

First Federal of Northern Michigan Bancorp, Inc.  
Form 10-Q  
November 14, 2013

**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, 2013**

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** **32-0135202**  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) 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 <input type="checkbox"/> | Accelerated filer <input type="checkbox"/>                    |
| Non-accelerated filer <input type="checkbox"/>   | Smaller reporting company <input checked="" type="checkbox"/> |

(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 14, 2013 |
| (Title of Class)               | 2,884,049 shares                 |

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

**FORM 10-Q**

**Quarter Ended September 30, 2013**

**INDEX**

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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," "project," or 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.

**First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**  
**Consolidated Balance Sheet**

|  | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and cash equivalents:   |                                      |                      |
| Cash on hand and due from banks  | \$ 3,506,272                         | \$ 2,732,109         |
| Overnight deposits with FHLB   | 30,725                               | 19,701               |
| Total cash and cash equivalents  | 3,536,997                            | 2,751,810            |
| Securities AFS   | 50,280,668                           | 50,763,551           |
| Securities HTM   | 2,305,000                            | 2,345,000            |
| Loans held for sale  | 973,920                              | 78,712               |
| Loans receivable, net of allowance for loan losses of \$1,793,258 and \$1,749,915 as of September 30, 2013 and December 31, 2012, respectively   | 138,005,242                          | 138,911,989          |
| Foreclosed real estate and other repossessed assets  | 2,241,522                            | 2,387,307            |
| Federal Home Loan Bank stock, at cost  | 3,266,100                            | 3,266,100            |
| Premises and equipment   | 5,190,283                            | 5,394,412            |
| Accrued interest receivable  | 953,288                              | 970,450              |
| Intangible assets  | 69,378                               | 158,316              |
| Prepaid FDIC premiums  | -                                    | 582,945              |
| Deferred tax asset   | 759,380                              | 330,831              |
| Originated mortgage servicing rights (net of valuation allowance)  | 906,012                              | 1,016,070            |
| Bank owned life insurance  | 4,575,291                            | 4,474,563            |
| Other assets   | 812,188                              | 402,090              |
| Total assets   | \$ 213,875,269                       | \$ 213,834,146       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Liabilities:   |                                      |                      |
| Deposits   | \$ 158,054,264                       | \$ 158,350,134       |
| Advances from borrowers for taxes and insurance  | 216,038                              | 132,823              |
| Federal Home Loan Bank Advances  | 25,015,573                           | 26,357,962           |
| REPO Sweep Accounts  | 5,560,451                            | 3,183,351            |
| Accrued expenses and other liabilities   | 1,179,461                            | 1,375,092            |
| Total liabilities  | 190,025,787                          | 189,399,362          |
| Stockholders' equity:  |                                      |                      |
| Common stock (\$0.01 par value 20,000,000 shares authorized 3,191,799 shares issued and outstanding) at September 30, 2013 and December 31, 2012 | 31,918                               | 31,918               |
| Additional paid-in capital   | 23,853,891                           | 23,853,891           |
| Retained earnings  | 3,012,759                            | 2,766,170            |
| Treasury stock at cost (307,750 shares) at September 30, 2013 and December 31, 2012  | (2,963,918                           | ) (2,963,918         |
| Accumulated other comprehensive (loss) income  | (85,168                              | ) 746,723            |

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|  |                |                |
|--|----------------|----------------|
| Total stockholders' equity                 | 23,849,482     | 24,434,784     |
| Total liabilities and stockholders' equity | \$ 213,875,269 | \$ 213,834,146 |

See accompanying notes to consolidated financial statements.

**First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries****Consolidated Statement of Income**

|   | For the Three Months<br>Ended September 30, |             | For the Nine Months<br>Ended September 30, |             |
|---|---|-------------|--|-------------|
|   | 2013  | 2012        | 2013                                       | 2012        |
|   | (Unaudited)                                 |             | (Unaudited)                                |             |
| Interest income:  |   |             |  |             |
| Interest and fees on loans  | \$1,786,663                                 | \$1,995,749 | \$5,429,925                                | \$6,047,447 |
| Interest and dividends on investments   |   |             |  |             |
| Taxable   | 121,899                                     | 136,100     | 361,219                                    | 423,308     |
| Tax-exempt  | 37,054                                      | 38,438      | 112,098                                    | 116,240     |
| Interest on mortgage-backed securities  | 119,852                                     | 142,309     | 342,018                                    | 486,153     |
| Total interest income   | 2,065,468                                   | 2,312,596   | 6,245,260                                  | 7,073,148   |
| Interest expense:   |   |             |  |             |
| Interest on deposits  | 201,046                                     | 249,442     | 631,586                                    | 793,620     |
| Interest on borrowings  | 73,553                                      | 144,584     | 249,017                                    | 491,872     |
| Total interest expense  | 274,599                                     | 394,026     | 880,603                                    | 1,285,492   |
| Net interest income   | 1,790,869                                   | 1,918,570   | 5,364,657                                  | 5,787,656   |
| Provision for loan losses   | 31,733                                      | 234,005     | 371,560                                    | 1,188,588   |
| Net interest income after provision for loan losses   | 1,759,136                                   | 1,684,565   | 4,993,097                                  | 4,599,068   |
| Non-interest income:  |   |             |  |             |
| Service charges and other fees  | 240,103                                     | 205,592     | 654,822                                    | 563,084     |
| Mortgage banking activities   | 155,869                                     | 441,445     | 487,993                                    | 876,090     |
| Net loss on sale of premises and equipment, real estate owned<br>and other repossessed assets | (11,462 )                                   | (10,691 )   | (10,712 )                                  | (80,796 )   |
| Net gain on sale of investment securities   | -   | 47,017      | -  | 47,017      |
| Other   | 74,468                                      | 119,519     | 231,831                                    | 234,961     |
| Total non-interest income   | 458,978                                     | 802,882     | 1,363,934                                  | 1,640,356   |
| Non-interest expense:   |   |             |  |             |
| Compensation and employee benefits  | 1,179,082                                   | 1,243,598   | 3,472,983                                  | 3,692,139   |
| FDIC Insurance Premiums   | 43,378                                      | 47,190      | 138,054                                    | 141,314     |
| Advertising   | 27,676                                      | 29,005      | 95,391                                     | 111,489     |
| Occupancy   | 237,924                                     | 239,900     | 689,578                                    | 719,148     |
| Amortization of intangible assets   | 29,646                                      | 29,646      | 88,938                                     | 146,893     |
| Service bureau charges  | 79,301                                      | 73,495      | 233,884                                    | 229,149     |
| Professional services   | 84,011                                      | 89,559      | 343,845                                    | 297,403     |
| Collection activity and real estate owned expense   | 42,840                                      | 41,165      | 106,603                                    | 156,434     |
| Other   | 311,798                                     | 283,738     | 941,166                                    | 1,026,775   |
| Total non-interest expense  | 2,035,656                                   | 2,077,296   | 6,110,442                                  | 6,520,744   |

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|  |             |           |              |            |
|--|-------------|-----------|--------------|------------|
| Income (loss) before income tax expense or benefit                     | 182,458     | 410,151   | 246,589      | (281,320 ) |
| Income tax expense (benefit)   | -           | 137,375   | -            | (884,822 ) |
| Net income   | 182,458     | 272,776   | 246,589      | 603,502    |
| Other comprehensive income (loss):                                     |             |           |              |            |
| Net income   | \$182,458   | \$272,776 | \$246,589    | \$603,502  |
| Change in unrealized gain on available-for-sale securities, net of tax | (274,115 )  | (48,099 ) | (831,890 )   | 118,587    |
| Comprehensive income (loss)  | \$(91,657 ) | \$224,677 | \$(585,301 ) | \$722,089  |
| Per share data:  |             |           |              |            |
| Net income per share   | \$0.06      | \$0.09    | \$0.09       | \$0.21     |
| Basic  | \$0.06      | \$0.09    | \$0.09       | \$0.21     |
| Diluted  |             |           |              |            |
| Weighted average number of shares outstanding                          |             |           |              |            |
| Basic  | 2,884,049   | 2,884,049 | 2,884,049    | 2,884,049  |
| Including dilutive stock options                                       | -           | -         | -            | -          |
| Dividends per common share   | \$-         | \$-       | \$-          | \$-        |

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 | Total        |
|--|-----------------|-------------------|----------------------------------|----------------------|---|--------------|
| Balance at December 31, 2012   | \$ 31,918       | \$(2,963,918)     | \$23,853,891                     | \$2,766,170          | \$ 746,723                                      | \$24,434,784 |
| Net income for the period  | -               | -                 | -                                | 246,589              | -   | 246,559      |
| Change in unrealized gain on<br>available-for-sale securities (net<br>of tax of \$428,550) | -               | -                 | -                                | -                    | (831,891 )                                      | (831,891 )   |
| Balance at September 30, 2013  | \$ 31,918       | \$(2,963,918)     | \$23,853,891                     | \$3,012,759          | \$ (85,168 )                                    | \$23,849,482 |

See accompanying notes to the consolidated financial statements.

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

|  | For Nine Months Ended<br>September 30, |              |
|--|--|--------------|
|  | 2013                                   | 2012         |
|  | (Unaudited)                            |              |
| <b>Cash Flows from Operating Activities:</b>                               |  |              |
| Net income   | \$246,589                              | \$603,502    |
| Adjustments to reconcile net income to net cash from operating activities: |  |              |
| Depreciation and amortization  | 301,053                                | 378,619      |
| Provision for loan loss  | 371,560                                | 1,188,588    |
| Amortization and accretion on securities                                   | 439,662                                | 371,770      |
| Gain on sale of investment securities                                      | -                                      | (47,017 )    |
| Stock-based compensation   | -                                      | 1,766        |
| Gain on sale of loans held for sale  | (207,229 )                             | (393,692 )   |
| Originations of loans held for sale  | (12,443,497)                           | (26,174,538) |
| Proceeds from sale of loans held for sale                                  | 11,755,518                             | 25,526,776   |
| Loss on sale of fixed assets   | (9,084 )                               | 698          |
| Loss on sale of real estate owned and other repossessed assets             | 19,796                                 | 80,098       |
| Net change in:   |  |              |
| Accrued interest receivable  | 17,162                                 | 29,168       |
| Other assets   | (300,039 )                             | (188,024 )   |
| Prepaid FDIC insurance premiums  | 582,945                                | 131,569      |
| Bank owned life insurance  | (100,728 )                             | (35,583 )    |
| Deferred income tax (benefit) expense                                      | -                                      | (807,808 )   |
| Accrued expenses and other liabilities                                     | (195,632 )                             | (95,492 )    |
| Net cash provided by operating activities                                  | 478,076                                | 570,400      |
| <b>Cash Flows from Investing Activities:</b>                               |  |              |
| Net (increase) decrease in loans   | (678,131 )                             | 47,965       |
| Proceeds from maturity and sale of available-for-sale securities           | 12,840,206                             | 16,906,748   |
| Proceeds from sale of property and equipment                               | 56,163                                 | 425          |
| Purchase of securities   | (14,017,425)                           | (16,446,962) |
| Purchase of premises and equipment   | (55,065 )                              | (117,655 )   |
| Proceeds from sale of real estate owned and other repossessed assets       | 1,339,307                              | 2,313,794    |
| Net cash (used for) provided by investing activities                       | (514,945 )                             | 2,704,315    |
| <b>Cash Flows from Financing Activities:</b>                               |  |              |
| Net (decrease) increase in deposits  | (295,870 )                             | 8,026,680    |
| Net increase (decrease) in Repo Sweep accounts                             | 2,377,100                              | (1,347,279 ) |
| Net increase in advances from borrowers                                    | 83,215                                 | 82,146       |
| Advances from Federal Home Loan Bank and notes payable                     | 39,155,000                             | 32,250,000   |
| Repayments of Federal Home Loan Bank advances and notes payable            | (40,497,389)                           | (41,750,000) |
| Net cash provided by (used for) financing activities                       | 822,056                                | (2,738,453 ) |
| Net increase in cash and cash equivalents                                  | 785,187                                | 536,262      |

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|   |             |             |
|---|-------------|-------------|
| Cash and cash equivalents at beginning of period                    | 2,751,810   | 2,749,498   |
| Cash and cash equivalents at end of period                          | \$3,536,997 | \$3,285,760 |
| Supplemental disclosure of cash flow information:                   |             |             |
| Cash paid during the period for                                     |             |             |
| Interest  | \$880,717   | \$1,322,705 |
| Income taxes  | -           | -           |
| Transfers of loans to foreclosed real estate and repossessed assets | 1,213,318   | 1,273,811   |

See accompanying notes to the consolidated financial statements.

**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, 2012.

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, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

**Note 2— PRINCIPLES OF CONSOLIDATION**

The consolidated financial statements include the accounts of First Federal of Northern Michigan Bancorp, Inc., First Federal of Northern Michigan (the "Bank"), and the Bank's wholly owned subsidiaries, Financial Services & Mortgage Corporation ("FSMC") and FFNM Agency. FSMC invests in real estate, which includes leasing, selling, developing, and maintaining real estate properties. The main activity of FFNM Agency is to collect the stream of income associated with the sale of the Blue Cross/Blue Shield override business to the Grotenhuis Group. All significant intercompany balances and transactions have been eliminated in the consolidation.

**Note 3—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, 2013     |                              |                               |                 |
|--|------------------------|------------------------------|-------------------------------|-----------------|
|  | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Market<br>Value |
|  | (dollars in thousands) |                              |                               |                 |
| <b>Securities Available for Sale</b>   |                        |                              |                               |                 |
| U.S. Government and agency obligations | \$7,130                | \$ 43                        | \$ (98 )                      | 7,075           |
| Municipal obligations                  | 11,876                 | 215                          | (297 )                        | 11,794          |
| Corporate bonds & other obligations    | 1,098                  | 13                           | -                             | 1,111           |
| Mortgage-backed securities             | 30,304                 | 340                          | (346 )                        | 30,298          |
| Equity securities                      | 2                      | 1                            | -                             | 3               |
| <b>Total</b>                           | <b>\$50,410</b>        | <b>\$ 612</b>                | <b>\$ (741 )</b>              | <b>\$50,281</b> |
| <b>Securities Held to Maturity</b>     |                        |                              |                               |                 |
| Municipal obligations                  | \$2,305                | \$ 145                       | \$ -                          | \$2,450         |

|  | December 31, 2012                   |                              |                                 |                 |
|--|-------------------------------------|------------------------------|---------------------------------|-----------------|
|  | Amortized<br>Cost<br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Market<br>Value |
| <b>Securities Available for Sale</b>   |                                     |                              |                                 |                 |
| U.S. Government and agency obligations | \$9,181                             | \$ 66                        | \$ -                            | \$9,247         |
| Municipal obligations                  | 10,413                              | 368                          | (23 )                           | 10,758          |
| Corporate bonds & other obligations    | 1,135                               | 15                           | -                               | 1,150           |
| Mortgage-backed securities             | 28,901                              | 736                          | (29 )                           | 29,608          |
| Equity securities                      | 3                                   | -                            | (2 )                            | 1               |
| <b>Total</b>                           | <b>\$49,633</b>                     | <b>\$ 1,185</b>              | <b>\$ (54 )</b>                 | <b>\$50,764</b> |
| <b>Securities Held to Maturity</b>     |                                     |                              |                                 |                 |
| Municipal obligations                  | \$2,345                             | \$ 225                       | \$ -                            | \$2,570         |

The amortized cost and estimated market value of securities at September 30, 2013, 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,<br>2013     |                 |
|---------------------------------------|---------------------------|-----------------|
|                                       | Amortized<br>Cost         | Market<br>Value |
|                                       | (dollars in<br>thousands) |                 |
| <b>Available For Sale:</b>            |                           |                 |
| Due in one year or less               | \$2,076                   | \$2,086         |
| Due after one year through five years | 11,042                    | 11,153          |
| Due in five year through ten years    | 6,740                     | 6,451           |
| Due after ten years                   | 246                       | 290             |
| <b>Subtotal</b>                       | <b>20,104</b>             | <b>19,980</b>   |
| Equity securities                     | 2                         | 3               |
| Mortgage-backed securities            | 30,304                    | 30,298          |
| <b>Total</b>                          | <b>\$50,410</b>           | <b>\$50,281</b> |
| <b>Held To Maturity:</b>              |                           |                 |
| Due in one year or less               | \$90                      | \$91            |
| Due after one year through five years | 1,615                     | 1,695           |
| Due in five year through ten years    | 300                       | 332             |

|                     |         |         |
|---------------------|---------|---------|
| Due after ten years | 300     | 332     |
| Total               | \$2,305 | \$2,450 |

At September 30, 2013 and December 31, 2012, securities with a carrying value and fair value of \$37,820,000 and \$44,135,000, 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, 2013 and 2012 were \$0 and \$1,553,000, respectively, resulting in gross gains of \$0 and \$54,000, respectively and gross losses of \$0 and \$7,000, 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, 2013 and December 31, 2012:

|  | September 30, 2013     |                                    |            |                                     |
|--|------------------------|------------------------------------|------------|-------------------------------------|
|  | Fair Value             | Gross Unrealized Losses <12 months | Fair Value | Gross Unrealized Losses > 12 months |
|  | (dollars in thousands) |                                    |            |                                     |
| Available For Sale:                    |                        |                                    |            |                                     |
| U.S. Government and agency obligations | \$901                  | \$ (98 )                           | \$ -       | \$ -                                |
| Municipal obligations                  | 6,773                  | (274 )                             | 953        | (23 )                               |
| Mortgage-backed securities             | 13,131                 | (282 )                             | 2,175      | (64 )                               |
| Equity securities                      | -                      | -                                  | -          | -                                   |
| Total                                  | \$20,805               | \$ (654 )                          | \$ 3,128   | \$ (87 )                            |
| Held to Maturity:                      |                        |                                    |            |                                     |
| Municipal obligations                  | \$-                    | \$ -                               | \$ -       | \$ -                                |
|  | December 31, 2012      |                                    |            |                                     |
|  | Fair Value             | Gross Unrealized Losses <12 months | Fair Value | Gross Unrealized Losses > 12 months |
|  | (in thousands)         |                                    |            |                                     |
| Available For Sale:                    |                        |                                    |            |                                     |
| U.S. Government and agency obligations | \$-                    | \$ -                               | \$ -       | \$ -                                |
| Municipal obligations                  | 1,537                  | (23 )                              | -          | -                                   |
| Mortgage-backed securities             | 2,725                  | (13 )                              | 1,687      | (16 )                               |
| Equity securities                      | -                      | -                                  | 1          | (2 )                                |
| Total                                  | \$4,262                | \$ (36 )                           | \$ 1,688   | \$ (18 )                            |
| Held to Maturity:                      |                        |                                    |            |                                     |
| Municipal obligations                  | \$-                    | \$ -                               | \$ -       | \$ -                                |

As of September 30, 2013, there were 5 securities with an estimated fair value of \$3,128,000 and unrealized losses of \$87,000 in a continuous unrealized loss position for more than twelve months compared to 2 securities with an estimated fair value of \$1,688,000 and unrealized losses of \$18,000 at December 31, 2012. The Company had 26 securities with an estimated fair value of \$20,805,000 and unrealized losses of \$654,000 in a continuous unrealized loss position for less than twelve months compared to 7 securities with an estimated fair value of \$4,262,000 and



unrealized loss of \$36,000 at December 31, 2012.

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 4—LOANS**

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

|                           | At                     |                 |
|---------------------------|------------------------|-----------------|
|                           | September 30,          | At December 31, |
|                           | 2013                   | 2012            |
|                           | (dollars in thousands) |                 |
| Real estate loans:        |                        |                 |
| Residential mortgage      | \$64,244               | \$ 66,539       |
| Commercial loans:         |                        |                 |
| Secured by real estate    | 53,022                 | 54,673          |
| Other                     | 12,429                 | 8,102           |
| Total commercial loans    | 65,451                 | 62,775          |
| Consumer loans:           |                        |                 |
| Secured by real estate    | 9,286                  | 10,409          |
| Other                     | 1,117                  | 1,259           |
| Total consumer loans      | 10,403                 | 11,668          |
| Total gross loans         | \$140,098              | \$ 140,982      |
| Less:                     |                        |                 |
| Net deferred loan fees    | (300 )                 | (320 )          |
| Allowance for loan losses | (1,793 )               | (1,750 )        |
| Total loans, net          | \$138,005              | \$ 138,912      |

The following table illustrates the contractual aging of the recorded investment in past due loans by class of loans as of September 30, 2013 and December 31, 2012:

**Contractual Aging of Recorded Balance in Past Due Loans by Class of Loan**

As of September 30, 2013

| 30 - 59<br>Days | 60 - 89<br>Days<br>Past Due | Greater<br>than<br>90 Days<br>Past Due | Total<br>Current | Total<br>Loans<br>Receivables | Recorded<br>Investment ><br>90<br>Days and<br>Accruing |
|-----------------|-----------------------------|--|------------------|-------------------------------|--|
|-----------------|-----------------------------|--|------------------|-------------------------------|--|

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|                                       | Past Due<br>(dollars in thousands) |          |          | Past Due |            |            |       |
|---------------------------------------|------------------------------------|----------|----------|----------|------------|------------|-------|
| Commercial Real Estate:               |                                    |          |          |          |            |            |       |
| Commercial Real Estate - construction | \$-                                | \$ -     | \$ 173   | \$ 173   | \$-        | \$ 173     | \$ -  |
| Commercial Real Estate - other        | 39                                 | 1,305    | 2,151    | 3,495    | 49,354     | 52,849     | -     |
| Commercial - non real estate          | 66                                 | 27       | -        | 93       | 12,336     | 12,429     | -     |
| Consumer:                             |                                    |          |          |          |            |            |       |
| Consumer - Real Estate                | 121                                | 13       | -        | 134      | 9,152      | 9,286      | -     |
| Consumer - Other                      | -                                  | -        | -        | -        | 1,117      | 1,117      | -     |
| Residential:                          |                                    |          |          |          |            |            |       |
| Residential                           | 1,631                              | 552      | 759      | 2,942    | 61,302     | 64,244     | 85    |
| Total                                 | \$ 1,857                           | \$ 1,897 | \$ 3,083 | \$ 6,837 | \$ 133,261 | \$ 140,098 | \$ 85 |

As of December 31, 2012

|                                       | 30 - 59<br>Days<br>Past<br>Due | 60 - 89<br>Days<br>Past Due | Greater<br>than<br>90 Days<br>Past Due | Total<br>Past<br>Due | Current    | Total<br>Loans<br>Receivables | Recorded<br>Investment ><br>90<br>Days and<br>Accruing |
|---------------------------------------|--------------------------------|-----------------------------|--|----------------------|------------|-------------------------------|--|
| (dollars in thousands)                |                                |                             |  |                      |            |                               |  |
| Commercial Real Estate:               |                                |                             |  |                      |            |                               |  |
| Commercial Real Estate - construction | \$-                            | \$ -                        | \$ 173                                 | \$ 173               | \$ 2,073   | \$ 2,246                      | \$ -   |
| Commercial Real Estate - other        | 3,210                          | 540                         | 282                                    | 4,032                | 48,395     | 52,427                        | -  |
| Commercial - non real estate          | 113                            | -                           | -                                      | 113                  | 7,989      | 8,102                         | -  |
| Consumer:                             |                                |                             |  |                      |            |                               |  |
| Consumer - Real Estate                | 59                             | -                           | 13                                     | 72                   | 10,337     | 10,409                        | -  |
| Consumer - Other                      | 11                             | 5                           | 6                                      | 22                   | 1,237      | 1,259                         | 6  |
| Residential:                          |                                |                             |  |                      |            |                               |  |
| Residential                           | 2,047                          | 796                         | 1,198                                  | 4,041                | 62,498     | 66,539                        | 61   |
| Total                                 | \$ 5,440                       | \$ 1,341                    | \$ 1,672                               | \$ 8,453             | \$ 132,529 | \$ 140,982                    | \$ 67  |

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 loans. The risk ratings are described as follows:

**Risk Grade 1 (Excellent)** - Prime loans based on liquid collateral, with adequate margin or supported by strong financial statements. Probability of serious financial deterioration is unlikely. High liquidity, minimum risk, strong ratios, and low handling costs are common to these loans. This classification also includes all loans secured by certificates of deposit or cash equivalents.

**Risk Grade 2 (Good)** - Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Probability of serious financial deterioration is unlikely. These loans possess a sound repayment source (and/or a secondary source). These loans represent less than the normal degree of risk associated with the type of financing contemplated.

**Risk Grade 3 (Satisfactory)** - Satisfactory loans of average risk – may have some minor deficiency or vulnerability to changing economic conditions, but still fully collectible. There may be some minor weakness but with offsetting features or other support readily available. These loans present a normal degree of risk associated with the type of financing. Actual and projected indicators and market conditions provide satisfactory assurance that the credit shall perform in accordance with agreed terms.

**Risk Grade 4 (Acceptable)** - Loans considered satisfactory, but which are of slightly “below average” credit risk due to financial weaknesses or uncertainty. The loans warrant a somewhat higher than average level of monitoring to insure that weaknesses do not advance. The level of risk is considered acceptable and within normal underwriting guidelines, so long as the loan is given the proper level of management supervision.

**Risk Grade 4.5 (Monitored)** - Loans are considered “below average” and monitored more closely due to some credit deficiency that poses additional risk but is not considered adverse to the point of being a “classified” credit. Possible reasons for additional monitoring may include characteristics such as temporary negative debt service coverage due to weak economic conditions; borrower may have experienced recent losses from operations, declining equity and/or increasing leverage, or marginal liquidity that may affect long-term sustainability. Loans of this grade have a higher degree of risk and warrant close monitoring to insure against further deterioration. In any tables presented subsequently, Risk Grade 4.5 credits are included with Risk Grade 4 credits.

**Risk Grade 5 (Other Assets Especially Mentioned) (OAEM)** - Loans which possess some credit deficiency or potential weakness, which deserve close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future.

**Risk Grade 6** (Substandard) - Loans are “substandard” whose full, final collectability does not appear to be a matter of serious doubt, but which nevertheless portray some form of well defined weakness that requires close supervision by Bank management. The noted weaknesses involve more than normal banking risk. One or more of the following characteristics may be exhibited in loans classified Substandard: (1) Loans possess a defined credit weakness and the likelihood that the loan shall be paid from the primary source of repayment is uncertain; (2) Loans are not adequately protected by the current net worth and/or paying capacity of the obligor; (3) primary source of repayment is gone, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees; (4) distinct possibility that the Bank shall sustain some loss if deficiencies are not corrected; (5) unusual courses of action are needed to maintain a high probability of repayment; (6) the borrower is not generating enough cash flow to repay loan principal, however, continues to make interest payments; (7) the Bank is forced into a subordinated or unsecured position due to flaws in documentation; (8) loans have been restructured so that payment schedules, terms, and collateral represent concessions to the borrower when compared to normal loan terms; (9) the Bank is contemplating foreclosure or legal action due to the apparent deterioration in the loan; or (10) there is a significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

**Grade 7 (Doubtful)** - Loans have all the weaknesses of those classified Substandard. Additionally, however, these weaknesses make collection or liquidation in full, based on existing conditions, improbable. Loans in this category are typically not performing in conformance with established terms and conditions. Full repayment is considered “Doubtful”, but extent of loss is not currently determinable.

**Risk Grade 8 (Loss)** - Loans are considered uncollectible and of such little value, that continuing to carry them as an asset on the Bank’s financial statements is not feasible.

**The following table presents the risk category of loans by class of loans based on the most recent analysis performed as of September 30, 2013 and December 31, 2012:**

**As of September 30, 2013**

| Loan Grade | Commercial Real Estate |           | Commercial |
|------------|------------------------|-----------|------------|
|            | Construction           | Other     |            |
|            | (dollars in thousands) |           |            |
| 1-2        | \$ -                   | \$ -      | \$ -       |
| 3          | -                      | 15,822    | 5,954      |
| 4          | -                      | 27,878    | 6,179      |
| 5          | -                      | 5,468     | 106        |
| 6          | 173                    | 3,681     | 190        |
| 7          | -                      | -         | -          |
| 8          | -                      | -         | -          |
| Total      | \$ 173                 | \$ 52,849 | \$ 12,429  |

**As of December 31, 2012**

| Loan Grade | Commercial Real Estate |           | Commercial |
|------------|------------------------|-----------|------------|
|            | Construction           | Other     |            |
|            | (dollars in thousands) |           |            |
| 1-2        | \$ -                   | \$ -      | \$ -       |
| 3          | 615                    | 13,895    | 2,376      |
| 4          | 1,458                  | 27,488    | 5,489      |
| 5          | -                      | 2,712     | 37         |
| 6          | 173                    | 8,332     | 200        |
| 7          | -                      | -         | -          |
| 8          | -                      | -         | -          |
| Total      | \$ 2,246               | \$ 52,427 | \$ 8,102   |

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, 2013 and December 31, 2012:

As of September 30, 2013  
(dollars in thousands)

| Residential     |           |
|-----------------|-----------|
| Loan Grade:     |           |
| Pass            | \$ 63,089 |
| Special Mention | -         |
| Substandard     | 1,155     |
| Total           | \$ 64,244 |

| Consumer               |             |                  |
|------------------------|-------------|------------------|
| -                      |             |                  |
|                        | Real Estate | Consumer - Other |
| (dollars in thousands) |             |                  |
| Performing             | \$9,279     | \$ 1,117         |
| Nonperforming          | 7           | -                |
| Total                  | \$9,286     | \$ 1,117         |

As of December 31, 2012

| Residential            |           |
|------------------------|-----------|
| (dollars in thousands) |           |
| Loan Grade:            |           |
| Pass                   | \$ 64,668 |
| Special Mention        | -         |
| Substandard            | 1,871     |
| Total                  | \$ 66,539 |

| Consumer               |             |                  |
|------------------------|-------------|------------------|
| -                      |             |                  |
|                        | Real Estate | Consumer - Other |
| (dollars in thousands) |             |                  |
| Performing             | \$10,381    | \$ 1,253         |
| Nonperforming          | 28          | 6                |
| Total                  | \$10,409    | \$ 1,259         |

The following table presents the recorded investment in non-accrual loans by class as of September 30, 2013 and December 31, 2012:



As of  
 September      December 31, 2012  
 30, 2013  
 (in thousands)

|                                       |          |          |
|---------------------------------------|----------|----------|
| Commercial Real Estate:               |          |          |
| Commercial Real Estate - construction | \$ 173   | \$ 173   |
| Commercial Real Estate - other        | 2,151    | 2,851    |
| Commercial                            | -        | -        |
| Consumer:                             |          |          |
| Consumer - real estate                | 7        | 28       |
| Consumer - other                      | -        | 1        |
| Residential:                          |          |          |
| Residential                           | 1,071    | 1,810    |
| Total                                 | \$ 3,402 | \$ 4,863 |

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 \$2.4 million of its impaired loans as troubled debt restructurings as of September 30, 2013. There were no commitments to extend credit to borrowers with loans classified as troubled debt restructurings as of September 30, 2013 and December 31, 2012.

For the three months ended September 30, 2013 the Company did not have any new troubled debt restructurings or troubled debt restructurings that subsequently defaulted.

| Troubled Debt Restructurings          | Troubled Debt Restructurings                  |  |   | Troubled Debt Restructurings that Subsequently Defaulted |   |
|---------------------------------------|---|--|---|--|---|
|                                       | For the three months ended September 30, 2012 |  |   | For the three months ended September 30, 2012            |   |
|                                       | Number of Loans                               | Pre-modification outstanding recorded investment<br>(dollars in thousands) | Post-modification outstanding recorded investment<br>(dollars in thousands) | Number of Loans  | Recorded Investment<br>(dollars in thousands) |
| Commercial Real Estate - Construction | -   | \$ -   | \$ -  | -  | \$ -  |
| Commercial Real Estate - Other        | -   | -  | -   | -  | -   |
| Commercial - non real estate          | 2   | 1,914  | 1,454   | -  | -   |
| Residential                           | -   | -  | -   | -  | -   |
| Total                                 | 2   | \$ 1,914   | \$ 1,454  | -  | \$ -  |

| Troubled Debt Restructurings          | Troubled Debt Restructurings                 |  |   | Troubled Debt Restructurings that Subsequently Defaulted |   |
|---------------------------------------|--|--|---|--|---|
|                                       | For the nine months ended September 30, 2013 |  |   | For the nine months ended September 30, 2013             |   |
|                                       | Number of Loans                              | Pre-modification outstanding recorded investment<br>(dollars in thousands) | Post-modification outstanding recorded investment<br>(dollars in thousands) | Number of Loans  | Recorded Investment<br>(dollars in thousands) |
| Commercial Real Estate - Construction | -  | \$ -   | \$ -  | -  | \$ -  |
| Commercial Real Estate - Other        | 2  | 2,442  | 2,434   | -  | -   |
| Consumer - Real Estate                | -  | -  | -   | -  | -   |
| Residential                           | 2  | 331  | 268   | 1  | 190   |
| Total                                 | 4  | \$ 2,773   | \$ 2,702  | 1  | \$ 190  |

| Troubled Debt Restructurings             | Troubled Debt Restructurings                    |   | Troubled Debt Restructurings that<br>Subsequently<br>Defaulted                           |                    |   |
|--|---|---|--|--------------------|---|
|  | For the nine months ended September 30,<br>2012 |   | For the nine months ended<br>September 30, 2012  |                    |   |
|  | Number<br>of<br>Loans                           | Pre-modification<br>outstanding<br>recorded<br>investment<br><br>(dollars in thousands) | Post-modification<br>outstanding<br>recorded<br>investment<br><br>(dollars in thousands) | Number<br>of Loans | Recorded<br>Investment<br><br>(dollars in<br>thousands) |
| Commercial Real Estate -<br>Construction | -   | \$ -  | \$ -   | -                  | \$ -  |
| Commercial Real Estate - Other           | -   | -   | -  | 1                  | 63  |
| Commercial - non real estate             | 4   | 3,542   | 3,052  | -                  | -   |
| Residential                              | -   | -   | -  | -                  | -   |
| Total                                    | 4   | \$ 3,542  | \$ 3,052   | 1                  | \$ 63   |

For the majority of the Bank's impaired loans, the Bank will apply the observable market price 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, 2013 and December 31, 2012:

| Impaired Loans<br>As of September 30, 2013 | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | For the Three Months           | For the Nine Months            | Average<br>Recorded<br>Investment<br>(dollars in thousands) | Interest<br>Income<br>Recognized<br>(dollars in thousands) | Average<br>Recorded<br>Investment<br>(dollars in thousands) | Interest<br>Income<br>Recognized<br>(dollars in thousands) |
|--|--------------------------------|------------------------|----------------------|--------------------------------|--------------------------------|---|--|---|--|
|  |                                |                        |                      | Ended<br>September 30,<br>2013 | Ended<br>September 30,<br>2013 |   |  |   |  |
| With no related allowance recorded:        |                                |                        |                      |                                |                                |   |  |   |  |
| Commercial                                 | \$-                            | \$ -                   | \$ -                 | \$ -                           | \$ -                           | \$ -  | \$ -   | \$ -  | \$ -   |
| Commercial Real Estate - Construction      | 1,589                          | 173                    | -                    | 173                            | -                              | 173   | -  | 173   | -  |
| Commercial Real Estate - Other             | 4,064                          | 4,064                  | -                    | 4,189                          | 56                             | 4,065   | 148  | 4,065   | 148  |
| Consumer - Real Estate                     | 8                              | 7                      | -                    | 9                              | -                              | 7   | -  | 7   | -  |
| Consumer - Other                           | -                              | -                      | -                    | -                              | -                              | -   | -  | -   | -  |
| Residential                                | 1,595                          | 1,169                  | -                    | 1,296                          | -                              | 1,170   | -  | 1,170   | -  |
| With a specific allowance recorded:        |                                |                        |                      |                                |                                |   |  |   |  |
| Commercial                                 | -                              | -                      | -                    | -                              | -                              | -   | -  | -   | -  |
| Commercial Real Estate - Construction      | -                              | -                      | -                    | -                              | -                              | -   | -  | -   | -  |
| Commercial Real Estate - Other             | 2,030                          | 2,030                  | 510                  | 2,030                          | -                              | 2,030   | -  | 2,030   | -  |
| Consumer - Real Estate                     | -                              | -                      | -                    | -                              | -                              | -   | -  | -   | -  |
| Consumer - Other                           | -                              | -                      | -                    | -                              | -                              | -   | -  | -   | -  |
| Residential                                | 73                             | 64                     | 21                   | 64                             | -                              | 64  | -  | 64  | -  |
| Totals:                                    |                                |                        |                      |                                |                                |   |  |   |  |
| Commercial                                 | \$-                            | \$ -                   | \$ -                 | \$ -                           | \$ -                           | \$ -  | \$ -   | \$ -  | \$ -   |
| Commercial Real Estate - Construction      | \$1,589                        | \$ 173                 | \$ -                 | \$ 173                         | \$ -                           | \$ 173  | \$ -   | \$ 173  | \$ -   |
| Commercial Real Estate - Other             | \$6,094                        | \$ 6,094               | \$ 510               | \$ 6,219                       | \$ 56                          | \$ 6,095  | \$ 148   | \$ 6,095  | \$ 148   |
| Consumer - Real Estate                     | \$8                            | \$ 7                   | \$ -                 | \$ 9                           | \$ -                           | \$ 7  | \$ -   | \$ 7  | \$ -   |
| Consumer - Other                           | \$-                            | \$ -                   | \$ -                 | \$ -                           | \$ -                           | \$ -  | \$ -   | \$ -  | \$ -   |
| Residential                                | \$1,668                        | \$ 1,233               | \$ 21                | \$ 1,360                       | \$ -                           | \$ 1,234  | \$ -   | \$ 1,234  | \$ -   |

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| Impaired Loans<br>As of December 31, 2012 | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | For the Three Months           | For the Nine Months            | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|---|--------------------------------|------------------------|----------------------|--------------------------------|--------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   |                                |                        |                      | Ended<br>September 30,<br>2012 | Ended<br>September 30,<br>2012 |                                   |                                  |                                   |                                  |
|   | (dollars in thousands)         |                        |                      | (dollars in thousands)         |                                | (dollars in thousands)            |                                  | (dollars in thousands)            |                                  |
| With no related allowance recorded:       |                                |                        |                      |                                |                                |                                   |                                  |                                   |                                  |
| Commercial                                | \$-                            | \$ -                   | \$ -                 | \$ -                           | \$ -                           | \$ -                              | \$ -                             | \$ -                              | \$ -                             |
| Commercial Real Estate - Construction     | 1,589                          | 173                    | -                    | 173                            | -                              | 173                               | -                                | 173                               | -                                |
| Commercial Real Estate - Other            | 4,869                          | 4,535                  | -                    | 3,206                          | 35                             | 3,309                             | 107                              | 3,309                             | 107                              |
| Consumer - Real Estate                    | 33                             | 28                     | -                    | 29                             | -                              | 31                                | -                                | 31                                | -                                |
| Consumer - Other                          | 1                              | 1                      | -                    | 3                              | -                              | 4                                 | -                                | 4                                 | -                                |
| Residential                               | 1,365                          | 1,194                  | -                    | 1,657                          | -                              | 1,666                             | -                                | 1,666                             | -                                |
| With a specific allowance recorded:       |                                |                        |                      |                                |                                |                                   |                                  |                                   |                                  |
| Commercial                                | -                              | -                      | -                    | -                              | -                              | -                                 | -                                | -                                 | -                                |
| Commercial Real Estate - Construction     | -                              | -                      | -                    | -                              | -                              | -                                 | -                                | -                                 | -                                |
| Commercial Real Estate - Other            | 2,138                          | 2,127                  | 101                  | 2,167                          | 20                             | 2,175                             | 61                               | 2,175                             | 61                               |
| Consumer - Real Estate                    | -                              | -                      | -                    | 96                             | -                              | 96                                | -                                | 96                                | -                                |
| Consumer - Other                          | -                              | -                      | -                    | -                              | -                              | -                                 | -                                | -                                 | -                                |
| Residential                               | 616                            | 616                    | 141                  | 45                             | -                              | 45                                | -                                | 45                                | -                                |
| Totals:                                   |                                |                        |                      |                                |                                |                                   |                                  |                                   |                                  |
| Commercial                                | \$-                            | \$ -                   | \$ -                 | \$ -                           | \$ -                           | \$ -                              | \$ -                             | \$ -                              | \$ -                             |
| Commercial Real Estate - Construction     | \$1,589                        | \$ 173                 | \$ -                 | \$ 173                         | \$ -                           | \$ 173                            | \$ -                             | \$ 173                            | \$ -                             |
| Commercial Real Estate - Other            | \$7,007                        | \$ 6,662               | \$ 101               | \$ 5,373                       | \$ 55                          | \$ 5,484                          | \$ 168                           | \$ 5,484                          | \$ 168                           |
| Consumer - Real Estate                    | \$33                           | \$ 28                  | \$ -                 | \$ 125                         | \$ -                           | \$ 127                            | \$ -                             | \$ 127                            | \$ -                             |
| Consumer - Other                          | \$1                            | \$ 1                   | \$ -                 | \$ 3                           | \$ -                           | \$ 4                              | \$ -                             | \$ 4                              | \$ -                             |
| Residential                               | \$1,981                        | \$ 1,810               | \$ 141               | \$ 1,702                       | \$ -                           | \$ 1,711                          | \$ -                             | \$ 1,711                          | \$ -                             |

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 quarter and year ended September 30, 2013 and September 30, 2012, respectively:

Allowance for Credit Losses and Recorded Investment in Financing Receivables  
For the Three Months Ended September 30, 2013

|                              | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Real Estate | Residential | Unallocated | Total   |
|------------------------------|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|-------------|---------|
| (dollars in thousands)       |                            |                           |            |                            |                         |             |             |         |
| Allowance for credit losses: |                            |                           |            |                            |                         |             |             |         |
| Beginning Balance            | \$-                        | \$ 673                    | \$ 79      | \$ 75                      | \$ 25                   | \$ 839      | \$ -        | \$1,691 |
| Charge-offs                  | -                          | -                         | -          | (33 )                      | (1 )                    | (29 )       | -           | (63 )   |
| Recoveries                   | -                          | 46                        | -          | 2                          | -                       | 85          | -           | 133     |
| Provision                    | -                          | 87                        | (9 )       | 24                         | (4 )                    | (66 )       | -           | 32      |
| Ending Balance               | \$-                        | \$ 806                    | \$ 70      | \$ 68                      | \$ 20                   | \$ 829      | \$ -        | \$1,793 |

For the Nine Months Ended September 30, 2013

|                              | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Real Estate | Residential | Unallocated | Total   |
|------------------------------|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|-------------|---------|
| (dollars in thousands)       |                            |                           |            |                            |                         |             |             |         |
| Allowance for credit losses: |                            |                           |            |                            |                         |             |             |         |
| Beginning Balance            | \$64                       | \$ 579                    | \$ 69      | \$ 99                      | \$ 33                   | \$ 906      | \$ -        | \$1,750 |
| Charge-offs                  | -                          | (85 )                     | -          | (40 )                      | (13 )                   | (397 )      | -           | (535 )  |
| Recoveries                   | -                          | 57                        | -          | 34                         | 5                       | 110         | -           | 206     |
| Provision                    | (64)                       | 255                       | 1          | (25 )                      | (5 )                    | 210         | -           | 372     |
| Ending Balance               | \$-                        | \$ 806                    | \$ 70      | \$ 68                      | \$ 20                   | \$ 829      | \$ -        | \$1,793 |

Loan Balances Individually Evaluated for Impairment  
As of September 30, 2013

|   | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Real Estate | Residential | Unallocated | Total   |
|---|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|-------------|---------|
| (dollars in thousands)                                |                            |                           |            |                            |                         |             |             |         |
| Ending balance: individually evaluated for impairment | \$-                        | \$ 510                    | \$ -       | \$ -                       | \$ -                    | \$ 21       | \$ -        | \$531   |
| Ending balance: loans collectively evaluated for      | \$-                        | \$ 296                    | \$ 70      | \$ 68                      | \$ 20                   | \$ 808      | \$ -        | \$1,262 |

impairment

|   |        |           |           |          |          |           |      |            |
|---|--------|-----------|-----------|----------|----------|-----------|------|------------|
| Ending balance: loans acquired with deteriorated credit quality | \$-    | \$ -      | \$ -      | \$ -     | \$ -     | \$ -      | \$ - | \$ -       |
| Financing Receivables:  |        |           |           |          |          |           |      |            |
| Ending Balance  | \$ 173 | \$ 52,849 | \$ 12,429 | \$ 9,286 | \$ 1,117 | \$ 64,244 | \$ - | \$ 140,098 |
| Ending balance: individually evaluated for impairment           | \$ 173 | \$ 6,094  | \$ -      | \$ 7     | \$ -     | \$ 1,233  | \$ - | \$ 7,507   |
| Ending balance: loans collectively evaluated for impairment     | \$-    | \$ 46,755 | \$ 12,429 | \$ 9,279 | \$ 1,117 | \$ 63,011 | \$ - | \$ 132,591 |
| Ending balance: loans acquired with deteriorated credit quality | \$-    | \$ -      | \$ -      | \$ -     | \$ -     | \$ -      | \$ - | \$ -       |

For the Three Months Ended September 30, 2012

|                              | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Residential | Unallocated | Total        |
|------------------------------|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|--------------|
| (dollars in thousands)       |                            |                           |            |                            |                         |             |              |
| Allowance for credit losses: |                            |                           |            |                            |                         |             |              |
| Beginning Balance            | \$-                        | \$ 770                    | \$ 40      | \$ 140                     | \$ 15                   | \$ 808      | \$ - \$1,773 |
| Charge-offs                  | -                          | (138 )                    | -          | (17 )                      | (20 )                   | (166 )      | - (341 )     |
| Recoveries                   | -                          | 2                         | -          | 6                          | 3                       | 7           | - 18         |
| Provision                    | 35                         | (13 )                     | 36         | 1                          | 36                      | 139         | - 234        |
| Ending Balance               | \$35                       | \$ 621                    | \$ 76      | \$ 130                     | \$ 34                   | \$ 788      | \$ - \$1,684 |

For the Nine Months Ended September 30, 2012

|                              | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Residential | Unallocated | Total        |
|------------------------------|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|--------------|
| (dollars in thousands)       |                            |                           |            |                            |                         |             |              |
| Allowance for credit losses: |                            |                           |            |                            |                         |             |              |
| Beginning Balance            | \$10                       | \$ 393                    | \$ 53      | \$ 146                     | \$ 46                   | \$ 870      | \$ - \$1,518 |
| Charge-offs                  | -                          | (265 )                    | -          | (54 )                      | (29 )                   | (724 )      | - (1,072)    |
| Recoveries                   | -                          | 10                        | -          | 14                         | 8                       | 17          | - 49         |
| Provision                    | 25                         | 483                       | 23         | 24                         | 9                       | 625         | - 1,189      |
| Ending Balance               | \$35                       | \$ 621                    | \$ 76      | \$ 130                     | \$ 34                   | \$ 788      | \$ - \$1,684 |

Loan Balances Individually Evaluated for Impairment  
As of September 30, 2012

|   | Commercial<br>Construction | Commercial<br>Real Estate | Commercial | Consumer<br>Real<br>Estate | Consumer<br>Residential | Unallocated | Total        |
|---|----------------------------|---------------------------|------------|----------------------------|-------------------------|-------------|--------------|
| (dollars in thousands)  |                            |                           |            |                            |                         |             |              |
| Ending balance: individually evaluated for impairment           | \$-                        | \$ 175                    | \$ -       | \$ -                       | \$ 21                   | \$ 5        | \$ - \$201   |
| Ending balance: loans collectively evaluated for impairment     | \$35                       | \$ 446                    | \$ 76      | \$ 130                     | \$ 13                   | \$ 783      | \$ - \$1,483 |
| Ending balance: loans acquired with deteriorated credit quality | \$-                        | \$ -                      | \$ -       | \$ -                       | \$ -                    | \$ -        | \$ - \$-     |

Financing Receivables:



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|   |        |           |          |           |          |           |      |            |
|---|--------|-----------|----------|-----------|----------|-----------|------|------------|
| Ending Balance  | \$487  | \$ 53,081 | \$ 8,414 | \$ 11,561 | \$ 1,276 | \$ 65,552 | \$ - | \$ 140,371 |
| Ending balance: individually evaluated for impairment           | \$ 173 | \$ 2,573  | \$ -     | \$ 174    | \$ 1     | \$ 1,556  | \$ - | \$ 4,477   |
| Ending balance: loans collectively evaluated for impairment     | \$ 314 | \$ 50,508 | \$ 8,414 | \$ 11,387 | \$ 1,275 | \$ 63,996 | \$ - | \$ 135,894 |
| Ending balance: loans acquired with deteriorated credit quality | \$ -   | \$ -      | \$ -     | \$ -      | \$ -     | \$ -      | \$ - | \$ -       |

**Note 5 – 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 6 – 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 three and nine months ended September 30, 2013 the Company awarded no shares under the either the 2006 or the 1996 Stock-Based Incentive Plan. Shares issued under the 2006 Plan 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, 2013 is presented below:

| Options                                   | Shares   | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|---|----------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2013            | 167,620  | \$ 9.53                         | 3.4   | \$ -                      |
| Granted                                   | -        | N/A                             |   |                           |
| Exercised                                 | -        | N/A                             |   |                           |
| Forfeited or expired                      | (4,900 ) | \$ 9.54                         |   |                           |
| Outstanding at September 30, 2013         | 162,720  | \$ 9.53                         | 2.6   | \$ -                      |
| Options Exercisable at September 30, 2013 | 162,720  | \$ 9.53                         | 2.6   | \$ -                      |

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 \$4.43 on September 30, 2013 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, 2013. This amount changes based on the fair market value of the stock.

As of September 30, 2013 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, 2013. In addition, there were no non-vested options as of September 30, 2013.

**Restricted Stock Awards** – As of September 30, 2013 all restricted stock awards have vested, therefore the Company had no unrecognized compensation costs under the Plan. There were 5,304 shares available for future stock award grants as of September 30, 2013.

**Note 7 – 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, 2013, the Company had outstanding commitments to originate loans of \$21.6 million. These commitments include the following:

|  | As of<br>September 30, 2013<br>(dollars in thousands) |
|--|---|
| Commitments to grant loans                 | \$ 9,119  |
| Unfunded commitments under lines of credit | 12,445  |
| Commercial and standby letters of credit   | 59  |

**Note 8 – 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, 2013 and December 31, 2012, 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, 2013

|  | 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 30,<br>2013 |
|--|---|---|--|-------------------------------------|
| Assets   | (dollars in thousands)  |   |  |                                     |
| Investment securities- available-for-sale:       |   |   |  |                                     |
| US Government and agency obligations             | \$-   | \$ 7,075  | \$ -   | \$ 7,075                            |
| Municipal obligations                            | -   | 11,794  | -  | 11,794                              |
| Corporate bonds & other obligations              |   | 1,111   |  | 1,111                               |
| Mortgage-backed securities                       | -   | 30,298  | -  | 30,298                              |
| Equity securities                                | -   | 3   | -  | 3                                   |
| Total investment securities - available-for-sale | \$-   | \$ 50,281   | \$ -   | \$ 50,281                           |

**Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2012**

|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1)<br>(dollars in thousands) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Fair Value as<br>of December<br>31, 2012 |
|---|---|---|--|--|
| <b>Assets</b>   |   |   |  |  |
| Investment securities - available-for-sale:             |   |   |  |  |
| US Government and agency obligations                    | \$ -  | \$ 9,247  | \$ -   | \$ 9,247                                 |
| Municipal obligations                                   | -   | 10,758  | -  | 10,758                                   |
| Corporate securities                                    | -   | 1,150   | -  | 1,150                                    |
| Mortgage-backed securities                              | -   | 29,608  | -  | 29,608                                   |
| Equity securities                                       | -   | 1   | -  | 1  |
| <b>Total investment securities - available-for-sale</b> | <b>\$ -</b>   | <b>\$ 50,764</b>  | <b>\$ -</b>  | <b>\$ 50,764</b>                         |

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, 2012 to September 30, 2013. For the available for sale securities, the Company obtains fair value measurements from an independent third-party service.

The Company has assets that, under certain conditions, are subject to measurement at fair value on a nonrecurring basis. At September 30, 2013 and December 31, 2012, 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, 2013**

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

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|   | 2013<br>(dollars in thousands) |      | (Level 2) |          |
|---|--------------------------------|------|-----------|----------|
| Impaired loans accounted for under ASC 310-10       | \$ 6,267                       | \$ - | \$ -      | \$ 6,267 |
| Other real estate owned -residential mortgages      | 279                            | -    | -         | 279      |
| Other Real estate owned - commercial                | 939                            | -    | -         | 939      |
| Other Repossessed Assets                            | 1,023                          | -    | -         | 1,023    |
| Total assets at fair value on a non-recurring basis |                                |      |           | \$ 8,508 |

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012

|   | Balance<br>at<br>December<br>31,<br>2012<br>(dollars in thousands) | Quoted Prices<br>in<br>Active Markets<br>for Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level 3) |
|---|--|---|---|---|
| Impaired loans accounted for under FASB ASC 310-10  | \$ 6,835   | \$ -  | \$ -  | \$ 6,835  |
| Other real estate owned -residential mortgages      | 947  | -   | -   | 947   |
| Other real estate owned - commercial                | 319  | -   | -   | 319   |
| Other repossessed assets                            | 1,121  | -   | -   | 1,121   |
| Total assets at fair value on a non-recurring basis |  |   |   | \$ 9,222  |

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.

**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.

**REPO Sweep Accounts** - The fair values disclosed for REPO Sweeps are equal to the amount payable on demand at the reporting date (i.e., their carrying amounts).

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

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

| September 30, 2013              | Carrying Value | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value |
|---------------------------------|----------------|---------|---------|---------|----------------------------|
| (dollars in thousands)          |                |         |         |         |                            |
| Financial assets:               |                |         |         |         |                            |
| Cash and cash equivalents       | \$3,537        | \$3,537 | \$-     | \$-     | \$3,537                    |
| Securities available for sale   | 50,281         | -       | 50,281  | -       | 50,281                     |
| Securities held to maturity     | 2,305          | -       | 2,450   | -       | 2,450                      |
| Loans held for sale             | 974            | -       | -       | 974     | 974                        |
| Loans receivable - net          | 138,005        | -       | -       | 137,759 | 137,759                    |
| Federal Home Loan Bank stock    | 3,226          | -       | 3,226   | -       | 3,226                      |
| Accrued interest receivable     | 953            | -       | 953     | -       | 953                        |
| Financial liabilities:          |                |         |         |         |                            |
| Customer deposits               | 158,054        | -       | 159,885 | -       | 159,885                    |
| Federal Home Loan Bank advances | 25,016         | -       | 24,651  | -       | 24,651                     |
| REPO sweep accounts             | 5,560          | -       | 5,560   | -       | 5,560                      |
| Accrued interest payable        | 100            | -       | 100     | -       | 100                        |
|                                 |                |         |         |         |                            |
| December 31, 2012               | Carrying Value | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value |
| (dollars in thousands)          |                |         |         |         |                            |
| Financial assets:               |                |         |         |         |                            |
| Cash and cash equivalents       | \$2,752        | \$2,752 | \$-     | \$-     | \$2,752                    |
| Securities available for sale   | 50,764         | -       | 50,764  | -       | 50,764                     |
| Securities held to maturity     | 2,345          | -       | 2,570   | -       | 2,570                      |
| Loans held for sale             | 79             | -       | -       | 84      | 84                         |
| Loans receivable - net          | 138,912        | -       | -       | 140,877 | 140,877                    |
| Federal Home Loan Bank stock    | 3,266          | -       | 3,266   | -       | 3,266                      |
| Accrued interest receivable     | 970            | -       | 970     | -       | 970                        |
| Financial liabilities:          |                |         |         |         |                            |
| Customer deposits               | 158,350        | -       | 159,335 | -       | 159,335                    |
| Federal Home Loan Bank advances | 26,358         | -       | 26,493  | -       | 26,493                     |
| REPO sweep accounts             | 3,183          | -       | 3,183   | -       | 3,183                      |
| Accrued interest payable        | 100            | -       | 100     | -       | 100                        |

**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, 2013 and December 31, 2012, and the results of operations for the three- and nine-month periods ended September 30, 2013 and 2012. This discussion should be read in conjunction with the interim financial statements and footnotes included herein.

**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, 2013, the Company reported net income of \$182,000, or \$0.06 per basic and diluted share, compared to \$272,000, or \$0.09 per basic and diluted share, for the quarter ended September 30, 2012, a decrease of \$90,000. For the nine months ended September 30, 2013 net income was \$247,000, or \$0.09 per basic and diluted share as compared to \$604,000, or \$0.21 per share, for the same period ended September 30, 2012.

Total assets increased \$41,000, or 0.02%, to \$213.9 million as of September 30, 2013 from \$213.8 million as of December 31, 2012. Investment securities available-for-sale decreased \$483,000, or 1.0%, from December 31, 2012 to September 30, 2013. Cash and cash equivalents increased by \$785,000, while net loans receivable decreased \$907,000 during this time period. In addition, during the nine months ended September 30, 2013 the Company received \$509,000 as a return of our unused FDIC insurance premiums as a result of the expiration of the prepaid assessment

period which began in 2009. Total deposits decreased \$296,000 from December 31, 2012 to September 30, 2013, Federal Home Loan Bank advances decreased \$1.3 million, while REPO sweep accounts increased \$2.4 million and equity declined \$585,000.

## **CRITICAL ACCOUNTING POLICIES**

As of September 30, 2013, 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, 2012. The Company's critical accounting policies are described in the Management's Discussion and Analysis and financial sections of its 2012 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.

## **COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2013 AND DECEMBER 31, 2012**

**Assets:** Total assets increased \$41,000, or 0.02%, to \$213.9 million at September 30, 2013 from \$213.8 million at December 31, 2012. During the nine-month period the following changes occurred: investment securities available for sale decreased \$483,000, or 1.0%, as a result of a decline of \$1.3 million in market value in our portfolio and net loans receivable decreased \$907,000, or 0.07%, to \$138.0 million at September 30, 2013 from \$138.9 million at December 31, 2012. Mortgage loans decreased \$2.3 million despite our continued efforts to grow this portfolio by retaining certain high-quality 10- and 15- year fixed rate residential mortgages as opposed to selling them. In addition, our consumer loan portfolio, consisting mainly of home equity loans, decreased by \$1.3 million and our commercial loans increased \$2.7 million for the nine months ended September 30, 2013.

**Liabilities:** Deposits decreased \$296,000 to \$158.1 million at September 30, 2013 from \$158.4 million at December 31, 2012. The composition of our deposits changed during the nine-month period ended September 30, 2013. We experienced increases of \$2.4 million in statement savings accounts, \$583,000 in money market accounts, \$721,000 in NOW demand deposit accounts and \$744,000 in non-interest bearing demand deposit accounts. Partially offsetting these increases were decreases of \$3.6 million in our traditional certificates of deposit and \$2.2 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 these product during this time period. FHLB advances decreased \$1.3 million to \$25.0 million at September 30, 2013 from \$26.4 million at December 31, 2012. During this same time period, REPO sweep balances increased \$2.4 million.

**Equity:** Stockholders' equity decreased \$585,000 to \$23.8 million at September 30, 2013 from \$24.4 million at December 31, 2012. The decrease was due primarily to a decrease of \$832,000, net of tax, in the unrealized gain on available-for-sale securities, partially offset by net income for the nine-month period of \$247,000.

## RESULTS OF OPERATIONS

### *Three Months Ended September 30, 2013 Compared to Three Months Ended September 30, 2012*

**General:** Net income decreased \$90,000 to \$182,000 for the three months ended September 30, 2013 from \$272,000 for the same period ended September 30, 2012.

**Interest Income:** Interest income was \$2.1 million for the three months ended September 30, 2013, compared to \$2.3 million for the comparable period in 2012. The decrease in interest income was due to a decrease in the average balance of our interest-earning assets resulting from a decrease in the size of our loan portfolio and a decrease in the yield on interest-earning assets. The average balance of mortgage loans decreased \$2.8 million quarter over quarter, as we continued to experience a decline in loan originations despite our continued efforts to retain certain high quality 10- and 15-year mortgages in our loan portfolio. The average balance of non-mortgage loans increased \$443,000 period over period. The decline in the loan portfolio was partially offset by an increase in cash and cash equivalents of \$785,000 for the three months ended September 30, 2013 when compared to the same period in 2012. As a result of the decline in our loan portfolios, the average yield on our interest-earning assets declined 44 basis points from 4.59% for the three-month period ended September 30, 2012 to 4.15% for the same period in 2013.

**Interest Expense:** Interest expense was \$275,000 for the three-month period ended September 30, 2013, compared to \$394,000 for the same period in 2012. The decrease in interest expense for the three-month period was due in part to a \$4.0 million decrease in the average balance of our interest-bearing liabilities and a decrease in our overall cost of funds of 26 basis points period over period. Most notably, the average balance of our FHLB advances decreased \$6.0

million from the three-month period ended September 30, 2013 when compared to the same period in 2012 and the cost of those borrowings decreased 70 basis points from 1.93% to 1.23%, period over period. In addition, the average balance of our certificate of deposits decreased \$5.0 million from the three-month period ended September 30, 2012 as compared to the same period in 2013 and the cost of these deposits decreased 19 basis points period over period. The decrease in certificate of deposit accounts were partially offset by increases of \$2.9 million in money market and NOW demand deposit accounts and \$3.3 million in savings deposit accounts quarter over quarter.

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

|                                      | Quarter ended September 30, 2013<br>Compared to<br>Quarter ended September 30, 2012<br>Increase (Decrease) Due to: |           |           |
|--------------------------------------|--|-----------|-----------|
|                                      | Volume   | Rate      | Total     |
|                                      | (dollars in thousands)   |           |           |
| <b>Interest-earning assets:</b>      |  |           |           |
| Loans receivable                     | \$ (36 )   | \$ (173 ) | \$ (209 ) |
| Investment securities                | -  | (37 )     | \$ (37 )  |
| Other investments                    | (6 )   | 5         | \$ (1 )   |
| Total interest-earning assets        | (42 )  | (205 )    | (247 )    |
| <b>Interest-bearing liabilities:</b> |  |           |           |
| Savings Deposits                     | 1  | -         | 1         |
| Money Market/NOW accounts            | 1  | (1 )      | -         |
| Certificates of Deposit              | (17 )  | (32 )     | (49 )     |
| Deposits                             | (15 )  | (33 )     | (48 )     |
| Borrowed funds                       | (44 )  | (27 )     | (71 )     |
| Total interest-bearing liabilities   | (59 )  | (60 )     | (119 )    |
| Change in net interest income        | \$ 17  | \$ (145 ) | \$ (128 ) |

**Net Interest Income:** Net interest income decreased \$128,000 to \$1.8 million for the three-month period ended September 30, 2013 as compared to the same period in 2012. For the three months ended September 30, 2013, average interest-earning assets decreased \$2.6 million, or 1.3%, to \$198.3 million when compared to the same period in 2012. Average interest-bearing liabilities decreased \$4.0 million, or 2.3%, to \$166.8 million for the quarter ended September 30, 2013 from \$170.8 million for the quarter ended September 30, 2012 as we experienced a shift from interest bearing to non-interest bearing deposits during the period. The yield on average interest-earning assets decreased to 4.15% for the three month period ended September 30, 2013 from 4.59% for the same period ended in 2012. The cost of average interest-bearing liabilities decreased to 0.65% from 0.91% for the three-month periods ended September 30, 2013 and September 30, 2012, respectively. The net interest margin decreased 21 basis points to 3.60% for the three-month period ended September 30, 2013 from 3.81% for same period in 2012.

**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, 2013 was \$32,000 as compared to \$234,000 for the prior year period. Prior to 2012, our provision for loan losses was based on an eight-quarter rolling average of actual net charge-offs adjusted for environmental factors for each segment of loans in our portfolio. Management has decided that eight quarters is no longer reflective of the inherent loss in the loan portfolios. In 2012, we began moving towards a twelve-quarter rolling average of actual net charge-offs by adding an additional quarter of net charge-offs each quarter in 2012. By the end of 2012 we were using a twelve-quarter rolling average. During the quarter ended September 30, 2013, we charged off \$29,000 in mortgage loans as compared to \$166,000 during the quarter ended September 30, 2012. In addition, we recorded no commercial loan charges offs during the three months ended September 30, 2013 in comparison to \$138,000 recorded for the three months ended September 30, 2012. The direct effect of the decrease in charge-offs quarter over quarter resulted in a decline in the general reserve factor applied to the entire pool of mortgage and commercial loans for the quarter ended September 30, 2013, which in turn was a main cause of the decrease in provision period over period. In addition, recoveries on charged off mortgage and commercial loans increased \$74,000 and \$46,000, respectively, for the three-month period ended September 30, 2013 when compared to the same period in 2012. 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 \$459,000 for the three months ended September 30, 2013 from \$803,000 for the three months ended September 30, 2012, related primarily to a decrease of \$286,000 in mortgage banking activities income period over period as mortgage origination activity declined in the nine-months ended September 30, 2013. Additionally, gain on sale of investments decreased \$47,000 period over period as we sold municipal bonds for credit reasons during the quarter ended September 30, 2012. Lastly, other income decreased \$45,000 for the three months ended September 30, 2013 compared to the same period in 2012, mainly as the result of a \$65,000 settlement of a lawsuit related to a troubled credit that was received during the three months ended September 30, 2012.

**Non-Interest Expense:** Non-interest expense was \$2.0 million for the three-months ended September 30, 2013 as compared to \$2.1 million for the same period in 2012. Compensation and employee benefit expense decreased \$65,000 period over period as we reduced staffing, suspended our accrual of the elective contribution to our 401(k) plan and reduced health insurance premiums as a result of self insuring deductibles for employee insurance coverage period over period. This decrease is partially offset by an increase of \$30,000 in other expenses associated with problem loans and bank-owned properties period over period.

**Income Taxes:** The Company recorded no federal income tax benefit for the three months ended September 30, 2013 compared to tax expense of \$137,000 for the three months ended September 30, 2012.

*Nine Months Ended September 30, 2013 Compared to Nine Months Ended September 30, 2012*

**General:** Net income decreased \$357,000 to \$247,000 for the nine months ended September 30, 2013 from \$604,000 for the same period ended September 30, 2012. This decrease is attributed to a decrease in federal income tax benefit relating to the reversal of a partial recovery of our deferred tax asset valuation allowance that was established in 2009.

**Interest Income:** Interest income was \$6.2 million for the nine months ended September 30, 2013, compared to \$7.1 million for the comparable period in 2012. This decrease of \$828,000, or 11.7%, in interest income was due in large part to a decrease of 45 basis points in the yield on interest earning assets to 4.25% for the nine-month period ended September 30, 2013 as compared to 4.70% for the same period in 2012. The decrease in yield was a result of a \$1.6 million decrease in average balances of mortgage loans and a decrease of \$2.0 million in average balance of available-for-sale securities period over period.

**Interest Expense:** Interest expense was \$881,000 for the nine-month period ended September 30, 2013 compared to \$1.3 million for the same period in 2012. The decrease in interest expense was due primarily to a period over period increase of \$7.5 million in the average balance of core deposits, which serve as a low cost funding source for the Company. In addition, we experienced an \$8.0 million decrease in the average balance of FHLB advances for the nine months ended September 30, 2013 when compared to the same period in 2012 with the average rate on those borrowings decreasing 65 basis points to 1.32% for the nine-month period ended September 30, 2013 as compared to the year-earlier period. Lastly, the cost of funds relating to our certificate of deposits decreased 23 basis points to 1.03% nine-month period over nine-month period.

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 September 30, 2013<br>Compared to<br>Nine Months ended September 30, 2012<br>Increase (Decrease) Due to: |           |           |
|--------------------------------------|--|-----------|-----------|
|                                      | Volume   | Rate      | Total     |
|                                      | (dollars in thousands)   |           |           |
| <b>Interest-earning assets:</b>      |  |           |           |
| Loans receivable                     | \$ (112 )  | \$ (506 ) | \$ (618 ) |
| Investment securities                | (36 )  | (184 )    | (220 )    |
| Other investments                    | 4  | 6         | 10        |
| Total interest-earning assets        | (144 )   | (684 )    | (828 )    |
| <b>Interest-bearing liabilities:</b> |  |           |           |
| Savings Deposits                     | 1  | -         | 1         |
| Money Market/NOW accounts            | 5  | (2 )      | 3         |
| Certificates of Deposit              | (47 )  | (119 )    | (166 )    |
| Deposits                             | (41 )  | (121 )    | (162 )    |
| Borrowed funds                       | (229 )   | (14 )     | (243 )    |
| Total interest-bearing liabilities   | (270 )   | (135 )    | (405 )    |
| Change in net interest income        | \$ 126   | \$ (549 ) | \$ (423 ) |

**Net Interest Income:** Net interest income decreased by \$423,000 to \$5.4 million for the nine-month period ended September 30, 2013 compared to the same period in 2012. For the nine months ended September 30, 2013, average interest-earning assets decreased \$4.3 million, or 2.2%, and average interest-bearing liabilities decreased \$6.9 million, or 4.0%, when compared to the same period in 2012. The yield on average interest-earning assets decreased to 4.25% for the nine months ended September 30, 2013 from 4.70% for the same period ended in 2012. The average cost of interest-bearing liabilities decreased to 0.71% from 0.98% for the nine month periods ended September 30, 2013 and September 30, 2012, respectively. The net interest margin decreased 20 basis points to 3.64% for the nine-month period ended September 30, 2013, from 3.84% for the same period in 2012.

**Delinquent Loans and Nonperforming Assets:** Nonperforming assets decreased by \$1.6 million from December 31, 2012 to September 30, 2013 due primarily to sales of real estate owned properties during the nine months ended September 30, 2013.

**Provision for Loan Losses:** The provision for loan losses was \$372,000 for the nine-month period ended September 30, 2013 as compared to \$1.2 million for the comparable period in 2012. As discussed above in the discussion for the three-month period ended September 30, 2013, 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-month period ended September 30, 2013, we added specific reserves of approximately \$190,000 on a commercial credit relationship, that is classified as Troubled Debt Restructuring, and had net charge-offs of approximately \$287,000 on mortgage loans. Additionally we reduced the general reserve factor applied to the entire portfolio of residential mortgages and commercial loans as a result of decreased charge-off history in 2013, and increased our general reserve pool for special mention and substandard commercial credits based on the inherent increased risk in 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:

|   | September<br>30,<br>2013 | December 31,<br>2012 |      |   |
|---|--------------------------|----------------------|------|---|
|   | (dollars in thousands)   |                      |      |   |
| Total non-accrual loans                           | \$ 3,402                 | \$ 4,863             |      |   |
| Accrual loans delinquent 90 days or more:         |                          |                      |      |   |
| One- to four-family residential                   | 85                       | 61                   |      |   |
| Other real estate loans                           | -                        | -                    |      |   |
| Construction                                      | -                        | -                    |      |   |
| Purchased Out-of-State                            | -                        | -                    |      |   |
| Commerical  | -                        | -                    |      |   |
| Consumer & other                                  | -                        | 6                    |      |   |
| Total accrual loans delinquent 90 days or more    | \$ 85                    | \$ 67                |      |   |
| Total nonperforming loans (1)                     | 3,487                    | 4,930                |      |   |
| Total real estate owned-residential mortgages (2) | 279                      | 947                  |      |   |
| Total real estate owned-Commercial (2)            | 939                      | 319                  |      |   |
| Total other repossessed assets (2)                | 1,023                    | 1,121                |      |   |
| Total nonperforming assets                        | \$ 5,728                 | \$ 7,317             |      |   |
| Total nonperforming loans to loans receivable     | 2.49                     | %                    | 3.50 | % |
| Total nonperforming assets to total assets        | 2.68                     | %                    | 3.42 | % |

(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.

|   | Portfolio<br>Balance<br>(in thousands) | Delinquent<br>Loans<br>Over 90 Days | Non-Accrual<br>Loans |
|---|--|-------------------------------------|----------------------|
| At September 30, 2013                     |  |                                     |                      |
| Real estate loans:                        |  |                                     |                      |
| Construction                              | \$ 1,598                               | \$ -                                | \$ 173               |
| One - to four - family                    | 62,819                                 | 85                                  | 1,071                |
| Commercial Mortgages                      | 52,849                                 | -                                   | 2,151                |
| Home equity lines of credit/ Junior liens | 9,286                                  | -                                   | 7                    |
| Commercial loans                          | 12,429                                 | -                                   | -                    |
| Consumer loans                            | 1,117                                  | -                                   | -                    |

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|                           |            |       |          |
|---------------------------|------------|-------|----------|
| Total gross loans         | \$ 140,098 | \$ 85 | \$ 3,402 |
| Less:                     |            |       |          |
| Net deferred loan fees    | (300 )     | (1 )  | (6 )     |
| Allowance for loan losses | (1,793 )   | -     | (400 )   |
| Total loans, net          | \$ 138,005 | \$ 84 | \$ 2,996 |

At December 31, 2012

|  |            |       |          |
|--|------------|-------|----------|
| Real estate loans:                       |            |       |          |
| Construction                             | \$ 3,208   | \$ -  | \$ 173   |
| One - to four - family                   | 65,578     | 61    | 1,810    |
| Commercial Mortgages                     | 52,427     | -     | 2,851    |
| Home equity lines of credit/Junior liens | 10,409     | -     | 28       |
| Commercial loans                         | 8,102      | -     | -        |
| Consumer loans                           | 1,258      | 6     | 1        |
| Total gross loans                        | \$ 140,982 | \$ 67 | \$ 4,863 |
| Less:                                    |            |       |          |
| Net deferred loan fees                   | (320 )     | -     | (5 )     |
| Allowance for loan losses                | (1,750 )   | -     | (346 )   |
| Total loans, net                         | \$ 138,912 | \$ 67 | \$ 4,512 |

**Non-Interest Income:** Non-interest income was \$1.4 million for the nine-month period ended September 30, 2013, a decrease of \$276,000, or 16.9%, from the same period in 2012. The nine-month results in 2013 reflect a decrease of \$388,000 in mortgage banking activities due to reduced refinance activity as compared to the prior year period, and a decline of \$47,000 in gain on sale of investments as a result of the sale of municipal bond due to credit concerns during the nine months ended September 30, 2012. These decreases were partially offset by an increase of \$92,000 in service charges and other fee income mostly related to non-sufficient funds fees and ATM access fees and a \$70,000 reduction in loss on sale of Bank owned real estate when comparing the nine-month periods ended September 30, 2013 and September 30, 2012.

**Non-Interest Expense:** Non-interest expense decreased to \$6.1 million for the nine months ended September 30, 2013 from \$6.5 million for the nine months ended September 30, 2012. For the nine-months ended September 30, 2013 we reduced other expenses by \$135,000 mainly related to lower costs associated with problem loans and bank-owned properties. Period over period we also experienced decreases in occupancy costs of \$30,000 due mainly to decreases in depreciation expense and equipment maintenance, amortization of intangible assets of \$58,000 and salaries and benefits of \$219,000 as we have reduced staffing, suspended our accrual of the elective contribution to the Company's 401(k) plan and reduced health insurance premiums as a result of self-insuring deductibles for employee insurance coverage period over period. These decreases were partially offset by an increase in professional services expense of \$46,000 as we incurred expenses related to the upgrade of our core banking software during the nine months ended September 30, 2013.

**Income Taxes:** At September 30, 2013 the Company did not record any income tax expense or benefit compared to an income tax benefit of \$885,000 for the nine months ended September 30, 2012. The variance of \$885,000 relates to a partial recovery of \$866,000, during the first quarter of 2012, of a valuation allowance for our deferred tax asset (DTA) that was established in 2009. The valuation allowance was recorded against the DTA because management determined that it was more likely than not that some or all of the DTA would not be realized. At March 31, 2012, management reevaluated the Company's valuation allowance related to its DTA. The analysis of the DTA was made to determine the utilization of those tax benefits based upon projected future taxable income. Based upon management's determination and in accordance with the generally accepted accounting principles, management concluded that the utilization of this asset was "more likely than not." Accordingly, as of March 31, 2012, \$866,000 of the valuation allowance was credited to income tax expense. Among the criteria that management considered in evaluating the DTA were: improved core profitability of the Bank in 2010 and 2011; substantial improvement in 2010 and 2011 of non-performing asset levels, which were driving losses in prior years; and positive forecast for taxable income looking forward over the next three years. However, during the fourth quarter of 2012 the \$866,000 was reversed as a result of management's reevaluation of the DTA and determination that it was more likely than not that some or all of the DTA would not be realized during the period. Management's decision to reverse the DTA recovery in the fourth quarter of 2012 was influenced by several factors including a higher than anticipated provision expense recorded throughout the year, lower than expected commercial loan demand and lastly placing two large commercial loans into non-accrual status during the fourth quarter. A valuation allowance of \$3.2 million remains on our current DTA as of September 30, 2013.

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 2032.

## **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, 2013 was \$54.0 million, or 42.6%, compared to \$52.5 million, or 42.5% at December 31, 2012. 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, 2013, the Bank had unused borrowing capacity totaling \$28.9 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, balloon 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, 2013 the Company originated \$21.8 million in residential mortgage loans, of which \$9.4 million were retained in portfolio while the remainder were sold in the secondary market or are being held for sale. This compares to \$36.7 million in originations during the first nine months of 2012 of which \$10.5 million were retained in portfolio. The Company also originated \$17.9 million of commercial loans and \$1.4 million of consumer loans in the first nine months of 2013 compared to \$14.4 million of commercial loans and \$1.5 million of consumer loans for the same period in 2012. Of total loans receivable, excluding loans held for sale, mortgage loans comprised 45.9% and 47.2%, commercial loans 46.7% and 44.5% and consumer loans 7.4% and 8.3% at September 30, 2013 and December 31, 2012, respectively.

Deposits are a primary source of funds for use in lending and for other general business purposes. At September 30, 2013 deposits funded 73.9% of the Company's total assets compared to 74.1% at December 31, 2012. Certificates of deposit scheduled to mature in less than one year at September 30, 2013 totaled \$36.3 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, 2013 the Company had \$25.0 million in FHLB advances. FHLB borrowings as a percentage of total assets were 11.7% at September 30, 2013 as compared to 12.3% at December 31, 2012. The Company has sufficient available collateral to obtain additional advances of \$28.9 million as of September 30, 2013.

## **CAPITAL RESOURCES**

Stockholders' equity at September 30, 2013 was \$23.8 million, or 11.2% of total assets, compared to \$24.4 million, or 11.4% of total assets, at December 31, 2012 (See "Consolidated Statement of Changes in Stockholders' Equity"). 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, 2013. 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, 2013:

|  | Actual<br>Amount<br>(dollars in thousands) | Ratio   | Regulatory<br>Minimum<br>Amount | Ratio  | Minimum to be<br>Well Capitalized<br>Amount | Ratio   |
|--|--|---------|---------------------------------|--------|---|---------|
| Tier 1 (Core) capital ( to adjusted assets)          | \$22,583                                   | 10.58 % | \$8,539                         | 4.00 % | \$10,674                                    | 5.00 %  |
| Total risk-based capital ( to risk-weighted assets)  | \$24,295                                   | 17.74 % | \$10,955                        | 8.00 % | \$13,694                                    | 10.00 % |
| Tier 1 risk-based capital ( to risk weighted assets) | \$22,583                                   | 16.49 % | \$5,477                         | 4.00 % | \$8,216                                     | 6.00 %  |
| Tangible Capital ( to tangible assets)               | \$22,583                                   | 10.58 % | \$3,202                         | 1.50 % | \$4,270                                     | 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 2013 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, 2013**

**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.INSXBRL Taxonomy Extension Schema  
101.SCHXBRL Taxonomy Extension Calculation Linkbase  
101.CALXBRL Taxonomy Extension Label Linkbase  
101.DEFBRL Taxonomy Extension Definition Linkbase  
101.LABXBRL Taxonomy Extension Label Linkbase  
101.PREXBRL Taxonomy Extension Presentation Linkbase

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

**FORM 10-Q**

**Quarter Ended September 30, 2013**

**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 14, 2013

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

Date: November 14, 2013