.1% at December 31, 2014. Certificates of deposit scheduled to mature in less than one year at September 30, 2015 totaled \$33.4 million. Management believes that a significant portion of such deposits will remain with the Bank. The Bank monitors the deposit rates offered by competition in the area and sets rates that take into account the prevailing market conditions along with the Bank's liquidity position. Moreover, management believes that the growth in assets is not expected to require significant in-flows of liquidity. As such, the Bank does not expect to be a significant market leader in rates paid for liabilities.

Borrowings may be used to compensate for seasonal or other reductions in normal sources of funds or for deposit outflows at more than projected levels. Borrowings may also be used on a longer-term basis to support increased lending or investment activities. At September 30, 2015 the Company had \$25.1 million in FHLB advances. FHLB advances as a percentage of total assets were 7.4% at September 30, 2015 as compared to 7.0% at December 31, 2014. The Company has sufficient available collateral to obtain additional FHLB advances of \$29.2 million as of September 30, 2015.

## **CAPITAL RESOURCES**

Stockholders' equity at September 30, 2015 was \$33.1 million, or 9.8% of total assets, compared to \$30.5 million, or 9.4% of total assets, at December 31, 2014 (See "Consolidated Statement of Changes in Stockholders' Equity"). The \$2.5 million increase during the nine months ended September 30, 2015 was primarily due to net income for the nine month period ended September 30, 2015 of \$2.6 million, an increase of \$178,000, net of tax in the unrealized gain on available-for-sale securities, offset in part by aggregate dividends paid of \$261,000.

The Bank is subject to certain capital-to-assets requirements in accordance with OCC regulations. The Bank exceeded all regulatory capital requirements at September 30, 2015.

The following table summarizes the Bank's actual capital with the regulatory capital requirements and with requirements to be "Well Capitalized" under prompt corrective action provisions, as of September 30, 2015:

|  | Actual               |         | Regulatory Minimum |        | Minimum to be Well Capitalized |         |
|--|----------------------|---------|--------------------|--------|--------------------------------|---------|
|  | Amount               | Ratio   | Amount             | Ratio  | Amount                         | Ratio   |
|  | Dollars in Thousands |         |                    |        |                                |         |
| Tier 1 (Core) capital ( to adjusted assets)          | \$29,123             | 8.80 %  | \$14,886           | 4.50 % | \$21,502                       | 6.50 %  |
| Total risk-based capital ( to risk- weighted assets) | \$30,637             | 17.30 % | \$14,172           | 8.00 % | \$17,715                       | 10.00 % |
| Tier 1 risk-based capital ( to risk weighted assets) | \$29,123             | 16.44 % | \$10,629           | 6.00 % | \$14,172                       | 8.00 %  |
| Tangible Capital ( to tangible assets)               | \$29,123             | 8.80 %  | \$6,616            | 2.00 % | \$6,616                        | 2.00 %  |

### ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable to smaller reporting companies.

### ITEM 4 - CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Company's Chief Executive Officer and VP-Director of Financial Reporting and Accounting, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and VP-Director of Financial Reporting and Accounting concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported, within the time periods specified by the SEC's rules and forms and in timely alerting them to material information relating to the Company (or its consolidated subsidiaries) required to be included in its periodic SEC filings.

There has been no change in the Company's internal control over the financial reporting during the Company's third quarter of fiscal year 2015 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.**

**FORM 10-Q**

**Quarter Ended September 30, 2015**

**PART II – OTHER INFORMATION**

Item 1 Legal Proceedings:  
-

There are no material legal proceedings to which the Company is a party or of which any of its property is subject. From time to time the Company is a party to various legal proceedings incident to its business.

Item 1A - Risk Factors:

Not applicable to smaller reporting companies

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds:  
-

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable

Item 3 Defaults upon Senior Securities:  
-

Not applicable

Item 4 Mine Safety Disclosures  
-

Not applicable

Item 5 Other Information:  
-

- (a) Not applicable
- (b) There was no material change to the procedures by which security holders may recommend nominees to the Company's Board of Directors during the period covered by the Form 10-Q.

Item 6 Exhibits:  
-

Exhibit 31.1 Certification by Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification by Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Statement of Chief Executive Officer furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Statement of Chief Financial Officer furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS XBRL Taxonomy Extension Schema  
101.SCH XBRL Taxonomy Extension Calculation Linkbase  
101.CAL XBRL Taxonomy Extension Label Linkbase  
101.DEF XBRL Taxonomy Extension Definition Linkbase  
101.LAB XBRL Taxonomy Extension Label Linkbase  
101.PRE XBRL Taxonomy Extension Presentation Linkbase

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.**

**FORM 10-Q**

**Quarter Ended September 30, 2015**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

**FIRST FEDERAL OF NORTHERN MICHIGAN  
BANCORP, INC.**

By: /s/ Michael W. Mahler  
Michael W. Mahler  
Chief Executive Officer

Date: November 13, 2015

By: /s/ Eileen M. Budnick  
Eileen M. Budnick  
VP-Director of Financial Reporting and Accounting  
(Principal Financial and Accounting Officer)

Date: November 13, 2015