# Eastern Michigan Financial Corporation

# 2020 ANNUAL REPORT

EASTERN MICHIGAN BANK
125 YEAR ANNIVERSARY

## MISSION STATEMENT

To continue as a progressive and growing community bank, serving our communities by offering a wide range of competitive services for our customers, resulting in a profitable organization, enabling us to build capital, pay appropriate dividends to our stockholders and competitive salaries to our employees.

## CORE VALUES

At Eastern Michigan Bank, we take great pride in being a community bank. At the center of our value system is our core commitment to provide value driven products and courteous service delivered by a caring and professional staff. After all, we're not just in the "banking business," we're in the business of financing people's lives and dreams - a responsibility we don't take lightly.

## OUR PROMISE

We promise our customers they can rely on us to listen to their needs and try to provide solutions. We also promise to always practice discretion and tact when it comes to personal or professional financial issues and to treat our customers with respect, dignity and integrity, all while doing our best to help them reach their financial goals.

### GENERAL INFORMATION

Eastern Michigan Financial Corporation is the holding company for Eastern Michigan Bank, a full service community bank with offices in Croswell, Deckerville, Fort Gratiot, Lakeport, Lexington, Marysville, Port Huron, Ruth and Sandusky.

### INVESTOR RELATIONS CONTACT

Errin M. Levitt, Senior Vice President, Chief Financial Officer
Eastern Michigan Financial Corporation
65 N. Howard Avenue
Croswell, Michigan 48422
810.398.5135

### INDEPENDENT AUDITORS

Rehmann Robson
5800 Gratiot, Suite 201
Saginaw, Michigan 48638
989.799.9580

### CORPORATE HEADQUARTERS

Eastern Michigan Financial Corporation
65 N. Howard Avenue
Croswell, Michigan 48422

### TRANSFER AGENT AND REGISTRAR

Computershare Shareholder Services
P.O. Box 30170
College Station, Texas 77842-3170
800.368.5948

### STOCK SYMBOL

Over-The-Counter Bulletin Board: EFIN

### ANNUAL MEETING

The Eastern Michigan Financial Corporation annual meeting of company shareholders is scheduled for Tuesday, April 20, 2021, and will be held virtually via teleconference.

# 2020 ANNUAL REPORT



**ADMINISTRATIVE OFFICES**
65 N. Howard Avenue
Croswell, Michigan 48422
810.679.2500

**CROSWELL BRANCH**
37 N. Howard Avenue
Croswell, Michigan 48422
810.679.3620

**DECKERVILLE BRANCH**
3636 Main Street
Deckerville, Michigan 48427
810.376.2015

**FORT GRATIOT BRANCH**
3061 Krafft Road
Fort Gratiot, Michigan 48059
810.966.2281

**LAKEPORT BRANCH**
7090 Lakeshore Road
Lakeport, Michigan 48059
810.385.3211

**LEXINGTON BRANCH**
5446 Main Street
Lexington, Michigan 48450
810.359.5353

**LOAN CENTER**
66 N. Howard Avenue
Croswell, Michigan 48422
810.679.2500

**MARYSVILLE BRANCH**
2970 Gratiot Boulevard
Marysville, Michigan 48040
810.364.4854

**PORT HURON BRANCH**
600 Water Street
Port Huron, Michigan 48060
810.987.9777

**RUTH BRANCH**
7004 E. Atwater Road
Ruth, Michigan 48470
989.864.3380

**SANDUSKY BRANCH**
324 S. Sandusky Road
Sandusky, Michigan 48471
810.648.3230

**CORPORATE WEBSITE**
emb.bank

# BOARD OF DIRECTORS

**Earl E. DesJardins, Chairman**
Retired Civil Engineer
BMJ Engineers & Surveyors, Inc., Port Huron

**Timothy M. Ward, Vice Chairman**
Retired Chief Executive Officer
Eastern Michigan Bank, Croswell

**William G. Oldford, Jr., Director**
President and Chief Executive Officer
Eastern Michigan Bank, Croswell

**Karen S. Flanagan, Director**
Farmer
Sandusky

**Bradley D. Apsey, Director**
President
Apsey Funeral Home Inc., Deckerville

**Kathlene M. Partaka, Director**
Retired Executive Vice President, Operations
Eastern Michigan Bank, Croswell

**Patricia W. Ryan, Director**
Retired Partner
Frohm, Kelley, Butler & Ryan, P.C., Port Huron

**Donna M. Niester, Director**
President and Chief Executive Officer
Acheson Ventures, LLC, Port Huron

**John C. Williams, Director**
Retired Superintendent
Electrical & Water Departments, Croswell

**Michael D. Wendling, Director**
Prosecuting Attorney
St. Clair County

## APPOINTMENTS

**Michael D. Wendling**
Director

Michael Wendling was appointed to the Board of Directors of Eastern Michigan Financial Corporation and its subsidiary, Eastern Michigan Bank, in August 2020. Mr. Wendling has served as the St. Clair County Prosecuting Attorney for the last fifteen years. Prior to his election to that position in 2005, he was the Assistant Prosecuting Attorney for Calhoun County (1995-1997), Sanilac County (1997) and St. Clair County (1997-2005). He is distinguished within his field and currently serves on the Executive Board of Directors for the Prosecuting Attorney Association of Michigan of which he was president from 2015 to 2016. He is also a member of the Michigan Association of Chiefs of Police Law Enforcement Accreditation Commission and was appointed by both Governor Snyder and Governor Whitmer to the Commission on Law Enforcement Standards.

Wendling is also active in the local community and currently serves on the Boards of Directors of Blue Water Safe Horizons and the St. Clair County Child Abuse Neglect Council, and is a trustee of the St. Clair County Community Foundation.

# OFFICERS

## RETIREMENTS

**Timothy M. Ward**
Retired Chief Executive Officer

The Board of Directors and staff of Eastern Michigan Bank ("Bank") would like to congratulate Tim Ward on his retirement as Chief Executive Officer (CEO). Mr. Ward has served as the CEO of Eastern Michigan Bank since 2005. During his time with the Bank, Tim also served on many local boards and committees, including the Community Foundation of St. Clair County, St. Joseph Mercy Hospital, SC4 Foundation, Economic Development Alliance of St. Clair County, St. Clair County Board of Commissioners, St. Clair County Parks and Recreation, Mid City Nutrition, Blue Water Area YMCA, Lakeshore Surgery Center and the Port Huron Golf Club. He currently represents northeastern St. Clair County on the St. Clair County Road Commission and Board of Public Works. Tim continues his association and dedication to Eastern Michigan Bank as Vice Chairman of the Board of Directors of both Eastern Michigan Bank and Eastern Michigan Financial Corporation.

## NEW MANAGEMENT TEAM

February 2020 saw some familiar faces in new roles on our senior management team.

**William G. Oldford, Jr., Director**
President and Chief Executive Officer

President Will Oldford was appointed President and Chief Executive Officer, assuming the role of CEO from Tim Ward, who retired last year but remains on the Board of Directors.

Oldford has more than 20 years' experience in the local banking industry. Prior to joining the Bank, he served as Regional President, Northeast (Thumb) Region of Talmer Bank and Trust as well as managing their wealth management division in Michigan, Ohio, Indiana and Illinois. Before his banking career, he practiced law in California, Illinois and Michigan. Will holds a Bachelor of Arts from the University of Michigan, a Juris Doctor from California Western Law School , a Master of Laws in Taxation from Wayne State University, and recently completed his Master of Business Administration. He also serves as a trustee of the Community Foundation of St. Clair County, chairman of the St. Clair County Community College Foundation, trustee of the St. Clair County Retirement Board, and member of the Lake Huron Hospital Board. Will was born and raised in Lexington.

**Chad Deaner**
Senior Vice President, Chief Lending Officer

Senior Lender Chad Deaner was promoted to Senior Vice President, Chief Lending Officer. Deaner joined the Bank staff in 2016 as Commercial Loan Manager, and was promoted to Senior Lender in 2019. In addition to more than 20 years' experience in the local banking industry, he holds a Bachelor of Science degree in business administration and management from Ferris State University. Chad is active in his local community, currently serving on both the audit committee for the Community Foundation of St. Clair County and the board of the Economic Development Alliance of St. Clair County. He is originally from Memphis, Michigan, and currently lives in Goodells with his family.

**Stacie Bales**
Senior Vice President, Chief Operating Officer

Vice President, Operations Stacie Bales was promoted to Senior Vice President, Chief Operating Officer. Bales has been a member of the Bank's team since 2001, serving as Human Resources Assistant, Administrative Assistant, Administrative Specialist and Bank Secrecy Act officer. Stacie has an associate degree in business from St. Clair County Community College and is in her third year of the Graduate School of Banking at University of Wisconsin – Madison. She is a Croswell native and currently resides there with her family.

**Errin Levitt**
Senior Vice President, Chief Financial Officer

Senior Vice President, Chief Financial Officer Errin Levitt joined the Bank's staff in October 2016 as Vice President, Controller. Levitt holds a Bachelor of Business Administration degree with a major in finance from Grand Valley State University and is currently earning her Master of Science in Accountancy from Walsh College. She is also a Croswell native and serves on both the Croswell Board of Review and Croswell Planning and Zoning Committee.

## IN MEMORIAM

**Robert (Bob) Wait**
Past President and Chief Executive Officer

Former President and Chief Executive Officer Robert (Bob) Wait passed away on January 31, 2020. Wait joined the Bank in 1961 when it was still the State Bank of Croswell. Bob was appointed CEO and elected to the Board of Directors in 1968, and in 1979, he was elected President. He retired from Eastern Michigan Bank in December 1994, after 33 years of service, and retired as a Director in 2005.
We extend our deepest sympathies to Bob's family.

# PROMOTIONS AND NEW HIRES

## PROMOTIONS

Kimberly Bowman
Vice President,
Retail Banking Manager

In January 2020, Assistant Vice President, Branch Manager Kimberly Bowman was promoted to Vice President, Retail Banking Manager. In her new role, Bowman will be responsible for multiple facets of overall branch operations, including business development, customer service and risk management.

Kim has seventeen years' experience in the local banking industry and holds a Bachelor of Science from Wayne State University. She is also active in the local community and currently serves as vice president of the Landmark Academy Board of Education, as well as serving on the McLaren Port Huron Women's Wellness advisory board and the Port Huron Township Downtown Development Authority (DDA).

Julie Chapdelaine
Assistant Vice President,
Bank Secrecy Act Officer

In February 2020, Bank Secrecy Act (BSA) Officer Julie Chapdelaine was promoted to Assistant Vice President. Chapdelaine began her career at Eastern Michigan Bank in August 2003 and held the positions of teller, teller trainer and operations specialist before being promoted to Bank Secrecy Act Officer in September 2015. She has an associate degree in business from St. Clair County Community College. In addition to her banking experience, Julie has served as deputy treasurer of Buel Township since 2018.

Melissa Gelinski
Officer, Senior Accountant

In September 2020, Melissa Gelinski was promoted from Accountant to Officer, Senior Accountant. Melissa has been a key member of Eastern Michigan Bank's accounting team since December 2000, serving as Accounting Clerk, Lead Accounting Clerk (2006) and Accountant (2014) before being promoted to her current position. She resides in Croswell with her family.

Alexander Messing
Assistant Vice President,
Commercial Loan Officer

Also in September 2020, Commercial Loan Officer Alexander (Alex) Messing was promoted to Assistant Vice President. Messing joined Eastern Michigan Bank in April of 2016 as a loan officer trainee and was promoted to Commercial Loan Officer in 2017. He serves business and agricultural customers in the Deckerville, Ruth and Sandusky markets. Messing is a graduate of Northwood University and has a Bachelor of Business Administration degree with a major in accounting. Alex is also actively involved is his local community, serving as president of the Deckerville Lions Club and a member of the Board of the Deckerville Education Foundation.

Jessica Simon
Vice President,
Commercial Loan Manager

In July 2020, Vice President, Commercial Loan Officer Jessica Simon was promoted to Commercial Loan Manager. Jessica has been an invaluable member of the Eastern Michigan Bank team for 14 years, working in a variety of lending-related roles before being promoted to Commercial Loan Officer. She holds an associate degree from St. Clair County Community College, a Bachelor of Business Administration degree from Walsh College with a major in accounting, and a Master of Business Administration degree from Purdue University.

Dedicated to serving her community as well, Jessica currently serves as president of the Fort Gratiot Rotary and national president of the National Association of Career Women (NACW). She resides in Croswell with her family.

## NEW HIRES

David Baker joined Eastern Michigan Bank in March 2020 as Assistant Vice President, Branch Manager of the Port Huron office. Baker comes to Eastern with 28 years of experience in the local banking industry, largely in the area of consumer lending. He holds an associate degree from St. Clair County Community College and is a graduate of the American Institute of Banking and the OMEGA Lending School. Dave and his family reside in North Street.

David Baker
Assistant Vice President, Branch Manager

# OFFICERS

## EASTERN MICHIGAN FINANCIAL CORPORATION OFFICERS
**Earl E. DesJardins,** Chairman of the Board
**Timothy M. Ward,** Vice Chairman of the Board
**William G. Oldford, Jr.,** President and Chief Executive Officer
**Stacie L. Bales,** Senior Vice President, Chief Operating Officer
**Chad W. Deaner,** Senior Vie President, Chief Lending Officer
**Errin M. Levitt,** Senior Vice President, Chief Financial Officer

## EASTERN MICHIGAN BANK SENIOR MANAGEMENT OFFICERS
**William G. Oldford, Jr.,** President and Chief Executive Officer
**Stacie L. Bales,** Senior Vice President, Chief Operating Officer
**Chad W. Deaner,** Senior Vie President, Chief Lending Officer
**Errin M. Levitt,** Senior Vice President, Chief Financial Officer

## EASTERN MICHIGAN BANK VICE PRESIDENTS
**Scott R. Badley,** Commercial Loan Officer
**Kimberly C. Bowman,** Retail Banking Manager
**Joseph L. Brown,** Appraiser
**Christopher M. Flann,** Commercial Loan Officer
**Gerald D. Hepfer,** Commercial Loan Officer
**L. Michael O'Vell,** Consumer Loan Manager and Security Officer
**Joseph Pink,** Information Technology Manager and Chief Information Security Officer
**Jessica S. Simon,** Commercial Loan Manager
**Kathleen M. Wurmlinger,** Mortgage Manager

## EASTERN MICHIGAN BANK ASSISTANT VICE PRESIDENTS
**Stefanie M. Abbott,** Deckerville Branch Manager
**Christi A. Agostino-Erd,** Mortgage Loan Officer
**David R. Baker,** Port Huron Branch Manager
**Julie A. Chapdelaine,** Bank Secrecy Act Officer
**Kathi J. Jahn,** Ruth Branch Manager
**Audra L. Levitte,** Human Resources Director
**Alexander J. Messing,** Commercial Loan Officer
**Kim M. Stencel,** Lexington Branch Manager
**Tammy J. Williford,** Marketing and Compliance Officer

## EASTERN MICHIGAN BANK OFFICERS
**Emily A. Campbell,** Fort Gratiot Branch Manager
**Trishette L. Davis,** Croswell Branch Manager
**Rachel L. Galbraith,** Commercial Loan Officer
**Melissa M. Gelinski,** Senior Accountant
**Tracy L. Jackson-Wedge,** Sandusky Branch Manager
**Jennifer M. Briolat,** Lakeport Branch Manager

# BRANCH AND ADMINISTRATIVE STAFF

### CROSWELL BRANCH
**Skye Bolsby,** Assistant Branch Manager
**Talysha VanEenoo,** Head Teller
**Alexess Lynch,** Teller
**Jillian Nichol,** Teller
**Leanne Quade,** Teller

### DECKERVILLE BRANCH
**Jennifer Sampier,** Assistant Branch Manager
**Anna-Marie Peresta,** Head Teller
**Scott Cameron,** Teller, Customer Service Representative

### FORT GRATIOT BRANCH
**Diane Johnson,** Assistant Branch Manager
**Michelle Bodeis,** Head Teller
**Cheryl McCoy,** Teller
**Kayleigh Mifsud,** Teller

### LAKEPORT BRANCH
**Kathleen Saelens,** Assistant Branch Manager
**Karen Louks,** Head Teller
**Leslie Snyder,** Teller

### LEXINGTON BRANCH
**Lisa Hatch,** Assistant Branch Manager
**Christine Raymo,** Head Teller
**Suzanne Hedges,** Teller
**Paula Mullen,** Teller
**Melanie Schoen,** Teller

### MARYSVILLE BRANCH
**Barry Catherines,** Assistant Branch Manager
**Nancy Kulman,** Head Teller
**Terri Herman,** Teller

### PORT HURON BRANCH
**Elizabeth Symon,** Assistant Branch Manager
**Chelsea Grant,** Head Teller
**Stephanie Blake,** Float Head Teller
**Sally Cislo,** Teller
**Joanne Lamar,** Teller

### RUTH BRANCH
**Noelle Mosier,** Assistant Branch Manager
**Jamie Brooks,** Head Teller
**Cheryl Becker,** Teller
**Nicole Wolschleger,** Teller

### SANDUSKY BRANCH
**Megan Hartwick,** Assistant Branch Manager
**Tamira Anderson,** Head Teller
**Mindy Fetting,** Teller
**Roxann Green,** Teller

### LOAN CENTER (CROSWELL)
**Kathleen Breckner,** Mortgage Loan Clerk
**Rebekah Houle,** Credit Analyst
**Ashley Foster,** Commercial Loan Clerk
**Thomas Gallagher,** Credit Clerk
**Amanda Mosher,** Retail Lending Specialist, Senior Underwriter
**Nicki Parker,** Consumer Loan Documentation, Collections Specialist
**Marian Romzek,** Loan Processing Manager
**Katherine Krause,** Loan Support Specialist
**Jasmine Williams,** Commercial Portfolio Officer

### ADMINISTRATIVE STAFF
**Nicole Butler,** Deposit Operations Manager
**Natajsha Day,** Deposit Operations Specialist
**Chelsea DuPree,** Human Resources Generalist
**Jamie Goline,** Deposit Operations Specialist
**Darlene Innes,** Courier
**Ashley Lindke,** Deposit Operations Specialist
**Brett Nemeckay,** Accounting Clerk
**Annemarie Prax-Cornelissen,** Communications Administrator
**Amanda Rennie,** Relationship Banker, Public Funds
**Mechel Smith,** Deposit Operations Specialist

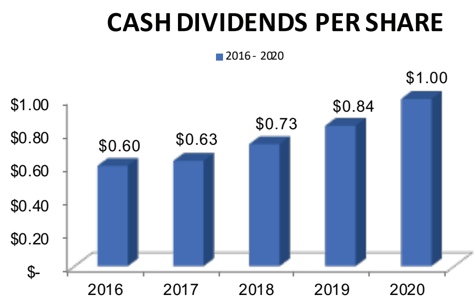
# LETTER TO SHAREHOLDERS

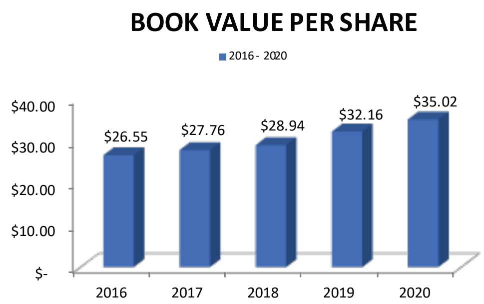
The year 2020 will forever be remembered as the year of Covid. In 2019, as we made our plans for 2020, we certainly did not anticipate the challenges our Bank, our customers, our employees, and our communities would face with a global pandemic. We are proud to report that despite those many challenges, your Company not only survived but in many respects emerged stronger for our experience and efforts, as evidenced by our results.

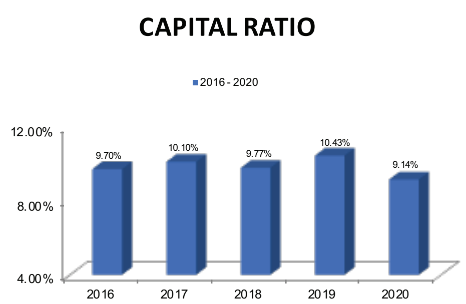
Financial Results

Eastern Michigan Bank ("Bank") celebrated its 125-year anniversary in 2020 with another year of record-breaking results for both the Bank and Eastern Michigan Financial Corporation ("Company"):

- For the fourth year in a row, your Company produced the highest full-year net income in its history: $4.2 million.
- Our tangible book value per share, which is an important measure of financial strength, ended 2020 at $35.02, reflecting an increase of $2.86, or 8.9%, over 2019.
- Compared to 2019, your Company experienced organic loan growth of $42.0 million, or 23.1%, and deposit growth of $89.8 million, or 26.9%.
- We are especially proud of our cost of funds at 8 basis points, one of the lowest cost of funds for any Michigan bank.
- With our loan growth and exposure to agricultural borrowers, credit challenges can be a concern. However, your Company recorded a very low level of charge-offs in 2020 at 0.01%.
- We did experience a drop in our net interest margin as Fed Funds dropped to 8 basis points, and the entire yield curve saw a steep decline. This was an industry-wide occurrence and one that will likely affect all banks' income in 2021.
- In response to the Covid crisis, the Small Business Administration ("SBA") developed the Paycheck Protection Program ("PPP") loan program. We were able to offer these government-guaranteed loans the morning the program became available, while many of our larger competitors were still on the sidelines.
- Discussed in more detail below, our ability to originate and fund SBA PPP loans provided significant fee income and interest income to overcome the negative effects of the reduction in Fed Fund rates and a declining yield curve.



# LETTER TO SHAREHOLDERS (CON'T)

In March of 2020, the Covid-19 pandemic caused a serious disruption of the economy and our local market was no exception. While the Bank's operations were affected, our team was able to respond to the challenges, maintaining our operations and serving our customers. Throughout the year, we quickly adapted our practices to the evolving landscape to keep our staff and customers safe, while providing the services needed by our customers.

In response to the pandemic, Congress passed legislation that included forgivable loans to businesses impacted by the economic disruption. The program is known as the Small Business Administration ("SBA") Paycheck Protection Program ("PPP"). This program permitted businesses to apply for a loan equal to 2.5 times their monthly payroll. In 2020, we were able to originate $62.7 million in SBA PPP loans for businesses in our market. These loans receive a guaranty of the SBA and have an interest rate of 1%. Further, we earn a fee for the origination of these loans and in 2020, we received fees of $2.5 million for our work.

Further, our liquidity grew significantly in 2020, adding $36.5 million or 22.3%. Much of this added liquidity came from stimulus payments, unemployment benefits, and PPP loan proceeds put on deposit with the Bank, coupled with the reduced opportunity for our customers to spend money due to restrictions on business activity. We expect and have planned for the likelihood that some of this liquidity will run off as the economy reopens.

Prior to the economic impact of the pandemic, we had already planned our 2020 purchase of an iconic building in St. Clair County to serve as our loan production and serving center for that market. While we remain committed to Sanilac and Huron County, consolidating our lending production and operations will permit us to increase our market share in this important area. St. Clair County offers significant opportunity for growth and lending diversification compared to our other markets. We expect to have these operations running by this summer.

Finally, we are asking our shareholders to vote to renew our Stock-Based Incentive Plan ("SBIP"). This plan permits the Board to provide compensation to board members and management in the form of stock in Eastern Michigan Financial Corporation. Including stock as part of a compensation package provides an additional incentive for employee performance as the employee will in turn benefit from stock appreciation as performance improves. Our SBIP also provides us with a competitive hiring advantage as many of our employees would not be eligible for this type of compensation at larger banks, and our smaller competitors do not offer this type of plan. We would encourage all of our shareholders to vote in favor of our SBIP as renewal requires approval by at least half of our outstanding shares.

Thank you for being part of our banking family. We want you to know that we expect to continue to perform for our shareholders, our customers, our communities, and our employees, regardless of the challenges with which we are faced. Our optimism continues for our future growth, and we will keep shareholder value a critical metric for our decisions.

Sincerely,

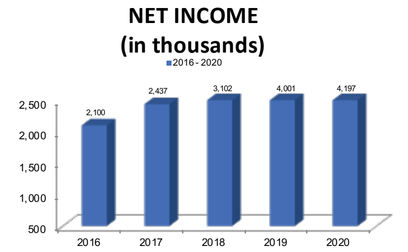
Earl E. DesJardins

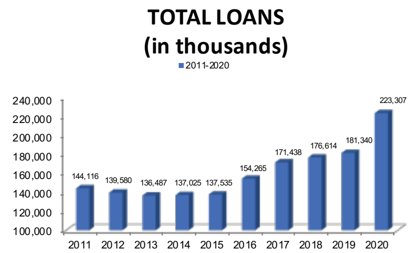
William G. Oldford, Jr.

# 2020 HIGHLIGHTS AND TEN YEAR FINANCIAL PROFILE

## 2020 HIGHLIGHTS

| FOR THE YEAR (in thousands) | 2020 | 2019 | % Change |
|---|---|---|---|
| Net interest income | $ 11,874 | $ 11,919 | -0.4% |
| Non-interest income | 2,855 | 1,765 | 61.8% |
| Non-interest expense | 9,351 | 8,664 | 7.9% |
| Net income | 4,197 | 4,001 | 4.9% |
| **YEAR END (in thousands)** | | | |
| Total assets | $ 467,965 | $ 373,906 | 25.2% |
| Loans, net of unearned interest | 223,307 | 181,340 | 23.1% |
| Allowance for loan losses | 1,835 | 1,574 | 16.6% |
| Deposits | 423,674 | 333,878 | 26.9% |
| Shareholders' equity | 42,897 | 38,752 | 10.7% |
| **PER SHARE** | | | |
| Net income | $ 3.44 | $ 3.33 | 3.3% |
| Book value | 35.02 | 32.16 | 8.9% |
| Cash dividends | 1.00 | 0.84 | 19.0% |
| Number of shares outstanding | 1,224,895 | 1,204,799 | 1.7% |




## TEN YEAR FINANCIAL PROFILE

| FOR THE YEAR (in thousands) | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| Net interest income | $ 11,874 | $ 11,919 | $ 10,582 | $ 9,244 | $ 9,086 | $ 8,306 | $ 8,275 | $ 8,175 | $ 8,500 | $ 8,674 |
| Provision for loan losses | 228 | 155 | 363 | 173 | 79 | (144) | 69 | 283 | 406 | 933 |
| Non-interest income | 2,855 | 1,765 | 1,942 | 2,095 | 1,725 | 1,694 | 1,530 | 1,669 | 1,571 | 1,278 |
| Non-interest expense | 9,351 | 8,664 | 8,377 | 7,637 | 7,856 | 7,448 | 7,291 | 7,223 | 7,395 | 7,132 |
| Income before income taxes | 5,150 | 4,865 | 3,784 | 3,529 | 2,876 | 2,696 | 2,445 | 2,338 | 2,270 | 1,887 |
| Less: income taxes | 953 | 864 | 682 | 1,092 | 776 | 724 | 618 | 518 | 497 | 404 |
| Net income | 4,197 | 4,001 | 3,102 | 2,437 | 2,100 | 1,972 | 1,827 | 1,820 | 1,773 | 1,483 |
| AT YEAR END (in thousands) | | | | | | | | | | |
| Total investment securities | $ 72,123 | $ 103,139 | $ 89,065 | $ 94,370 | $ 106,504 | $ 110,344 | $ 118,054 | $ 113,141 | $ 85,452 | $ 72,389 |
| Restricted investments | 1,116 | 1,116 | 1,056 | 1,056 | 1,056 | 980 | 1,022 | 916 | 916 | 905 |
| Federal funds sold | 386 | 21,128 | 20,448 | 176 | 582 | - | - | - | - | - |
| Total loans | 223,307 | 181,340 | 176,614 | 171,438 | 154,265 | 137,535 | 137,025 | 136,487 | 139,580 | 144,116 |
| Allowance for loan losses | 1,835 | 1,574 | 1,551 | 1,330 | 1,222 | 1,204 | 1,688 | 1,765 | 2,758 | 2,796 |
| Total assets | 467,965 | 373,906 | 355,073 | 329,426 | 324,956 | 293,028 | 283,251 | 279,362 | 270,472 | 259,757 |
| Total deposits | 423,674 | 333,878 | 319,584 | 295,923 | 293,079 | 262,124 | 253,998 | 252,086 | 242,897 | 233,578 |
| Shareholders' equity | 42,897 | 38,752 | 34,477 | 32,649 | 30,643 | 29,572 | 28,394 | 26,489 | 26,616 | 25,103 |
| PER SHARE | | | | | | | | | | |
| Net income | $ 3.44 | $ 3.33 | $ 2.61 | $ 2.36 | $ 1.82 | $ 1.73 | $ 1.61 | $ 1.60 | $ 1.57 | $ 1.31 |
| Book value | 35.02 | 32.16 | 28.94 | 27.76 | 26.55 | 25.81 | 24.97 | 23.32 | 23.52 | 22.24 |
| Cash dividends per share | 1.00 | 0.84 | 0.73 | 0.63 | 0.60 | 0.55 | 0.55 | 0.55 | 0.55 | 0.48 |
| Number of shares outstanding | 1,224,895 | 1,204,799 | 1,191,159 | 1,176,011 | 1,154,370 | 1,145,731 | 1,137,294 | 1,135,669 | 1,131,649 | 1,128,737 |
| Return on average assets | 0.98% | 1.08% | 0.91% | 0.74% | 0.67% | 0.69% | 0.65% | 0.67% | 0.68% | 0.58% |
| Return on average equity | 10.37% | 10.97% | 9.49% | 7.70% | 6.90% | 6.64% | 6.65% | 6.83% | 6.83% | 5.94% |
| Capital ratio | 9.14% | 10.43% | 9.77% | 10.10% | 9.70% | 10.33% | 9.95% | 9.75% | 9.76% | 9.68% |

# CONSOLIDATED BALANCE SHEETS

| (Dollars in thousands except per share data) | Year Ended December 31 2020 | 2019 |
|---|---|---|
| **Assets** | | |
| Cash and demand deposits due from banks | $ 9,116 | $ 6,542 |
| Interest bearing balances due from banks | 118,782 | 20,642 |
| Federal funds sold | 386 | 21,128 |
| **Cash and cash equivalents** | **128,284** | **48,312** |
| Certificates of deposit held in other banks | 24,932 | 23,510 |
| Debt securities | | |
| Available-for-sale | 68,237 | 96,013 |
| Held-to-maturity | 3,886 | 7,126 |
| Restricted, at cost | 1,116 | 1,116 |
| Net loans | 221,472 | 179,766 |
| Accrued interest receivable | 1,286 | 1,336 |
| Premises and equipment, net | 7,244 | 5,456 |
| Bank-owned life insurance | 10,001 | 9,988 |
| Other assets | 1,507 | 1,283 |
| **Total assets** | **$ 467,965** | **$ 373,906** |
| **Liabilities and Shareholders' Equity** | | |
| **Deposits** | | |
| Noninterest-bearing | $ 122,251 | $ 79,300 |
| Interest-bearing | 301,423 | 254,578 |
| **Total deposits** | **423,674** | **333,878** |
| Accrued interest payable and other liabilities | 1,394 | 1,276 |
| **Total liabilities** | **425,068** | **335,154** |
| Commitments and contingencies (Notes 11, 13, and 14) | | |
| **Shareholders' equity** | | |
| Common stock, $5 par value; 3,000,000 shares authorized, 1,224,895 (1,204,799 in 2019) shares issued and outstanding | 6,082 | 6,006 |
| Additional paid-in-capital | 2,299 | 2,261 |
| Retained earnings | 33,433 | 30,459 |
| Deferred compensation | 210 | 78 |
| Accumulated other comprehensive income (loss) | 873 | (52) |
| **Total shareholders' equity** | **42,897** | **38,752** |
| **Total liabilities and shareholders' equity** | **$ 467,965** | **$ 373,906** |

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF INCOME

| (Dollars in thousands except per share data) | Year Ended December 31 2020 | Year Ended December 31 2019 |
|---|---|---|
| **Interest and dividend income** | | |
| Loans (including fees) | $ 9,703 | $ 8,893 |
| Securities | | |
| Taxable | 1,628 | 2,001 |
| Nontaxable | 232 | 337 |
| Other | 54 | 68 |
| Federal funds sold and deposits with banks | 710 | 1,505 |
| **Total interest and dividend income** | **12,327** | **12,804** |
| Interest expense | 453 | 885 |
| **Net interest income** | **11,874** | **11,919** |
| Provision for loan losses | 228 | 155 |
| **Net interest income, after provision for loan losses** | **11,646** | **11,764** |
| **Noninterest income** | | |
| Service charges on deposit accounts | 1,043 | 1,086 |
| Other service charges and fees | 278 | 258 |
| Other | 1,534 | 421 |
| **Total noninterest income** | **2,855** | **1,765** |
| **Noninterest expenses** | | |
| Compensation and benefits | 5,370 | 5,128 |
| Occupancy and equipment | 1,017 | 878 |
| Other | 2,964 | 2,658 |
| **Total noninterest expenses** | **9,351** | **8,664** |
| **Income before federal income taxes** | **5,150** | **4,865** |
| Federal income taxes | 953 | 864 |
| **Net income** | **$ 4,197** | **$ 4,001** |
| **Net income per common share** | | |
| Basic | $ 3.44 | $ 3.33 |
| Diluted | $ 3.39 | $ 3.29 |

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands except per share data)

| | Year Ended December 31 | |
|---|---|---|
| | 2020 | 2019 |
| **Other comprehensive income** | | |
| Unrealized holding gains on available-for-sale securities arising during the year | $ 1,178 | $ 1,405 |
| Reclassification adjustment for net realized (gains) losses included in net income | (7) | 37 |
| **Other comprehensive income before income tax expense** | **1,171** | **1,442** |
| Income tax expense related to other comprehensive income | (247) | (303) |
| **Other comprehensive income** | **924** | **1,139** |
| Net income | 4,197 | 4,001 |
| **Comprehensive income** | **$ 5,121** | **$ 5,140** |

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands except per share data)

| | Common Stock | | Additional Paid-In-Capital | Retained Earnings | Deferred Compensation | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | | | | | |
| **Balances, January 1, 2019** | **$ 1,191,159** | **$ 5,955** | **$ 2,214** | **$ 27,497** | **$ 2** | **$ (1,191)** | **34,477** |
| Comprehensive income | - | - | - | 4,001 | - | 1,139 | 5,140 |
| Common stock options recognized | - | - | 4 | - | - | - | 4 |
| Deferred compensation | 2,912 | - | - | - | 76 | - | 76 |
| Issuance of restricted stock awards | 3,624 | 17 | 33 | - | - | - | 50 |
| Issuance of shares upon exercise of common stock options | 8,404 | 41 | 10 | - | - | - | 51 |
| Repurchase of common stock | (1,300) | (7) | - | (29) | - | - | (36) |
| Cash dividends paid ($0.84 per share) | - | - | - | (1,010) | - | - | (1,010) |
| **Balances, December 31, 2019** | **1,204,799** | **6,006** | **2,261** | **30,459** | **78** | **(52)** | **38,752** |
| Comprehensive income | - | - | - | 4,197 | - | 924 | 5,121 |
| Common stock options recognized | - | - | 4 | - | - | - | 4 |
| Deferred compensation | 5,475 | - | - | - | 132 | - | 132 |
| Issuance of restricted stock awards | 5,699 | 31 | 44 | - | - | - | 75 |
| Issuance of shares upon exercise of common stock options | 8,922 | 45 | (10) | - | - | - | 35 |
| Cash dividends paid ($1 per share) | - | - | - | (1,223) | - | - | (1,223) |
| **Balances, December 31, 2020** | **1,224,895** | **$ 6,082** | **$ 2,299** | **$ 33,433** | **$ 210** | **$ 872** | **$ 42,896** |

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in thousands except per share data) | Year Ended December 31 | |
|---|---|---|
| | 2020 | 2019 |
| **Cash flows from operating activities** | | |
| Net income | $ 4,197 | $ 4,001 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Provision for loan losses | 228 | 155 |
| Depreciation | 403 | 358 |
| Net amortization of investment securities premiums | 766 | 315 |
| Recognized gain on sale of equity security | - | (22) |
| (Gain) loss on available-for-sale debt securities | (7) | 37 |
| Share-based compensation | 211 | 130 |
| Net gain on sale of loans | (832) | (107) |
| Net increase in cash value of bank-owned life insurance | (13) | (235) |
| Deferred income tax benefit | (2) | (27) |
| Origination of loans held for sale | (27,170) | (4,099) |
| Proceeds from loan sales | 28,002 | 4,206 |
| Changes in operating assets and liabilities which provided (used) cash | | |
| Accrued interest receivable | 50 | (65) |
| Other assets | (224) | 28 |
| Accrued interest payable and other liabilities | (126) | 264 |
| **Net cash provided by operating activities** | **5,483** | **4,939** |
| **Cash flows from investing activities** | | |
| Net change in certificates of deposit held in other banks | (1,422) | (17,115) |
| Activity in held-to-maturity securities | | |
| Maturities, prepayments, and calls | 3,176 | 1,927 |
| Activity in available-for-sale securities | | |
| Purchases | (20,545) | (82,935) |
| Maturities, prepayments, calls and sales | 48,797 | 67,263 |
| Proceeds from sale of equity security | - | 783 |
| Purchase of restricted investments | - | (60) |
| Loan principal originations, net | (41,934) | (4,858) |
| Purchases of premises and equipment | (2,191) | (389) |
| **Net used in investing activities** | **(14,119)** | **(35,384)** |
| **Cash flows from financing activities** | | |
| Acceptances and withdrawals of deposits, net | 89,796 | 14,294 |
| Net proceeds from exercise of common stock options | 35 | 51 |
| Repurchase and retirement of common stock | - | (36) |
| Cash dividends paid | (1,223) | (1,010) |
| **Net cash provided by financing activities** | **88,608** | **13,299** |
| **Net increase (decrease) in cash and cash equivalents** | **79,972** | **(17,146)** |
| Cash and cash equivalents, beginning of year | 48,312 | 65,458 |
| **Cash and cash equivalents, end of year** | **$ 128,284** | **$ 48,312** |

The accompanying notes are an integral part of these consolidated financial statements.

(Dollars in thousands except per share data)

## 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Consolidation and Nature of Business***

The accompanying consolidated financial statements include the accounts of ***Eastern Michigan Financial Corporation***, a registered bank holding company (the "Corporation"), and its wholly owned subsidiary, Eastern Michigan Bank (the "Bank"), and the Bank's wholly owned subsidiaries Eastern Michigan Properties, LLC; Eastern Michigan Financial Services, Inc.; and Eastern Michigan Real Estate, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Corporation is independently owned and operates a community bank engaged in the business of retail and commercial banking services through its nine branches located in Sanilac, Huron, and St. Clair counties in Michigan. Active competition, principally from other commercial banks, savings banks and credit unions, exists in all of the Bank's primary markets. The Bank's results of operations can be significantly affected by changes in interest rates or changes in the automotive and agricultural industries which comprise a significant portion of the local economic environment.

***Concentration Risks***

The Bank's primary deposit products are interest- and noninterest-bearing checking accounts, savings accounts and time deposits and its primary lending products are real estate mortgages, commercial and consumer loans. The Bank does not have significant concentrations with respect to any one industry, customer, or depositor.

The Bank is a state chartered bank and a member of the Federal Deposit Insurance Corporation ("FDIC") Bank Insurance Fund. The Bank is subject to the regulations and supervision of the Federal Reserve Board and state regulators and undergoes periodic examinations by these regulatory authorities. The Corporation is also subject to regulations of the Federal Reserve Board governing bank holding companies.

***Economic Uncertainties***

The outbreak of a novel coronavirus (COVID-19), which the World Health Organization declared in March 2020 to be a pandemic, continues to spread throughout the United States of America and the globe. In response, many State Governors have issued temporary Executive Orders that, among other stipulations, effectively prohibit in-person work activities for most industries, businesses, and occupations, having the effect of altering the Bank's normal service delivery methods. As a result, the outbreak has disrupted the Bank's customary operating activities. The extent of the ultimate impact of the pandemic on the Bank's operational and financial performance will depend on various developments, including the duration and spread of the outbreak, and its impact on borrowers, customers, employees, vendors, and regulatory actions, all of which cannot be reasonably predicted at this time. While management reasonably expects the COVID-19 outbreak could negatively impact the Bank's financial condition, operating results, and timing and amounts of cash flows, the related financial consequences, including the effects of potential changes in key accounting estimates, are highly uncertain.

***Recent Events***

The CARES Act, as amended, included an allocation of loans to be issued by financial institutions through the Small Business Administration ("SBA") Paycheck Protection Program ("PPP"). PPP loans are forgivable, in whole or in part, if the proceeds are used for payroll and other permitted purposes in accordance with the requirements of the PPP. These loans carry a fixed rate of 1.00% and a term of two years (loans made before June 5, 2020) or five years (loans made on or after June 5, 2020), if not forgiven, in whole or in part. Payments are deferred until either the date that the SBA remits the amount of forgiveness proceeds to the lender or the date that is 10 months after the last day of the covered period if the borrower does not apply for forgiveness within that 10 month period. Through December 31, 2020, the Bank had originated 575 PPP loans totaling $62.7 million in principal. Fees totaling $2.5 million were collected from the SBA for these loans as of December 31, 2020. The Bank began submitting loan forgiveness in the fourth quarter of 2020. As of December 31, 2020, the remaining balance of PPP loans was $50.7 million. Loan origination fees associated with PPP loans are deferred and amortized into interest income over the contractual period of 24 months or 60 months, as applicable (or expected term method). Upon SBA forgiveness, any remaining unamortized fees are then recognized into interest income. Participation in the PPP had a significant impact on the Bank's asset mix and net interest income in 2020. The PPP program under the CARES Act expired on August 8, 2020, however, the Consolidated Appropriations Act includes additional funds to be made available in 2021 within the Paycheck Protection Program.

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and the reported amounts of income and expenses during the year. Actual results could differ from those estimates. Significant estimates include but are not limited to the determination of the allowance for loan losses.

***Summary of Significant Accounting Policies***

Accounting policies used in preparation of the accompanying consolidated financial statements are in conformity with accounting principles generally accepted in the United States of America. The principles which materially affect the determination of the consolidated financial position and results of operations of the Corporation and its subsidiaries are summarized below.

***Cash and Cash Equivalents***

For the purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and securities purchased under agreements to resell, all of which mature within ninety days. Generally, federal funds are sold for a one-day period. The Corporation maintains deposit accounts in various financial institutions which generally exceed the FDIC insured limits or are not insured. Management does not believe the Corporation is exposed to any significant interest, credit or other financial risk as a result of these deposits.

***Certificates of Deposit Held in Other Banks***

Certificates of deposit held in other banks mature within 3 years and are carried at cost.

***Fair Value Measurements***

Fair value refers to the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants in the market in which the reporting entity transacts such sales or transfers based on the assumptions market participants would use when pricing an asset or liability. Assumptions are developed based upon prioritizing information within a fair value hierarchy that gives the highest priority to quoted prices in active markets (Level 1) and the lowest priority to unobservable data, such as the reporting entity's own data (Level 3).

A description of each category in the fair value hierarchy is as follows:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the estimates of assumptions that market participants would use in pricing the asset or liability.

For a further discussion of Fair Value Measurements, refer to Note 2.

***Investment Securities***

Debt securities that management has the ability and positive intent to hold to maturity are classified as held-to-maturity and are recorded at amortized cost. Debt securities not classified as held-to-maturity are classified as available-for-sale and are recorded at fair value, with unrealized gains and losses, net of the effect of deferred income taxes, recorded in other comprehensive income. Equity securities are carried at fair value, with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains or losses on the sale of debt securities are recorded in investment income on the trade date and are determined using the specific identification method.

Debt securities are reviewed at each reporting period for possible other-than-temporary impairment ("OTTI"). In determining whether an other-than-temporary impairment exists, management must assert that: (a) it does not have the intent to sell the security; and (b) it is more likely than not the Corporation will not have to sell the security before recovery of its cost basis. If these conditions are not met, the Corporation must recognize an other-than-temporary impairment charge through earnings for the difference between the debt security's amortized cost basis and its fair value, and such amount is included in noninterest income. For these debt securities, the Corporation separates the total impairment into the credit loss component and the amount of the loss related to other factors. In order to determine the amount of the credit loss for a debt security, the Corporation calculates the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows management expects to recover. The amount of the total other-than-temporary impairment related to the credit risk is recognized in earnings and is included in noninterest income. The amount of the total other-than-temporary impairment related to other risk factors is recognized as a component of other comprehensive income. For debt securities that have recognized an other-than-temporary impairment through earnings, if through subsequent evaluation there is a significant increase in the cash flow expected, the difference between the amortized cost basis and the cash flows expected to be collected is accreted as interest income.

***Restricted Investments***

The Bank is a member of the Federal Home Loan Bank System and is required to invest in capital stock of the Federal Home Loan Bank of Indianapolis ("FHLB"). The amount of the required investment is based upon the available balance of the Bank's outstanding home mortgage loans or advances from the FHLB and is carried at cost plus the value assigned to stock dividends.

Continued...

(Dollars in thousands except per share data)

The Bank is also a member of the Federal Reserve System and is required to invest in capital stock of the Federal Reserve Bank ("FRB"). The amount of the required investment is based upon the contributed capital of Eastern Michigan Bank and is carried at cost.

In addition, the Bank is a Farmer Mac I seller and is required to invest in capital stock of Farmer Mac. The amount of required investment is determined based upon the consolidated assets at the time of the initial stock purchase and is carried at cost.

***Loans***

Loans that management has the positive intent and ability to hold for the foreseeable future or until maturity or pay-off are generally reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct loan origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

All interest accrued in the current year but not collected for loans that are placed on nonaccrual or are charged off, is reversed against interest income while interest accrued but not collected in prior years is reversed against the allowance for loan losses. The interest on these loans is accounted for on the cash-basis until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. For impaired loans not classified as nonaccrual, interest income is recognized daily as it is earned according to the terms of the loan agreement.

Nonperforming loans of the loan portfolio are comprised of those loans accounted for on a nonaccrual basis, accruing loans contractually past due 90 days or more as to interest or principal payments and loans modified under troubled debt restructurings (nonperforming originated loans).

***Allowance for Loan Losses***

The allowance for loan losses ("allowance") is an estimate of loan losses inherent in the Bank's loan portfolio. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the appropriateness of the total allowance after loan losses. Loan losses are charged off against the allowance when the Bank determines the loan balance to be uncollectible. Cash received on previously charged off amounts is recorded as a recovery to the allowance.

The allowance consists of two primary components, general reserves and specific reserves. For such loans that are classified as impaired, a specific reserve is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of the loan. The general component covers non-impaired loans and is based on historical losses adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Bank over the most recent two years. This actual loss experience is adjusted for economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. These factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired.

Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loans obtained market price, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. A loan is collateral dependent if the repayment is expected to be provided solely by the underlying collateral.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer, home equity, and residential real estate loans for impairment disclosures, unless such loans are the subject of a restructuring agreement or in nonaccrual status.

The Bank evaluates the credit quality of loans in the consumer loan portfolio, based primarily on the aging status of the loan and payment activity. Accordingly, nonaccrual loans, loans past due as to principal or interest 90 days or more and loans modified under troubled debt restructurings of the originated portfolio and acquired loans past due in accordance with the loans' original contractual terms are considered in a nonperforming status for purposes of credit quality evaluation.

Under certain circumstances, the Bank will provide borrowers relief through loan restructurings. A loan restructuring constitutes a troubled debt restructuring ("TDR") if for economic or legal reasons related to the borrower's financial difficulties the Bank grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment as described above.

The Bank assigns a risk rating to all loans except pools of homogeneous loans and periodically performs detailed internal reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by the Bank's regulators. During the internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which the borrowers operate and the fair values of collateral securing the loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into six major categories, defined as follows:

**Pass:** A pass loan is a credit with no existing or known potential weaknesses deserving of management's close attention.

**Watch:** Loans classified as watch have most of the characteristics of a pass loan; however, emerging weaknesses have been detected and warrant additional attention.

**Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, this potential weakness may result in deterioration of the repayment prospects for the loan or of the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

**Substandard:** Loans classified as substandard are not adequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Well defined weaknesses include a borrower's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss:** Loans classified as loss are considered uncollectible and are charged off immediately.

The majority of the Bank's consumer and residential loan portfolios are comprised of secured loans that are evaluated at origination on a centralized basis against standardized underwriting criteria. The ongoing measurement of credit quality of the consumer, home equity, and residential real estate loan portfolios is largely done on an exception basis. If payments are made on schedule, as agreed, then no further monitoring is performed. However, if delinquency occurs, the delinquent loans are turned over to the Bank's collection department for resolution, which generally occurs fairly rapidly and often through repossession and foreclosure. Credit quality for the entire consumer, home equity, and residential real estate loan portfolio is measured by the periodic delinquency rate, nonaccrual amounts and actual losses incurred.

The Bank maintains a separate general valuation allowance for each portfolio segment. These portfolio segments include commercial and industrial, agricultural, real estate related industries, other commercial loans, residential real estate, consumer and other, and home equity with risk characteristics described as follows:

**Commercial and Industrial:** Commercial and industrial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

**Agricultural:** The risk associated with agricultural loans depends on current market prices, weather conditions and other outside factors that are distinct to this segment. These loans, as with commercial and industrial loans, are generally underwritten to existing cash flows of operating businesses. Debt coverage, however, is influenced by different economic indicators than other commercial loans.

**Real Estate Related Industries:** These loans generally possess a higher inherent risk of loss than other loan portfolio segments. Adverse economic developments or an overbuilt market impact real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for the properties to produce sufficient cash flow to service debt obligations.

**Other Commercial:** Other commercial loans are collateralized by real estate and are underwritten based upon existing cash flows of operating businesses. Because debt coverage is provided by business cash flows, trends in real estate values have less impact on this segment than other real estate segments and would be influenced more by unemployment rates and other key economic indicators.

**Residential Real Estate:** The degree of risk in residential mortgage lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Continued...

(Dollars in thousands except per share data)

**Consumer and Other:** The consumer and other loan portfolio is usually comprised of a large number of small loans, including automobile, personal loans, etc. Most loans are made directly for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate the borrowers' capacity to repay their obligations may be deteriorating.

**Home Equity:** As with residential real estate, the degree of risk in home equity lending depends on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion but in addition depends on the value of any loan with a first lien interest. These loans generally possess a higher inherent risk of loss than residential real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be appropriate, ultimate losses may vary from its periodic estimates. The Board of Directors reviews the appropriateness of the allowance monthly, including consideration of the relevant risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators review the appropriateness of the allowance. The regulatory agencies may require changes to the allowance based on their judgment about information available at the time of their examination.

***Loans Held for Sale***

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate and are included in loans on the accompanying consolidated balance sheets, if any. Net unrealized losses, if any, are recognized through a valuation allowance of which the provision is accounted for in the consolidated statements of income.

***Transfers of Financial Assets***

Transfers of financial assets, including mortgage loans held for sale, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when 1) the assets have been legally isolated from the Corporation, 2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and 3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Other than servicing, as disclosed in Note 5, the Corporation has no substantive continuing involvement related to these loans. The Corporation sold to an unrelated third party residential mortgage loans with proceeds of $28,002 and $4,206 during 2020 and 2019, respectively, which resulted in a net gain of $832 and $107 for 2020 and 2019, respectively. Servicing fee income earned on such loans was $83 and $72 for 2020 and 2019, respectively, and is included in other noninterest income on the consolidated statements of income.

***Servicing***

Servicing assets are recognized as separate assets when rights are acquired through the purchase or sale of financial assets. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

Servicing assets or liabilities are amortized in proportion to and over the period of net servicing income or net servicing loss and are assessed for impairment or increased obligation based on the fair value of rights compared to amortized cost at each reporting date. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Bank later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans for others. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan and are recognized as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income, a component of other noninterest income.

***Foreclosed Assets***

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value, less costs to sell, on the date of transfer, establishing a new cost basis. Physical possession of residential real estate property collateralizing a consumer mortgage loan occurs when legal title is obtained upon completion of foreclosure or when the borrower conveys all interest in the property to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the carrying amount or fair value less costs to sell. Revenue and expenses from operations and changes in the valuation allowance are included in expenses from foreclosed assets, net, a component of other noninterest expenses in the consolidated statements of income.

***Premises and Equipment***

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation which is computed principally by the straight-line method based upon the estimated useful lives of the related assets, which range from 3 to 40 years. Major improvements are capitalized and appropriately amortized based upon the useful lives of the related assets or the expected terms of the leases, if shorter, using the straight-line method. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur. Management annually reviews these assets to determine whether carrying values have been impaired.

***Share-Based Compensation Plans***

Compensation cost relating to share-based payment transactions, including common stock option grants, restricted stock awards, and deferred compensation, are measured based on the estimated fair value of the equity or liability instruments issued on the grant dates and is recognized over the service period, which is generally the vesting period.

***Bank-Owned Life Insurance***

The Bank holds life insurance policies purchased on the lives of key officers. In the event of death of one of these individuals, the Bank, as beneficiary of the policies, would receive a specified cash payment equal to the face value of the policy. Such policies are recorded at their cash surrender value, or the amount that can be currently realized as of the balance sheet date. The change in cash surrender value is an adjustment of premiums paid in determining the net expense or income recognized under the contracts for the year and is included in other noninterest income.

***Off-Balance Sheet Credit Related Financial Instruments***

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commercial letters of credit and standby letters of credit. Such financial instruments are considered to be guarantees; however, as the amount of the liability related to such guarantees on the commitment date is considered insignificant, the commitments are generally recorded only when they are funded.

***Business Acquisition Intangibles and Goodwill***

A past business combination included identified amounts related to the valuation of customer deposit relationships (core deposit intangibles), which are being amortized on the straight line method over ten years, and residual goodwill, which is included in other assets. Such goodwill represents the purchase price in excess of identifiable assets and is not amortized but is evaluated by management for impairment at least annually, or at an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value.

***Income Taxes***

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred income tax asset or liability is determined based on the federal income tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in federal income tax rates and laws. Valuation allowances are established, where necessary, to reduce deferred tax assets to the amount expected more likely than not to be realized. Income tax expense is the tax payable or refundable for the year plus or minus the change during the year in deferred tax assets and liabilities.

***Net Income Per Share***

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding less unvested restricted stock during the year. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustments to income that would result from the assumed issuance. Potential common shares that may be issued by the Corporation relate to outstanding common stock options and restricted stock awards, and are determined using the treasury stock method.

***Subsequent Events***

In preparing these consolidated financial statements, the Corporation has evaluated, for potential recognition or disclosure, significant events or transactions that occurred during the period subsequent to December 31, 2020, the most recent balance sheet presented herein, through March 3, 2021, the date these consolidated financial statements were available to be issued. No such events or transactions were identified.

***New Accounting Pronouncement***

***Accounting Standards Update ("ASU") 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,*** and all subsequent amendments to the ASU, was issued with the intention of improving financial reporting by requiring timelier recording of credit losses on loans and certain other financial instruments held by financial institutions. The ASU requires that the measurement of all expected credit losses for financial assets that are measured at amortized cost at the reporting date be based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions will also use forward-looking information to develop their credit loss estimates. The ASU requires enhanced disclosures to assist investors and other financial statement users better understand significant estimates and judgements used in estimating credit losses, as well as the credit quality and underwriting standards of an institution's portfolio. In addition, the ASU amends existing guidance on accounting for credit losses on available-for-sale debt securities, purchased financial assets with credit deterioration, and also applies to certain off-balance sheet credit exposures. The ASU on credit losses will take effect for fiscal years beginning after December 15, 2022. Management is currently evaluating the provisions of the standard to determine the potential impact on the Corporation's consolidated financial statements.

## 2. FAIR VALUE MEASUREMENTS

The Corporation utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Equity securities and available-for-sale debt securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as debt securities held-to-maturity, loans, loans held for sale, foreclosed assets, mortgage servicing rights, goodwill and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write downs of individual assets.

Continued...

(Dollars in thousands except per share data)

Following is a description of the valuation methodologies and key inputs used to measure financial assets and liabilities recorded at fair value, which includes an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

***Investment Securities***

Equity securities and available-for-sale debt securities are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions.

Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, those that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 fair value measurement is based upon quoted prices for similar securities, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. Level 2 securities include U.S. government and federal agency securities, mortgage-backed securities issued by government-sponsored entities, state and municipal bonds, corporate debt securities in active markets, and auction rate money market preferred securities. For Level 3 securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators. Securities classified as Level 3 include securities in less liquid markets.

***Impaired Loans***

The fair value of impaired loans is measured in accordance with accounting standards for subsequent measurement of receivables. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Corporation records the impaired loan as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Corporation records the impaired loan as nonrecurring Level 3.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Corporation believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

***Assets Recorded at Fair Value on a Recurring Basis***

The following tables set forth by level, within the fair value hierarchy, the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31:

| | Assets at Fair Value | | | |
|---|---|---|---|---|
| **2020** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Debt securities available-for-sale: | | | | |
| U.S. treasury notes | $ 508 | $ - | $ - | $ 508 |
| U.S. government and federal agencies | - | 8,033 | - | 8,033 |
| Corporate bonds | 269 | 9,988 | - | 10,257 |
| Agency issued mortgage-backed securities | - | 39,786 | - | 39,786 |
| States and municipals | - | 8,356 | 500 | 8,856 |
| Other asset-backed securities | - | 797 | - | 797 |
| **Total assets at fair value** | **$ 777** | **$ 66,960** | **$ 500** | **$ 68,237** |

| | Assets at Fair Value | | | |
|---|---|---|---|---|
| **2019** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Debt securities available-for-sale: | | | | |
| U.S. treasury notes | $ 504 | $ - | $ - | $ 504 |
| U.S. government and federal agencies | - | 25,358 | - | 25,358 |
| Corporate bonds | - | 15,112 | - | 15,112 |
| Agency issued mortgage-backed securities | - | 34,833 | - | 34,833 |
| States and municipals | - | 16,079 | 553 | 16,632 |
| Other asset-backed securities | - | 3,574 | - | 3,574 |
| **Total assets at fair value** | **$ 504** | **$ 94,956** | **$ 553** | **$ 96,013** |

The following table sets forth a summary of changes in fair value of the Corporation's Level 3 assets measured at fair value on a recurring basis:

| **2020** | **Municipal Securities** |
|---|---|
| Balance of recurring Level 3 assets at January 1, 2020 | $ 553 |
| Total gains or losses (realized/unrealized): | |
| Realized | - |
| Unrealized | (53) |
| **Balance of recurring Level 3 assets at December 31, 2020** | **$ 500** |

| **2019** | **Municipal Securities** |
|---|---|
| Balance of recurring Level 3 assets at January 1, 2019 | $ 606 |
| Total gains or losses (realized/unrealized): | |
| Realized | - |
| Unrealized | (53) |
| **Balance of recurring Level 3 assets at December 31, 2019** | **$ 553** |

Unrealized losses on available-for-sale debt securities, net of deferred taxes, are included in accumulated other comprehensive income (loss) on the consolidated balance sheets.

***Assets Recorded at Fair Value on a Nonrecurring Basis***

The following tables set forth by level, within the fair value hierarchy, the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis as of December 31:

| | Assets of Carrying Value | | | |
|---|---|---|---|---|
| **2020** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Impaired loans (1) | $ - | $ - | $ 2,868 | $ 2,868 |

| | Assets of Carrying Value | | | |
|---|---|---|---|---|
| **2019** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Impaired loans (1) | $ - | $ - | $ 2,854 | $ 2,854 |

(1) Certain impaired loans were remeasured and reported at fair value through a specific valuation allowance. Impaired loans of $2,868 and $2,854 as of December 31, 2020 and 2019, respectively, were reduced by a specific valuation allowance totaling $140 and $145 as of those dates.

Quantitative information about Level 3 fair value measurements is as follows as of December 31, 2020:

| | Level 3 Instruments | | | |
|---|---|---|---|---|
| **Instrument** | **Fair Value** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average)** |
| Impaired loans | $ 2,868 | Discounted Appraisal Value | Discount Applied to Collateral Appraisal | 1-28% (9.5%) |

Quantitative information about Level 3 fair value measurements is as follows as of December 31, 2019:

| | Level 3 Instruments | | | |
|---|---|---|---|---|
| **Instrument** | **Fair Value** | **Valuation Technique** | **Unobservable Input** | **Range** |
| Impaired loans | $ 2,854 | Discounted Appraisal Value | Discount Applied to Collateral Appraisal | 1-32% |

***Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis***

Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, the Corporation uses present value techniques and other valuation methods to estimate the fair values of its financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used. The methodologies for estimating fair value of financial assets and liabilities on a recurring and nonrecurring basis are discussed above.

Continued...

(Dollars in thousands except per share data)

The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis on the Corporation's consolidated balance sheets are as follows at December 31:

| | 2020 | | 2019 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| **Assets** | | | | |
| Cash and cash equivalents | $ 128,284 | $ 128,284 | $ 48,312 | $ 48,312 |
| Certificates of deposit held in other banks | 24,932 | 25,392 | 23,510 | 23,721 |
| Investment securities held-to-maturity | 3,886 | 3,957 | 7,126 | 7,080 |
| Restricted investments | 1,116 | 1,116 | 1,116 | 1,116 |
| Net loans | 221,472 | 220,573 | 179,766 | 178,646 |
| Mortgage servicing rights | 390 | 390 | 253 | 266 |
| Accrued interest receivable | 1,286 | 1,286 | 1,336 | 1,336 |
| **Liabilities** | | | | |
| Noninterest-bearing deposits | $ 122,251 | $ 122,251 | $ 79,300 | $ 79,300 |
| Interest-bearing deposits | 301,423 | 301,416 | 254,578 | 254,032 |
| Accrued interest payable | 8 | 8 | 8 | 8 |

## 3. INVESTMENT SECURITIES

The amortized cost and fair value of non-trading investment securities, including gross unrealized gains and losses, are summarized as follows as of December 31:

| 2020 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Held-to-maturity** | | | | |
| Agency issued mortgage-backed securities | $ 3,386 | $ 68 | $ 1 | $ 3,453 |
| States and municipals | 500 | 4 | - | 504 |
| **Total held-to-maturity** | **3,886** | **72** | **1** | **3,957** |
| **Available-for-sale** | | | | |
| U.S. treasury notes | 503 | 5 | - | 508 |
| U.S. government and federal agencies | 7,981 | 52 | - | 8,033 |
| Corporate bonds | 10,253 | 40 | 36 | 10,257 |
| Agency issued mortgage-backed securities | 38,877 | 950 | 41 | 39,786 |
| States and municipals | 8,710 | 146 | - | 8,856 |
| Other asset-backed securities | 809 | - | 12 | 797 |
| **Total available-for-sale** | **67,133** | **1,193** | **89** | **68,237** |
| **Total securities** | **$ 71,019** | **$ 1,265** | **$ 90** | **$ 72,194** |

| 2019 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Held-to-maturity** | | | | |
| Agency issued mortgage-backed securities | $ 5,355 | $ 1 | $ 53 | $ 5,303 |
| States and municipals | 1,771 | 6 | - | 1,777 |
| **Total held-to-maturity** | **7,126** | **7** | **53** | **7,080** |
| **Available-for-sale** | | | | |
| U.S. treasury notes | 506 | - | 2 | 504 |
| U.S. government and federal agencies | 25,304 | 62 | 8 | 25,358 |
| Corporate bonds | 15,221 | 27 | 136 | 15,112 |
| Agency issued mortgage-backed securities | 34,944 | 132 | 243 | 34,833 |
| States and municipals | 16,547 | 87 | 2 | 16,632 |
| Other asset-backed securities | 3,558 | 16 | - | 3,574 |
| **Total available-for-sale** | **96,080** | **324** | **391** | **96,013** |
| **Total securities** | **$ 103,206** | **$ 331** | **$ 444** | **$ 103,093** |

Investment securities with carrying values of $21,093 and $4,011 at December 31, 2020 and 2019, respectively, were pledged to secure public deposits or for other purposes as permitted or required by law.

The amortized cost and fair value of held-to-maturity and available-for-sale debt securities grouped by contractual maturity at December 31, 2020, are summarized as follows:

| | Maturing | | | | | |
|---|---|---|---|---|---|---|
| | Due in One Year or Less | Due After One Year Through Five Years | Due After Five Years Through Ten Years | Over Ten Years | Securities With Variable Monthly Payments or No Contractual Maturity | Total |
| **Held-to-maturity** | | | | | | |
| Agency issued mortgage-backed securities | $ - | $ - | $ - | $ - | $ 3,386 | $ 3,386 |
| States and municipals | 500 | - | - | - | - | 500 |
| **Total held-to-maturity** | **500** | **-** | **-** | **-** | **3,386** | **3,886** |
| **Available-for-sale** | | | | | | |
| U.S. treasury notes | 503 | - | - | - | - | 503 |
| U.S. government and federal agencies | 7,526 | 455 | - | - | - | 7,981 |
| Corporate bonds | 2,007 | 6,292 | 1,954 | - | - | 10,253 |
| Agency issued mortgage-backed securities | - | - | - | - | 38,877 | 38,877 |
| State and municipals | 4,066 | 2,554 | 909 | 1,181 | - | 8,710 |
| Other asset-backed securities | - | - | - | - | 809 | 809 |
| **Total available-for-sale** | **$ 14,102** | **$ 9,301** | **$ 2,863** | **$ 1,181** | **$ 39,686** | **$ 67,133** |
| **Total amortized cost** | **$ 14,602** | **$ 10,131** | **$ 2,863** | **$ 1,181** | **$ 43,072** | **$ 71,019** |
| **Fair value** | **$ 14,677** | **$ 9,368** | **$ 2,922** | **$ 1,191** | **$ 44,036** | **$ 72,194** |

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

Because of their variable monthly payments, mortgage-backed and other asset-backed securities are not reported by a specific maturity group.

During 2020, proceeds from sales of available-for-sale securities amounted to approximately $5,979. Gross realized gains amounted to approximately $19 and gross realized losses amounted to approximately $12. During 2019, proceeds from sales of available-for-sale securities amounted to approximately $3,711 and realized losses amounted to approximately $37.

Information pertaining to securities with unrealized losses aggregated by investment category and the length of time that individual securities have been in a continuous loss position at December 31 is as follows:

| | Less Than 12 Months | | Over 12 Months | | | Total |
|---|---|---|---|---|---|---|
| 2020 | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| **Securities held-to-maturity** | | | | | | |
| Agency issued mortgage-backed securities | **$ -** | **$ -** | **$ 262** | **$ 1** | **$ 262** | **$ 1** |
| **Securities available-for-sale** | | | | | | |
| Corporate bonds | 2,535 | 7 | 1,971 | 29 | 4,506 | 36 |
| Agency issued mortgage-backed securities | 473 | 6 | 3,640 | 35 | 4,113 | 41 |
| Other asset-backed securities | 797 | 12 | - | - | 797 | 12 |
| **Total securities available-for-sale** | **$ 3,805** | **$ 25** | **$ 5,611** | **$ 64** | **$ 9,416** | **$ 89** |

| | Less Than 12 Months | | Over 12 Months | | | Total |
|---|---|---|---|---|---|---|
| 2019 | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| **Securities held-to-maturity** | | | | | | |
| Agency issued mortgage-backed securities | **$ -** | **$ -** | **$ 4,755** | **$ 53** | **$ 4,755** | **$ 53** |
| **Securities available-for-sale** | | | | | | |
| U.S. treasury notes | $ - | $ - | $ 504 | $ 2 | $ 504 | $ 2 |
| U.S. government and federal agencies | 7,059 | 6 | 1,011 | 2 | 8,070 | 8 |
| Corporate bonds | 7,959 | 41 | 3,853 | 95 | 11,812 | 136 |
| Agency issued mortgage-backed securities | 16,889 | 92 | 11,260 | 151 | 28,149 | 243 |
| States and municipals | 1,083 | 1 | 202 | 1 | 1,285 | 2 |
| **Total securities available-for-sale** | **$ 32,990** | **$ 140** | **$ 16,830** | **$ 251** | **$ 49,820** | **$ 391** |

Continued...

(Dollars in thousands except per share data)

As of December 31, 2020, the Corporation's investment security portfolio consisted of 135 securities, 12 of which were in an unrealized loss position.

As of December 31, 2020 and 2019, management conducted an analysis to determine whether all securities currently in an unrealized loss position should be considered other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

- Has the value of the investment declined more than what is deemed reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable that the issuer will be unable to pay the amount when due?
- Is it more likely than not that the Corporation will not have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended for an unreasonable period of time?

Based on the Corporation's analysis using the above criteria, the fact that management has asserted that it does not have the intent to sell these securities in an unrealized loss position, and that it is more likely than not the Corporation will not be required to sell the securities before recovery of their cost basis, management does not believe that the values of any securities are other-than-temporarily impaired as of December 31, 2020 or 2019.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Bank grants commercial, consumer and residential mortgage loans to customers situated primarily in Sanilac, Huron and St. Clair counties in Michigan. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area. Substantially all of the consumer and residential loans are secured by various items of property, while commercial loans are secured primarily by business assets and personal guarantees; a portion of loans are unsecured.

Loans are summarized as follows at December 31:

| | 2020 | 2019 |
|---|---|---|
| Commercial and industrial | $ 72,341 | $ 32,279 |
| Agricultural | 40,386 | 41,658 |
| Real estate related industries | 37,185 | 29,626 |
| Other commercial | 32,737 | 32,128 |
| Residential real estate | 20,342 | 24,052 |
| Consumer and other | 13,481 | 13,993 |
| Home equity | 6,835 | 7,604 |
| Total loans | 223,307 | 181,340 |
| Allowance for loan losses | 1,835 | 1,574 |
| **Loans, net** | **$ 221,472** | **$ 179,766** |

The allowance for loan losses and loans are as follows for the year ended December 31, 2020:

| | Commercial and Industrial | Agricultural | Real Estate Related Industries | Other Commercial | Residential Real Estate | Consumer and Other | Home Equity | Total |
|---|---|---|---|---|---|---|---|---|
| **Allowance for loan losses** | | | | | | | | |
| Balance at beginning of year | $ 266 | $ 581 | $ 277 | $ 290 | $ 74 | $ 53 | $ 33 | $ 1,574 |
| Provision for loan losses | (37) | (23) | 47 | 144 | 44 | 46 | 7 | 228 |
| Loans charged off | - | - | - | - | - | (23) | - | (23) |
| Recoveries of loans previously charged off | 1 | 10 | 32 | - | - | 13 | - | 56 |
| **Balance at end of year** | **$ 230** | **$ 568** | **$ 356** | **$ 434** | **$ 118** | **$ 89** | **$ 40** | **$ 1,835** |
| **Allowance for loan losses attributable to loans** | | | | | | | | |
| Individually evaluated for impairment | $ - | $ 65 | $ 54 | $ 17 | $ - | $ 3 | $ 1 | $ 140 |
| Collectively evaluated for impairment | 230 | 503 | 302 | 417 | 118 | 86 | 39 | 1,695 |
| **Total allowance for loan losses** | **$ 230** | **$ 568** | **$ 356** | **$ 434** | **$ 118** | **$ 89** | **$ 40** | **$ 1,835** |
| **Loans** | | | | | | | | |
| Individually evaluated for impairment | $ - | $ 4,036 | $ 218 | $ 1,586 | $ 150 | $ 16 | $ 42 | $ 6,048 |
| Collectively evaluated for impairment | 72,341 | 36,350 | 36,967 | 31,151 | 20,192 | 13,465 | 6,793 | 217,259 |
| **Total loans** | **$ 72,341** | **$ 40,386** | **$ 37,185** | **$ 32,737** | **$ 20,342** | **$ 13,481** | **$ 6,835** | **$ 223,307** |

The allowance for loan losses and loans are as follows for the year ended December 31, 2019:

| | Commercial and Industrial | Agricultural | Real Estate Related Industries | Other Commercial | Residential Real Estate | Consumer and Other | Home Equity | Total |
|---|---|---|---|---|---|---|---|---|
| **Allowance for loan losses** | | | | | | | | |
| Balance at beginning of year | $ 262 | $ 426 | $ 220 | $ 475 | $ 77 | $ 54 | $ 37 | $ 1,551 |
| Provision for loan losses | 138 | 155 | 45 | (175) | (3) | (1) | (4) | 155 |
| Loans charged off | (147) | (23) | - | (10) | - | (11) | - | (191) |
| Recoveries of loans previously charged off | 13 | 23 | 12 | - | - | 11 | - | 59 |
| **Balance at end of year** | **$ 266** | **$ 581** | **$ 277** | **$ 290** | **$ 74** | **$ 53** | **$ 33** | **$ 1,574** |
| **Allowance for loan losses attributable to loans** | | | | | | | | |
| Individually evaluated for impairment | $ - | $ 65 | $ 56 | $ 17 | $ 1 | $ 4 | $ 2 | $ 145 |
| Collectively evaluated for impairment | 266 | 516 | 221 | 273 | 73 | 49 | 31 | 1,429 |
| **Total allowance for loan losses** | **$ 266** | **$ 581** | **$ 277** | **$ 290** | **$ 74** | **$ 53** | **$ 33** | **$ 1,574** |
| **Loans** | | | | | | | | |
| Individually evaluated for impairment | $ 428 | $ 3,385 | $ 235 | $ 278 | $ 181 | $ 22 | $ 58 | $ 4,587 |
| Collectively evaluated for impairment | 31,851 | 38,273 | 29,391 | 31,850 | 23,871 | 13,971 | 7,546 | 176,753 |
| **Total loans** | **$ 32,279** | **$ 41,658** | **$ 29,626** | **$ 32,128** | **$ 24,052** | **$ 13,993** | **$ 7,604** | **$ 181,340** |

The following table shows the loans allocated by management's internal risk ratings at December 31, 2020:

| | Commercial Credit Risk Profile by Risk Rating | | | | |
|---|---|---|---|---|---|
| | Commercial and Industrial | Agricultural | Real Estate Related Industries | Other Commercial | Total |
| **Risk Rating** | | | | | |
| Pass | $ 72,341 | $ 27,100 | $ 36,967 | $ 24,443 | $ 160,851 |
| Watch | - | 11,368 | - | 6,705 | 18,073 |
| Special mention | - | 830 | - | 1,341 | 2,171 |
| Substandard | - | 1,088 | 218 | 248 | 1,554 |
| **Total** | **$ 72,341** | **$ 40,386** | **$ 37,185** | **$ 32,737** | **$ 182,649** |

The following table shows the homogeneous loans allocated by payment activity as of December 31, 2020:

| | Consumer Credit Risk Profile by Risk Rating | | | |
|---|---|---|---|---|
| | Residential Real Estate | Consumer and Other | Home Equity | Total |
| **Payment Activity** | | | | |
| Performing | $ 20,192 | $ 13,465 | $ 6,835 | $ 40,492 |
| Non-Performing | 150 | 16 | - | 166 |
| **Total** | **$ 20,342** | **$ 13,481** | **$ 6,835** | **$ 40,658** |

The following table shows the loans allocated by management's internal risk ratings at December 31, 2019:

| | Commercial Credit Risk Profile by Risk Rating | | | | |
|---|---|---|---|---|---|
| | Commercial and Industrial | Agricultural | Real Estate Related Industries | Other Commercial | Total |
| **Risk Rating** | | | | | |
| Pass | $ 31,851 | $ 29,141 | $ 28,335 | $ 29,241 | $ 118,568 |
| Watch | - | 11,377 | - | 2,604 | 13,981 |
| Special mention | 428 | - | 1,056 | - | 1,484 |
| Substandard | - | 1,140 | 235 | 283 | 1,658 |
| **Total** | **$ 32,279** | **$ 41,658** | **$ 29,626** | **$ 32,128** | **$ 135,691** |

The following table shows the homogeneous loans allocated by payment activity as of December 31, 2019:

| | Consumer Credit Risk Profile by Risk Rating | | | |
|---|---|---|---|---|
| | Residential Real Estate | Consumer and Other | Home Equity | Total |
| **Payment Activity** | | | | |
| Performing | $ 23,871 | $ 13,971 | $ 7,599 | $ 45,441 |
| Non-Performing | 181 | 22 | 5 | 208 |
| **Total** | **$ 24,052** | **$ 13,993** | **$ 7,604** | **$ 45,649** |

Continued...

(Dollars in thousands except per share data)

The following table shows an aging analysis of the loan portfolio by time past due as of December 31, 2020:

| | Accruing Interest | | | | |
|---|---|---|---|---|---|
| | Current | 30 - 89 Days Past Due | More Than 90 Days Past Due | Total Nonaccrual | Total Loans |
| Commercial and industrial | $ 72,341 | $ - | $ - | $ - | $ 72,341 |
| Agricultural | 39,385 | - | - | 1,001 | 40,386 |
| Real estate related industries | 37,176 | - | - | 9 | 37,185 |
| Other commercial | 32,387 | - | - | 350 | 32,737 |
| Residential real estate | 20,135 | 57 | - | 150 | 20,342 |
| Consumer and other | 13,463 | 2 | - | 16 | 13,481 |
| Home equity | 6,835 | - | - | - | 6,835 |
| **Total** | **$ 221,722** | **$ 59** | **$ -** | **$ 1,526** | **$ 223,307** |

The following table shows an aging analysis of the loan portfolio by time past due as of December 31, 2019:

| | Accruing Interest | | | | |
|---|---|---|---|---|---|
| | Current | 30 - 89 Days Past Due | More Than 90 Days Past Due | Total Nonaccrual | Total Loans |
| Commercial and industrial | $ 31,739 | $ 112 | $ - | $ 428 | $ 32,279 |
| Agricultural | 40,118 | 495 | - | 1,045 | 41,658 |
| Real estate related industries | 29,605 | - | - | 21 | 29,626 |
| Other commercial | 32,103 | - | - | 25 | 32,128 |
| Residential real estate | 23,871 | - | - | 181 | 24,052 |
| Consumer and other | 13,947 | 24 | - | 22 | 13,993 |
| Home equity | 7,577 | 22 | - | 5 | 7,604 |
| **Total** | **$ 178,960** | **$ 653** | **$ -** | **$ 1,727** | **$ 181,340** |

The following table presents information related to impaired loans as of December 31, 2020:

| | Recorded Balance | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **Loans with no related allowance recorded** | | | | | |
| Agricultural | $ 1,840 | $ 2,420 | $ - | $ 1,449 | $ 48 |
| Real estate related industries | 9 | 540 | - | 15 | 53 |
| Other commercial | 1,170 | 1,266 | - | 812 | - |
| Residential real estate | 150 | 426 | - | 163 | - |
| Consumer and other | 6 | 15 | - | 8 | - |
| Home equity | 5 | 39 | - | 10 | 1 |
| **Loans with an allowance recorded** | | | | | |
| Agricultural | 2,196 | 2,196 | 65 | 2,262 | 112 |
| Real estate related industries | 209 | 209 | 54 | 212 | 21 |
| Other commercial | 416 | 416 | 17 | 334 | 13 |
| Residential real estate | - | - | - | 3 | - |
| Consumer and other | 10 | 11 | 3 | 11 | - |
| Home equity | 37 | 37 | 1 | 40 | 2 |
| **Total impaired loans** | | | | | |
| Agricultural | $ 4,036 | $ 4,616 | $ 65 | $ 3,711 | $ 160 |
| Real estate related industries | 218 | 749 | 54 | 227 | 74 |
| Other commercial | 1,586 | 1,682 | 17 | 1,146 | 13 |
| Residential real estate | 150 | 426 | - | 166 | - |
| Consumer and other | 16 | 26 | 3 | 19 | - |
| Home equity | 42 | 76 | 1 | 50 | 3 |
| **Total** | **$ 6,048** | **$ 7,575** | **$ 140** | **$ 5,319** | **$ 250** |

The following table presents information related to impaired loans as of December 31, 2019:

| | Recorded Balance | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **Loans with no related allowance recorded** | | | | | |
| Commercial and industrial | $ 428 | $ 443 | $ - | $ 218 | $ - |
| Agricultural | 1,057 | 1,602 | - | 1,099 | 5 |
| Real estate related industries | 21 | 613 | - | 27 | - |
| Other commercial | 25 | 80 | - | 59 | - |
| Residential real estate | 176 | 436 | - | 161 | - |
| Consumer and other | 10 | 19 | - | 11 | - |
| Home equity | 16 | 47 | - | 21 | 1 |
| **Loans with an allowance recorded** | | | | | |
| Commercial and industrial | - | - | - | - | - |
| Agricultural | 2,328 | 2,328 | 65 | 1,334 | 128 |
| Real estate related industries | 214 | 214 | 56 | 220 | 13 |
| Other commercial | 252 | 252 | 17 | 644 | 14 |
| Residential real estate | 5 | 5 | 1 | 91 | - |
| Consumer and other | 13 | 13 | 4 | 14 | - |
| Home equity | 42 | 42 | 2 | 45 | 2 |
| **Total impaired loans** | | | | | |
| Commercial and industrial | $ 428 | $ 443 | $ - | $ 218 | $ - |
| Agricultural | 3,385 | 3,930 | 65 | 2,433 | 133 |
| Real estate related industries | 235 | 827 | 56 | 247 | 13 |
| Other commercial | 278 | 332 | 17 | 703 | 14 |
| Residential real estate | 181 | 441 | 1 | 252 | - |
| Consumer and other | 22 | 32 | 4 | 25 | - |
| Home equity | 58 | 89 | 2 | 66 | 3 |
| **Total** | **$ 4,587** | **$ 6,094** | **$ 145** | **$ 3,944** | **$ 163** |

A summary of loans that were modified in troubled debt restructurings during 2020 is as follows:

| | Troubled Debt Restructurings | | |
|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Agricultural | 1 | $ 283 | $ 283 |

The following table details the number of loans and the recorded investment in loans considered to be troubled debt restructurings ("TDRs") by type of modification during 2020:

| | Total Modifications | | | | |
|---|---|---|---|---|---|
| | Principal Deferrals | | Interest Rate Reductions | | |
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment | Total Modifications |
| Agricultural | 1 | $ 283 | - | $ - | $ 283 |

A summary of loans that were modified in troubled debt restructurings during 2019 is as follows:

| | Troubled Debt Restructurings | | |
|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Agricultural | 6 | $ 2,373 | $ 2,229 |

The following table details the number of loans and the recorded investment in loans considered to be troubled debt restructurings ("TDRs") by type of modification during 2019:

| | Total Modifications | | | | |
|---|---|---|---|---|---|
| | Principal Deferrals | | Interest Rate Reductions | | |
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment | Total Modifications |
| Agricultural | 6 | $ 2,373 | - | $ - | $ 2,373 |

There were no TDRs for which there was a payment default whereby the borrower was past due with respect to principal and/or interest for 90 days or more during the 12 months ended December 31, 2020 and 2019, that had been modified during the 12-month period prior to default.

Continued...

(Dollars in thousands except per share data)

The Bank is working with borrowers impacted by COVID-19 and providing modifications to include interest only deferrals or principal and interest deferrals. These modifications are excluded from troubled debt restructuring classification under Section 4013 of the CARES Act or under applicable interagency guidance of the federal banking regulators. As of December 31, 2020, all modifications under the Section 4013 and applicable interagency guidance have reverted to their original payment terms.

## 5. SERVICING

The Bank services loans for others which generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and taxing authorities, and processing foreclosures. Loans serviced as of December 31, 2020 and 2019, were $44,715 and $28,790, respectively; such loans are not included on the consolidated balance sheets.

The following summarizes the carrying value and the changes therein of mortgage servicing rights for the years ended December 31:

| | 2020 | 2019 |
|---|---|---|
| **Mortgage servicing rights** | | |
| Balance at beginning of year | $ 253 | $ 297 |
| Mortgage servicing rights capitalized | 296 | 55 |
| Mortgage servicing rights amortized | (159) | (99) |
| **Balance at end of year** | **$ 390** | **$ 253** |

## 6. PREMISES AND EQUIPMENT

Net premises and equipment consists of the following amounts at December 31:

| | 2020 | 2019 |
|---|---|---|
| Bank premises and land | $ 10,762 | $ 8,715 |
| Furniture and equipment | 4,623 | 4,542 |
| Total | 15,385 | 13,257 |
| Less accumulated depreciation | 8,141 | 7,801 |
| **Premises and equipment, net** | **$ 7,244** | **$ 5,456** |

Depreciation expense was $403 and $358 for 2020 and 2019, respectively.

## 7. DEPOSITS

The composition of deposits is summarized as follows as of December 31:

| | 2020 | 2019 |
|---|---|---|
| Interest-bearing | | |
| NOW accounts | $ 123,628 | $ 106,003 |
| Savings | 89,858 | 66,844 |
| Money market demand | 57,848 | 50,364 |
| Time, $250,000 and over | 2,189 | 2,182 |
| Other time | 27,900 | 29,185 |
| Total interest-bearing | 301,423 | 254,578 |
| Noninterest-bearing demand | 122,251 | 79,300 |
| **Total deposits** | **$ 423,674** | **$ 333,878** |

Scheduled maturities of time deposits for each of the five years succeeding December 31, 2020 and thereafter, are summarized as follows:

| Year | Amount |
|---|---|
| 2021 | $ 15,981 |
| 2022 | 4,080 |
| 2023 | 3,701 |
| 2024 | 2,141 |
| 2025 | 4,168 |
| After | 18 |
| **Total** | **$ 30,089** |

## 8. FEDERAL INCOME TAXES

The provision for federal income taxes consists of the following components for the years ended December 31:

| | 2020 | 2019 |
|---|---|---|
| Currently payable | $ 955 | $ 891 |
| Deferred benefit | (2) | (27) |
| **Income taxes** | **$ 953** | **$ 864** |

A reconciliation between federal income tax expense reported and the amount computed by applying the statutory federal income tax rate to income before federal income taxes is as follows for the years ended December 31:

| | 2020 | 2019 |
|---|---|---|
| Income tax provision at statutory rate | $ 1,082 | $ 1,022 |
| Effect of tax-exempt interest income | (78) | (108) |
| Other, net | (51) | (50) |
| **Income taxes** | **$ 953** | **$ 864** |

The components of the net deferred income tax asset included within other assets in the accompanying consolidated balance sheets (measured at a 21% tax rate) resulted from the following temporary differences between the carrying amounts of assets and liabilities for federal income tax and financial reporting purposes as of December 31:

| | 2020 | 2019 |
|---|---|---|
| **Deferred tax assets** | | |
| Allowance for loan losses | $ 247 | $ 199 |
| Nonaccrual loan interest | 14 | 14 |
| Unrealized loss on available-for-sale securities | - | 14 |
| Market adjustment on equity securities | - | 38 |
| Other | 109 | 60 |
| **Total deferred tax assets** | **370** | **325** |
| **Deferred tax liabilities** | | |
| Unrealized gain on available-for-sale securities | 231 | - |
| Depreciation | 141 | 137 |
| Mortgage servicing rights | 82 | 53 |
| Deferred loan fees/costs | 17 | (12) |
| Other | 21 | 26 |
| **Total deferred tax liabilities** | **492** | **204** |
| **Net deferred tax (liability) asset** | **$ (122)** | **$ 121** |

The Corporation concluded that there are no significant uncertain tax positions requiring recognition in the Corporation's consolidated financial statements based on the evaluation performed for 2017 through 2020, the years which remain subject to examination by major tax jurisdictions as of December 31, 2020. The Corporation does not expect the total amount of unrecognized tax benefits ("UTB") (e.g. tax deductions, exclusions, or credits claimed or expected to be claimed) to significantly change in the next 12 months. The Corporation does not have any amounts accrued for interest and penalties related to UTBs at December 31, 2020 or 2019 and it is not aware of any claims for such amounts by federal or state income tax authorities.

## 9. RELATED PARTY TRANSACTIONS

***Loans***

In the ordinary course of business, the Bank grants loans to certain directors, executive officers and their affiliates. Such loans aggregated to $5,798 and $3,014 at December 31, 2020 and 2019, respectively.

***Deposits***

Deposits of Corporate directors, executive officers and their affiliates were $922 and $690 at December 31, 2020 and 2019, respectively.

## 10. OFF-BALANCE SHEET ACTIVITIES

The Bank 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 letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policy in making commitments, including requirements for collateral, as it does for on-balance-sheet instruments; no significant losses are anticipated as a result of these commitments.

At December 31, 2020 and 2019, the following financial instruments were outstanding whose contract amounts represent credit risk:

| | Contract Amount | |
|---|---|---|
| | 2020 | 2019 |
| Unfunded commitments under lines of credit | $ 53,720 | $ 44,939 |
| Commitments to grant loans | 5,864 | 4,607 |
| Commercial and standby letters of credit | 568 | 759 |

Unfunded commitments under commercial lines of credit, revolving home equity lines of credit and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. The commitments for equity lines of credit may expire without being drawn upon. These lines of credit are uncollateralized and usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed. A majority of such commitments are at fixed rates of interest; a portion is unsecured.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Continued...

(Dollars in thousands except per share data)

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments, if deemed necessary. Guarantees that are not derivative contracts have been recorded on the Corporation's consolidated balance sheets at their fair value at inception. The Bank considers standby letters of credit to be guarantees; however, as the amount of the liability related to such guarantees on the commitment date is not significant, a liability related to such guarantees is not recorded at December 31, 2020 or 2019.

**11. COMMON STOCK ACTIVITY, INCLUDING SHARE-BASED INCENTIVE PLANS**

***Common Stock Repurchases***

During 2019, the Corporation repurchased 1,300 shares of its common stock. The repurchase price in excess of the amounts identified with the original issuance of the common stock was charged entirely to retained earnings. In 2020, there were no such repurchases.

***Share-Based Compensation***

Common Stock Options

The fair value of each option award is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted average assumptions for the year ended December 31, 2020:

| | |
|---|---|
| Risk-free interest rate | 0.93% |
| Expected term | 10 years |
| Expected stock price volatility | 50.61% |
| Dividend yield or expected | 3.73% |

Under the Corporation's 2012 Employee Stock Option Plan (the "Plan"), the Corporation may grant options to its directors, officers and employees for the purchase of up to 128,000 shares of common stock, which can be increased annually up to 3% of the shares outstanding at January 1, 2013, (1,131,649) or 33,949 shares. The exercise of each option equals the market price of the Corporation's stock on the date of grant and an option's maximum term is ten years. The options vest ratably over five years from date of grant. For each of the years ended December 31, 2020 and 2019, the Corporation recognized $4 in compensation expense for stock options. As of December 31, 2020, unrecognized compensation costs related to nonvested awards amounted to $8 and will be recognized over a remaining weighted average period of approximately 6 years.

The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Corporation's history and expectation of dividend payouts.

In general, the Corporation's policy is to issue new shares upon the exercise of a stock option; however, the option holder has the option under the Plan to sell shares of stock owned by the holder to the Corporation to facilitate the exercise of options. A summary of the changes in the status of the Corporation's stock option plan is presented below:

| | Common Shares Subject to Option | Weighted Average Exercise Price | Average Remaining Contractual Terms (Years) |
|---|---|---|---|
| **Outstanding at January 1, 2019** | 122,938 | $ 18.90 | 5.29 |
| Granted | 39,346 | 24.76 | |
| Exercised | (25,122) | 18.98 | |
| Forfeited | (10,947) | 16.96 | |
| **Outstanding at December 31, 2019** | **126,215** | **$ 20.88** | **5.00** |
| Granted | 37,511 | 30.10 | |
| Exercised | (25,025) | 20.81 | |
| **Outstanding at December 31, 2020** | **138,701** | **$ 23.39** | **6.05** |

The fair value of options granted during 2020 and 2019 was $4.59 and $5.00, respectively.

As of December 31, 2020, 138,701 options under the 2012 plan were outstanding at an average exercise price of $23.39 (range of $12.75 - $31.00) of which 77,075 are exercisable.

Shares granted in 2020 and 2019, include 16,103 and 16,726 shares received in connection with the exercise of a "reload" option whereby the grantee tendered shares to pay the exercise price of an option and received a new option to purchase the number of shares of common stock equal to the number of shares tendered to pay the exercise price.

Reload options have an exercise price equal to the estimated fair value as of the date of exercise of the underlying option. The date of grant of the reload option is the date of exercise of the underlying option. The reload option may be exercised one year after it is granted and expires on the date of expiration of the underlying option to which the reload options related.

Restricted Stock Awards

The Plan also authorizes the use of restricted stock awards, which were granted in 2019 and 2018. The fair value of restricted stock awards is estimated by the market price of the Corporation's common stock at the date of grant. Under the provisions of the plan, the Corporation cannot be obligated to "cash-settle" any of the restricted stock awards through redemption. The shares become vested over a 5-year service period. During the period the shares are not vested, the grantee may not sell, assign, transfer or pledge the shares but has all other rights of a shareholder, including the right to receive dividends and the right to vote such shares. Restricted stock is immediately forfeited when the employment of a grantee ceases. Restricted stock activity during 2020 and 2019, is summarized as follows:

| | Number of Shares | Weighted-Average Grant - Date Fair Value per Share |
|---|---|---|
| **Non-vested, January 1, 2019** | **8,126** | **$ 21.99** |
| Granted | 4,524 | 24.25 |
| Vested | (1,733) | 21.93 |
| Cancelled and forfeited | (605) | 22.55 |
| **Non-vested, December 31, 2019** | **10,312** | **22.96** |
| Granted | 6,229 | 28.70 |
| Vested | (2,535) | 22.72 |
| **Non-vested, December 31, 2020** | **14,006** | **$ 25.56** |

Awards are being amortized to expense over the 5-year vesting period. Compensation cost related to restricted stock awards was $75 and $50 for 2020 and 2019, respectively. As of December 31, 2020, there was $237 of total remaining unrecognized compensation cost related to nonvested restricted stock awards granted under the Plan. The cost is expected to be recognized over the next 4 years.

There was an impact of $.05 and $.04 to diluted earnings per share resulting from such common stock equivalents in 2020 and 2019, respectively.

**12. REGULATORY REQUIREMENTS**

**Capital Requirements**

The Corporation (on a consolidated basis) and the Bank are subject to various regulatory capital requirements, including restrictions on dividends, administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, capital and certain off-balance-sheet items as defined in the regulations and calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Failure to meet capital requirements can initiate regulatory action. The final rules related to the implementation of the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III Rules) became effective for the Corporation on January 1, 2016, with full compliance of all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The capital conservation buffer as of December 31, 2020 and 2019 is 2.50%. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital.

Quantitative measurements established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the following table). Management believes, as of December 31, 2020 and 2019, that the Corporation and the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2020 and 2019, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since the notification that management believes have changed the Bank's category. The Corporation's and the Bank's actual capital amounts and ratios as of December 31, 2020 and 2019 are also presented in the table.

Continued...

(Dollars in thousands except per share data)

| December 31, 2020 | Actual Amount | Actual Ratio | Minimum Capital Requirements Amount | Minimum Capital Requirements Ratio | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions Ratio |
|---|---|---|---|---|---|---|
| Total Capital to Risk Weighted Assets | | | | | | |
| Consolidated | $ 43,859 | 22.34 % | $ 20,619 | 10.50 % | N/A | N/A |
| Bank | 42,803 | 21.80 | 20,619 | 10.50 | $ 19,637 | 10.00 % |
| Tier 1 (Core) Capital To Risk Weighted Assets | | | | | | |
| Consolidated | 42,025 | 21.40 | 16,692 | 8.50 | N/A | N/A |
| Bank | 40,968 | 20.86 | 16,692 | 8.50 | 15,710 | 8.00 |
| Common Tier 1 (CET1) | | | | | | |
| Consolidated | 42,025 | 21.40 | 13,746 | 7.00 | N/A | N/A |
| Bank | 40,968 | 20.86 | 13,746 | 7.00 | 12,764 | 6.50 |
| Tier 1 (Core) Capital To Average Assets | | | | | | |
| Consolidated | 42,025 | 9.14 | 18,401 | 4.00 | N/A | N/A |
| Bank | 40,968 | 8.91 | 18,401 | 4.00 | 23,002 | 5.00 |

| December 31, 2019 | Actual Amount | Actual Ratio | Minimum Capital Requirements Amount | Minimum Capital Requirements Ratio | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions Ratio |
|---|---|---|---|---|---|---|
| Total Capital to Risk Weighted Assets | | | | | | |
| Consolidated | $ 40,378 | 18.82 % | $ 22,532 | 10.50 % | N/A | N/A |
| Bank | 39,394 | 18.36 | 22,532 | 10.50 | $ 21,459 | 10.00 % |
| Tier 1 (Core) Capital To Risk Weighted Assets | | | | | | |
| Consolidated | 38,804 | 18.08 | 18,240 | 8.50 | N/A | N/A |
| Bank | 37,821 | 17.62 | 18,420 | 8.50 | 17,167 | 8.00 |
| Common Tier 1 (CET1) | | | | | | |
| Consolidated | 38,804 | 18.08 | 15,021 | 7.00 | N/A | N/A |
| Bank | 37,821 | 17.62 | 15,021 | 7.00 | 13,948 | 6.50 |
| Tier 1 (Core) Capital To Average Assets | | | | | | |
| Consolidated | 38,804 | 10.43 | 14,876 | 4.00 | N/A | N/A |
| Bank | 37,821 | 10.18 | 14,876 | 4.00 | 18,572 | 5.00 |

***Restrictions on Cash and Amounts Due from Banks***

The Bank is required by regulatory agencies to maintain legal cash reserves based on the level of certain customer deposits. There was no required reserve balance at December 31, 2020 or 2019.

***Restrictions on Dividends, Loans and Advances***

Federal and state banking regulations place certain restrictions on the amount of loans or advances that can be extended to the Corporation by the Bank and dividends that can be paid to the Corporation by the Bank. The total amount of dividends which may be paid at any date is generally limited to the retained earnings of the Bank, and loans or advances are limited to 10% of the Bank's capital stock and surplus on a secured basis. In addition, dividends paid by the Bank to the Corporation would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

## 13. CONTINGENCIES

***Litigation***

The Corporation is party to litigation arising during the normal course of business. In the opinion of management, based on consultation with legal counsel, the resolution of such litigation is not expected to have a material effect on the consolidated financial statements.

***Environmental Issues***

As a result of acquiring real estate from foreclosure proceedings, the Corporation is subject to potential claims and possible legal proceedings involving environmental matters. No such claims have been asserted as of December 31, 2020.

## 14. OTHER EMPLOYEE BENEFIT PLANS

***401(k) Plan***

The Bank maintains a deferred compensation plan qualified under Section 401(k) of the Internal Revenue Code. Under this plan, eligible employees are permitted to contribute up to 25% of gross compensation into the retirement plan up to a maximum determined by the Internal Revenue Code; the Bank matches each employee contribution at a rate of up to 50% of the first 6% contributed by the employee. Expenses associated with the plan amounted to $85 and $81 in 2020 and 2019, respectively.

The 401(k) retirement plan also has a defined contribution profit sharing feature that covers substantially all of its employees. Contributions to the plan are based on an employee's earnings, as defined in the plan document. Expenses associated with the plan amounted to $296 and $268 in 2020 and 2019, respectively.

***Deferred Compensation Plan***

In 2018, the Corporation adopted a deferred compensation plan. Pursuant to the terms of the Deferred Compensation Plan, Bank Officers are permitted to defer all or a portion of any annual bonus and receive shares of the Corporation equal to the stock value based on the closing price on the day the bonus is issued. In addition, the participant's account will be credited with additional shares representing 25% bonus shares based on the number of shares credited from the deferral. Board members may also elect to defer any or all of their board fees and receive the same 25% bonus shares, subject to a 3-year vesting. The bonus shares for both deferred annual bonus amounts and deferred directors fees vest after three years of service, death, disability, or upon mandatory retirement from the board. The Deferred Compensation Plan does not allow for cash settlement.

The amounts deferred under the arrangements and invested in Corporation common stock are maintained in a grantor ("rabbi") trust. Assets of the rabbi trust are consolidated with the Corporation, and the value of the Corporation's common shares held in the rabbi trust is classified in shareholders' equity. The Corporation recognizes the original amount of deferred compensation as the basis for recognition in the rabbi trust. Changes in the fair value owed to employees are not recognized as the Deferred Compensation Plan does not permit diversification and must be settled only by the delivery of a fixed number of shares of the Corporation's common stock.

The Corporation recognized $132 and $76 of compensation expense related to this plan in 2020 and 2019, respectively, and has recorded a related obligation totaling $172 within shareholders' equity at December 31, 2020. As of December 31, 2020, a total of 6,005 shares are held in the rabbi trust of which 632 remain unvested. The weighted average share price of shares held in the rabbi trust at December 31, 2020, is $27.50.

***Bank-Owned Life Insurance***

The Bank has invested in single premium, bank owned, whole life insurance policies on certain officers of the Bank. Bank owned life insurance is an alternative investment vehicle, generally non-liquid, which may produce additional earnings to offset, and later fund, various employee supplemental benefit expenses The earnings on the policies are not taxed unless withdrawn or surrendered prior to the death of the insured. The increase in cash surrender value of the policies, which was $241 and $235 in 2020 and 2019, respectively, is included in noninterest income in the consolidated statements of income.

The benefit promised by the Bank to the covered officers is established at one times the officer's salary at date of death; such benefit expires if the officers' employment is terminated for any reason other than death, including voluntary or involuntary termination or retirement. Based primarily on the ages of the covered officers, the Bank believes that the payment of such benefits is not probable; accordingly, the Bank has not recognized compensation expense for such benefits.

## 15. SUPPLEMENTAL CASH FLOWS INFORMATION

***Other Cash Flows Information***

Cash paid for interest and income taxes amounted to the following during the years ended December 31:

| | 2020 | 2019 |
|---|---|---|
| Interest | $ 453 | $ 885 |
| Income taxes | $ 1,181 | $ 816 |

***Non-Cash Financing Activities***

During 2020 and 2019, options for the purchase of 1,696 and 2,983, common shares, respectively, were exercised.

Additionally, during 2020 and 2019, 23,113 and 22,147 common shares were exercised through a reload option whereby 16,104 and 16,726 common shares were tendered to pay the exercise price ("cashless exercise"). The issuance of shares upon exercise of common stock options has been recorded net of the tendered shares in the statements of shareholders' equity.

## 16. REVENUE FROM CONTRACTS WITH CUSTOMERS

The Corporation's primary revenue stream accounted for under ASC 606 relates to service charges on deposit accounts.

The Corporation earns fees from its deposit customers for transaction-based fees, account maintenance, and overdraft services. Transaction-based fees, including these for services such as ATM fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Corporation fulfills the customer's request. Account maintenance fees, which primarily relate to monthly account maintenance, are earned over the course of the month, which represents the period over which the Corporation satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are deducted from the customer's account balance.

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End of Notes

Rehmann

## INDEPENDENT AUDITORS' REPORT

March 3, 2021

Shareholders and Board of Directors
Eastern Michigan Financial Corporation
Croswell, Michigan

We have audited the accompanying consolidated financial statements of ***Eastern Michigan Financial Corporation*** ("the Corporation"), which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

***Management's Responsibility for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

***Independent Auditors' Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ***Eastern Michigan Financial Corporation*** as of December 31, 2020 and 2019, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Rehmann Robson LLC

Rehmann is an independent member of Nexia International. A member of Nexia International

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# MILESTONES

Eastern Michigan Bank is honored to celebrate those staff members with milestone anniversaries in 2020. They are a valuable part of our banking family, and their commitment and contributions are greatly appreciated.

## 30 YEAR AWARD

**Darlene Innes**
Courier

## 15 YEAR AWARD

**Christi Agostino-Erd**
AVP, Mortgage Loan Officer

**Julie Chapdelaine**
AVP, Bank Secrecy Act Officer

**Ashley Lindke**
Deposit Operations Specialist

## 10 YEAR AWARD

**Gerald Hepfer**
VP, Commercial Loan Officer

## 5 YEAR AWARD

**Chelsea Grant**
Head Teller
Port Huron

**Diane Johnson**
Assistant Branch Manager
Fort Gratiot

**William G. Oldford, Jr.**
President and
Chief Executive Officer

EASTERN MICHIGAN BANK
125
YEAR
ANNIVERSARY

On December 4, 1895, the bank that is known today as Eastern Michigan Bank (EMB) was chartered as the State Bank of Croswell. Almost a century later in 1984, Eastern Michigan Financial Corporation, the holding company for Eastern Michigan Bank, was formed and all locations were rebranded as Eastern Michigan Bank in 1992. Celebrating our 125th anniversary in 2020, EMB continues to serve the residents of Croswell and has expanded its footprint to include communities throughout Michigan's Thumb and Blue Water area. Today, EMB's market area has grown to include the communities of Croswell, Deckerville, Fort Gratiot, Lakeport, Lexington, Marysville, Port Huron, Sandusky and Ruth, a location which EMB acquired from the former Ruth State Bank in 2016. This modern network consists of nine branches, a loan operations center, administrative offices, and a recently purchased office building in downtown Port Huron where the Bank intends to open a limited branch with a focus on lending services.

Throughout its history, EMB has had many achievements and changes. In 1935, despite the stock market crash and recession, EMB reached its first million dollars in assets. Today, our asset size has grown to just over $440 million. In 2020 alone, Eastern Michigan Bank originated 576 Small Business Association Paycheck Protection Program (PPP) Loans totaling more than $72 million.

Through world wars, the Depression, and now a pandemic, EMB has stood tall and been there for its customers. The first twelve words in our mission statement nicely sums up EMB's goal moving forward: "To continue as a progressive and growing community bank, serving our communities…"

# 2020 ANNUAL REPORT

Eastern Michigan Financial Corporation

Eastern Michigan Bank
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