Q2 '12: One of our strongest quarters yet

Arbor Bancorp, Inc.
Statement of Condition, June 30, 2012

Bank OF ANN ARBOR

www.boaa.com

Member FDIC

Downtown Ann Arbor
125 S. Fifth Ave.
Ann Arbor, MI 48104
(734) 662-1600

Stadium & Liberty
2204 W. Stadium Blvd.
Ann Arbor, MI 48103
(734) 822-1900

Traver Village Shopping Center
2649 Plymouth Rd.
Ann Arbor, MI 48105
(734) 662-3800

Ellsworth Rd. & Airport Blvd.
801 W. Ellsworth Rd.
Ann Arbor, MI 48108
(734) 669-8900

Downtown Ypsilanti
7 W. Michigan Ave.
Ypsilanti, MI 48197
(734) 485-9400

Plymouth
1333 W. Ann Arbor Rd.
Plymouth, MI 48170
(734) 455-1511

Dear fellow shareholders: *July 2012*

It is with great pleasure that I share with you the operating results for the six months ending June 30, 2012. Earnings for Arbor Bancorp eclipsed the $4 million level and are up by over $1 million from last year. Earnings per share were $4.62 compared to $3.47 in 2011, which reflects a 33% year over year increase. Our earnings growth continues to be driven by the exceptional growth in the balance sheet, a lower loan loss provision, and strong expense management.

The bank reached several new high-water marks at quarter-end including total assets exceeding the $800 million level, total deposits eclipsing $700 million, total loans moving over $500 million, and total capital exceeding $54 million. The year-to-date and prior two consecutive years of record earnings has been greatly assisted by a steady stream of new clients moving their banking relationships to Bank of Ann Arbor and existing clients expanding their relationships with us. The growth is highlighted as follows:

(In Millions)	6/30/12	6/30/11	6/30/10
Total Assets	$ 802	$ 706	$ 547
Total Loans	507	473	400
Total Deposits	711	632	478
Total Capital	54	46	39

All of my colleagues at the bank, the World's Best Bankers, are highly energized by the terrific results the Bank of Ann Arbor team is generating and the local and national recognition the bank has received from its advertising and social media campaigns. Since the first of the year the bank has been featured in the Ann Arbor Observer, Forbes, Crain's Detroit, American Banker, Financial Brand, and received award-winning recognition from Michigan Bankers Association and the Independent Community Bankers of America. A well-deserved word of thanks to the whole team at Perich Advertising + Design who works closely with us in the design and execution of our advertising and social media campaigns.

As we begin the last six months of the year, we are encouraged by the year-to-date earnings momentum but expect continued challenges in successfully managing our net interest margin in this low rate environment, compensating for the lost net interest income from the closing of our wholesale mortgage division, and the continued global economic unrest. We look forward to facing the challenges head-on and delivering another strong year of performance for your bank.

Tim Marshall

Timothy G. Marshall
President and CEO

ARBOR BANCORP, INC.

Balance Sheet

(000's omitted)

	As of June 30 2012	2011
Assets:		
Cash	$ 12,968	$ 12,828
Overnight Investments	114,924	73,916
Investments	141,463	110,416
Loans:		
Commercial	390,250	358,054
Residential Mortgages	70,085	58,036
Mortgages held for resale	7,834	19,211
Installment	38,833	38,608
Total loans	507,002	473,909
Allowance for loan loss	(9,389)	(9,442)
Interest receivable	1,520	1,665
Bank Owned Life Insurance	12,067	11,665
Other real estate owned	1,803	4,622
Other assets	9,062	16,005
Bank premises and equip.	11,026	10,601
Total Assets	$ 802,446	$ 706,185
Liabilities and Capital:		
Deposits		
Demand	$ 172,476	$ 129,206
NOW	59,540	75,978
Smart One	108,331	97,621
Money market savings	206,960	150,542
Savings	29,989	26,976
CDs < $100,000	40,473	48,020
CDs > $100,000	92,802	103,163
Total deposits	710,571	631,506
Federal Funds purchased	0	0
Federal Home Loan Bank advances	1,429	7,821
Repurchase agreements	26,774	13,863
Interest payable	217	277
Other liabilities	4,164	2,098
Trust Preferred Securities	5,000	5,000
Retained earnings	45,608	38,524
Unrealized gain/(loss) on securities held for sale	2,807	1,090
Common stock	5,876	6,006
Total Capital	54,291	45,620
Total Liabilities and Capital	$ 802,446	$ 706,185

Income Statement

(000's omitted)

	For six months ended 6/30/12	6/30/11
Interest income:		
Loans	$13,342	$13,285
Overnight Investments	145	117
Investments	1,689	1,474
Loans fees	713	632
Total income and fees	15,889	15,508
Interest expense:		
NOW	40	53
Smart One	135	199
Money market savings	212	299
Savings	66	82
CD's < $100,000	232	357
CD's > $100,000	320	419
Repurchase agreements	46	23
Other borrowed money	149	159
Total interest expense	1,200	1,591
Net interest income	14,689	13,917
Provision for loan losses	1,200	2,100
Net interest income after provision for loan losses	13,489	11,817
Other income:		
Service charges	250	245
Mortgage origination	1,019	1,936
Trust income	1,809	1,744
Gain (loss) on sale of securities	0	0
Miscellaneous income	735	627
Total other income	3,813	4,552
Operating expenses:		
Salaries and benefits	6,733	6,784
Marketing and bus. development	420	382
Building and equipment	953	1,039
Contracted services	1,163	1,091
FDIC expense	270	533
Other expenses	2,288	2,392
Total operating expenses	11,827	12,221
Net income before tax	5,475	4,148
Federal income tax	1,431	1,130
Net Income	$ 4,044	$ 3,018
Earnings per Share	$ 4.62	$ 3.47

Arbor Bancorp, Inc. 2011 Annual Report

For a second year in a row, your bank has generated record deposits, assets, commercial loans and earnings.

Dear Fellow Shareholders:

For a second consecutive year, "the team, the team, the team" at Bank of Ann Arbor worked extremely well together to post record numbers.

Record deposits. In 2011, more people and businesses moved their money to Bank of Ann Arbor than ever before. $77 million in deposits were added, for a total of $686 million. The FDIC ranked Bank of Ann Arbor the fourth largest bank in the area—up from seventh in 2010—thanks to the year-over-year increase in deposits. Through our ongoing commitment to superior customer service, relationship banking and giving back to our community, "the team" worked hard to expand existing deposit relationships, and cultivate new ones.

Record assets. We finished the year with an asset level exceeding $774 million, while many competitors shrank or retreated from the market altogether. Over the past two years, bank assets have increased by more than $230 million, or nearly 43%. Looking forward, we believe additional growth will come organically within our existing markets as well as through possible acquisitions.

Record commercial loans. Significant growth in 2011 was also realized in our commercial loan portfolio—the highest earning asset on our balance sheet—which now totals a record $395 million. In addition, we were able to increase the number of residential mortgages we held on our balance sheet. The growth in both our commercial and mortgage loan portfolios more than offset the large reduction in our loans-held-for-sale portfolio.

> "The team, the team, the team" is as effective a catch phrase in banking as it is in college football.

Due to the ever-growing compliance requirements set forth by our regulators, your board of directors and senior management team decided in late 2011 to exit the wholesale mortgage lending market. This resulted in a year-over-year reduction in the loans-held-for-sale portfolio. Still, providing mortgage loans is important to us, and to the communities in which we lend. In 2012, our focus will be on helping even more customers realize their dream of home ownership or their desire to change addresses for the better.

Our growth in total assets is a reflection of what we strive to do each and every day: Help the businesses and families of Washtenaw County, and now Plymouth, achieve their financial goals.

Record earnings. Growing total assets to record levels effectively increased the core earnings of the bank. In 2011, our earnings reached an all-time high of $6.5 million, a 29% increase over the previous record set last year, which included a one-time gain of nearly $2.3 million from our May 2010, FDIC-assisted acquisition of the former New Liberty Bank in Plymouth. The significant increase in total assets positively impacted our earnings because more assets are at work generating greater amounts of interest income.

> Other banks have loosened their credit standards. Not us. Our credit quality standards are more consistent and stronger than ever.

In addition to experiencing higher levels of interest income, our Trust and Investment Management Group and Retail Mortgage Department continued to generate exceptional levels of noninterest income. The Trust and Investment area funded over $36 million in new investments to manage. And for the third consecutive year, our mortgage team completed approximately $100 million in new residential mortgage loans. The reduction in total noninterest income on the year-end statement is due to the elimination of our wholesale mortgage lending area resulting in a lower level of net gains on loans sold year-over-year.

As always, we closely monitor our noninterest expense categories, especially our biggest operating expenditure, salaries and benefits. Those expenditures remained essentially flat for the year while still adding key team members to better enable us to take advantage of market opportunities that have arisen.

Earnings per share reached $7.55, up from $5.90 in 2010, resulting in return on shareholders' equity of approximately 13%. This puts us in the top 10% of all banks across the country. We paid a 50% larger dividend to you, our valued shareholders, than the one we paid last year. The rest of our earnings were used to support our near-term growth opportunities and to manage regulatory capital levels. By year-end, our capital or shareholders' equity reached a record $50 million.

The 2011 earnings performance, driven by growth in earning assets, was a significant accomplishment, one that we'll work hard to meet and exceed in 2012.

Credit Quality. The FDIC's most recent bank comparative report shows Bank of Ann Arbor once again materially outperforming other banks in Michigan and throughout the U.S. in key metrics such as earnings coverage of net charge-offs, net charge-offs to total loans, and noncurrent loans to total loans. Significant year-over-year improvement was also seen in a number of credit quality metrics we routinely track. This allowed us to reduce our provision for loan loss in 2011. However, the reduction was offset by a similar increase in our reserve for mortgage loan buybacks which is reflected in the year-over-year increase in the noninterest expense category on our income statement.

The Credit Administration team at Bank of Ann Arbor and all of our lenders believe in and deliver an exceptionally strong credit culture. Lending money to consumers and businesses that have shown an ability to hold up their end of the bargain is the best and only way to remain successful.

While other banks have loosened their credit standards in an attempt to generate more loans, we've redoubled our commitment to maintaining consistent and strong credit quality standards.

Our record levels of deposits, total assets, earnings, and capital—especially during these demanding economic times—is due to the amazing work of "the team, the team, the team" at Bank of Ann Arbor (a.k.a. "the World's Best Bankers"); the oversight and guidance of our board of directors; and the continued support of all of our shareholders.

We paid a 50% larger dividend than the one we paid last year.

Other notable 2011 accomplishments. Numerous colleagues throughout the bank tested, planned, and implemented new ways to deliver banking services and strengthen our marketing efforts.

We used social media—most notably, Facebook and Twitter—to a significantly greater degree to enhance our relationships with both clients and prospective clients. Our first Facebook application, the Sweet 15 Local Charity Drive, was launched in early 2011 to mark the bank's 15th anniversary and served to bolster our long-time support of the area's nonprofit community. Through Sweet 15, our Facebook community grew from just a few hundred fans to over 16,000 in just 60 days. We cordially welcomed thousands of new friends into the Bank of Ann Arbor community, many of whom have ties to very worthwhile local charities.

The success of Sweet 15 got us national attention, too. It was highlighted at the national banking conference of Fiserv, the bank's core processing system; featured on the cover of *Michigan Banker* magazine; and earned the 2011 Community Bank Service Award from the Independent Community Bankers Association, a national organization supporting our industry.

Our valued clients have been hearing more details about time-saving—and money-saving—products introduced or upgraded in 2011. These products include: Free online bill pay for individuals and businesses, now fully integrated within the Bank of Ann Arbor online banking system; email alerts that can be set up by our online banking clients; paperless online bank statements; and business remote deposit capture, which benefitted from a major upgrade over the last year.

Soon, we'll introduce **mobile banking apps** for iPhone, Android and Blackberry, followed by mobile deposit capture from your smartphone. We will soon install the first Bank of Ann Arbor ATMs that will not require envelopes to make a deposit. Checks and paper currency will simply be fed into those machines, and images of deposited currency and checks will be printed on the receipt. We are also working toward paperless board of directors meetings and other internal processes.

For well more than a year now, our **"Non-local banks think"** advertising campaign has generated significant increases in our brand awareness and positive community feedback. In fact, we've received a number of suggested lines to be used in the campaign from customers, friends and the general public. Because of the response, we created our second Facebook app, the Build-A-Billboard contest, which was launched in the fall. The app resulted in more than 700 "Non-local banks think" headlines submitted. A number of those headlines will be featured on actual Bank of Ann Arbor billboards posted throughout town. Our thanks to all who participated.

"The team, the team, the team" is everything. As we look forward, it's important to recognize the importance of "the team, the team, the team" in the success of our bank. The legendary University of Michigan football coach Bo Schembechler believed that no single player or coach is more important than the team; and by working together as a team, great things will happen. At Bank of Ann Arbor, no individual is more important than the team. Our record-level results over the past two years could only happen because of the outstanding group of colleagues, directors, and shareholders who work exceptionally well together as a team. Belief in each other, strong communications, generous encouragement, only the most constructive criticism, and hard work have proven extremely useful in local banking, as they have in Michigan football.

Our entire team looks forward to continued success in 2012 and beyond. Thank you for your continued support and referrals. You are an essential contributor to the Bank of Ann Arbor's team success.

Sincerely,

Tim Marshall

Timothy G. Marshall
President & CEO

Bill Martin

William C. Martin
Chairman of the Board

REPORT OF INDEPENDENT AUDITORS

Board of Directors and Shareholders
Arbor Bancorp, Inc.
Ann Arbor, Michigan

We have audited the accompanying consolidated balance sheets of Arbor Bancorp, Inc. as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arbor Bancorp. Inc, as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Crowe Horwath LLP

Crowe Horwath LLP
Grand Rapids, Michigan
February 9, 2012

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2011 AND 2010

	2011	2010
ASSETS		
Cash and due from financial institutions	$ 14,509	$ 9,243
Federal funds sold	–	35
Interest-bearing balances in banks	109,532	92,502
Cash and cash equivalents	124,041	101,780
Securities available-for-sale	110,817	52,905
Loans held for sale	13,420	71,516
Loans, excluding covered loans, net	439,334	352,345
Covered loans	43,944	57,816
Total loans	483,278	410,161
Federal Home Loan Bank stock, at cost	2,634	2,927
Premises and equipment, net	10,534	9,143
Cash surrender value of life insurance	11,865	11,466
Other real estate owned	4,187	4,603
FDIC indemnification asset	7,726	12,627
Accrued interest receivable and other assets	5,713	11,837
	$774,215	**$688,965**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$ 150,962	$ 125,018
Interest-bearing	534,872	484,217
Total deposits	685,834	609,235
Federal Home Loan Bank advances	7,496	9,936
Repurchase agreements	21,652	18,048
Accrued expense and other liabilities	4,200	5,115
Subordinated debentures	5,155	5,155
Total liabilities	724,337	647,489
Shareholders' equity		
Common stock, no par value; 2,000,000 shares authorized; 875,004 and 867,057 shares issued and outstanding at December 31, 2011 and 2010	6,230	5,750
Retained earnings	42,090	35,854
Accumulated other comprehensive income/(loss)	1,558	(499)
	49,878	41,105
Non-controlling interests	–	371
Total shareholders' equity	49,878	41,476
	$ 774,215	**$ 688,965**

All dollar amounts in thousands except per share data. See accompanying notes.

CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2011 AND 2010

	2011	2010
Interest income		
Loans, including fees	$ 28,257	$ 26,506
Securities:		
Taxable	1,434	1,225
Tax exempt	1,592	1,131
Federal funds sold and other	265	153
	31,548	29,015
Interest expense		
Deposits	2,635	3,501
Federal Home Loan Bank advances	129	501
Subordinated debentures	175	177
Repurchase agreements	64	66
	3,003	4,245
Net interest income	28,545	24,770
Provision for loan losses	3,350	6,000
Net interest income after provision for loan losses	25,195	18,770
Noninterest income		
Service charges on deposit accounts	517	533
Income from fiduciary activities	3,412	3,137
Net gains on sales of loans	4,728	7,155
Net gains on sales of securities	494	–
Gain (loss) on OREO	(133)	(814)
Gain on FDIC-assisted acquisition	–	2,265
Other	1,396	1,050
	10,414	13,326
Noninterest expense		
Salaries and employee benefits	14,680	14,683
Occupancy and equipment	2,098	2,058
Marketing and business promotion	916	696
FDIC expense	707	885
Provision for loan repurchase liability	2,967	1,500
Other	5,439	5,351
	26,807	25,173
Income before income taxes	8,802	6,923
Income tax expense	2,219	1,826
Net income	**$ 6,583**	**$ 5,097**
Basic earnings per share	$ 7.55	$ 5.90
Diluted earnings per share	7.21	5.77

See accompanying notes.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2011 AND 2010

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Non-Controlling Interests	Total Shareholders' Equity
Balance, January 1, 2010	$ 5,180	$ 30,757	$ (32)	$ 250	$ 36,155
Comprehensive income:					
Net income	–	5,097	–	–	5,097
Change in net unrealized loss on securities available-for-sale, net tax effects	–	–	(467)	–	(467)
Total comprehensive income	–	–	–	–	4,630
Deferred shares plan	126	–	–	–	126
Capital contribution by minority owner	–	–	–	121	121
Exercise of stock options (8,600 shares)	240	–	–	–	240
Issuance of 1,500 shares of common stock	37	–	–	–	37
Purchase of 600 shares of common stock	(23)	–	–	–	(23)
Stock-based compensation expense	190	–	–	–	190
Balance, December 31, 2010	5,750	35,854	(499)	371	41,476
Comprehensive income:					
Net income	–	6,583	–	–	6,583
Change in net unrealized loss on securities available-for-sale, net tax effects	–	–	2,057	–	2,057
Total comprehensive income	–	–	–	–	8,640
Deferred shares plan	73	–	–	–	73
Liquidation of minority interest	–	–	–	(371)	(371)
Exercise of stock options (9,863 shares)	326	–	–	–	326
Issuance of 2,500 shares of common stock	105	–	–	–	105
Purchase of 4,857 shares of common stock	(215)	–	–	–	(215)
Stock based compensation expense	191	–	–	–	191
Cash dividend paid - $.40 per share	–	(347)	–	–	(347)
Balance, December 31, 2011	**$ 6,230**	**$ 42,090**	**$1,558**	**$ –**	**$ 49,878**

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2011 AND 2010

	2011	2010
Cash flows from operating activities		
Net income	$ 6,583	$ 5,097
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	3,350	6,000
Depreciation	609	632
(Gain)/loss on OREO	133	814
Stock-based compensation	191	190
Net amortization of securities	319	44
Increase in cash surrender value of life insurance	(399)	(409)
Loans originated for sale	(287,068)	(594,546)
Proceeds from loan sales	341,118	587,353
Net gains on sales of loans	(4,728)	(7,155)
Provision for loan repurchase liability	2,967	1,500
Net realized (gain) loss on sales of securities	(494)	–
Gain on FDIC-assisted acquisition	–	(2,265)
Net change in:		
Other assets	6,023	(5,090)
Accrued expenses and other liabilities	(5,240)	(1,196)
Net cash from operating activities	63,364	(9,031)
Cash flows from investing activities		
Activity in available-for-sale securities:		
Sales	25,832	–
Maturities, prepayments and calls	43,591	33,554
Purchases	(124,043)	(35,096)
Proceeds from redemption of FHLB stock	293	347
Proceeds from sale of other real estate owned	2,882	3,086
Loan originations and payments, excluding covered loans	(81,886)	(32,528)
Net decrease in covered loans	11,695	13,463
Additions to premises and equipment, net	(2,000)	(503)
Decrease in FDIC indemnification asset	4,901	3,322
Net cash proceeds from FDIC-assisted acquisition	–	12,770
Net cash from investing activities	(118,735)	(1,585)
Cash flows from financing activities		
Net change in deposits	76,599	53,184
Net change in repurchase agreements	3,604	2,149
Dividends paid	(347)	–
Repayments on FHLB advances	(2,440)	(13,398)
Proceeds from exercise of stock options and sale of common stock	431	277
Repurchase of common stock	(215)	(23)
Net cash from financing activities	77,632	42,189
Net change in cash and cash equivalents	22,261	31,573
Beginning cash and cash equivalents	101,780	70,207
Ending cash and cash equivalents	**$ 124,041**	**$ 101,780**

(Continued)

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
YEARS ENDED DECEMBER 31, 2011 AND 2010

	2011	2010
Supplemental cash flow information:		
Interest paid	$ 3,307	$ 4,367
Loans transferred to other real estate	2,498	2,953
Loans transferred to portfolio	8,774	–
Income taxes paid	5,695	350
Supplemental schedule for investing activities:		
Assets acquired – New Liberty Bank	$ –	$ 98,895
Liabilities assumed – New Liberty Bank	–	99,581
Gain on FDIC-assisted acquisition	–	2,265

See accompanying notes.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation: The consolidated financial statements include Arbor Bancorp, Inc. and its wholly owned subsidiaries, Bank of Ann Arbor, and, in 2010, its majority owned subsidiary Progressive Mortgage Company LLC (Progressive), together referred to as "the Corporation." The non-controlling (minority) interest in Progressive at year end 2010 is classified as a component of equity within the consolidated balance sheets. During 2011, Progressive ceased operations. Intercompany transactions and balances are eliminated in consolidation.

The Bank provides financial services through its offices in Washtenaw and Wayne counties. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Other financial instruments, which potentially represent concentrations of credit risk, include deposit accounts in other financial institutions and federal funds sold. Progressive Mortgage Company LLC operated from its Oakland County, Michigan headquarters and a satellite office in Chicago. Progressive originated residential real estate loans for sale in the secondary market through a network of brokers located primarily in Michigan, Illinois, Indiana and Ohio. The Bank provided funding at closing for these loans which were all sold, service-released in the secondary market.

Subsequent Events: The Corporation has evaluated subsequent events for recognition and disclosure through February 9, 2012 which is the date the financial statements were available to be issued.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the reserve for repurchase of sold loans, the carrying amount of the FDIC Indemnification Asset and the fair values of financial instruments are particularly subject to change.

Cash Flows: Cash and cash equivalents includes cash, deposits with other financial institutions under 90 days, short-term investments and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, federal funds purchased and repurchase agreements.

Interest-Bearing Deposits in Banks: Interest bearing deposits in banks mature within one year and are carried at cost. The balance outstanding at year end 2011 and 2010 was at the Federal Reserve Bank.

Securities: Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income. Interest income includes amortization of purchase premium or discount. Gains and losses on sales are based on the amortized cost of the security sold.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer and also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value, in the aggregate, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Loans are sold with servicing released. Buyers do not have recourse against the Corporation for subsequent loan losses. However, in certain situations, the buyer can require the Corporation to repurchase loans.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of purchase premiums and discounts and an allowance for loan losses.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Interest income on all loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Covered Loans: Loans acquired in 2010 in a Federal Deposit Insurance Corporation (FDIC)-assisted transaction are covered under a loss sharing agreement and are referred to as "covered loans." Pursuant to the terms of the loss sharing agreements, covered loans are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. The Corporation will reimburse the FDIC for its share of recoveries with respect to losses for which the FDIC paid the Corporation a reimbursement under the loss sharing agreement. The FDIC's obligation to reimburse the Corporation for losses with respect to covered loan begins with the first dollar of loss incurred.

Covered loans were recorded at fair value at the time of acquisition. Fair values for covered loans are based on a discounted cash flow methodology that considered various factors including the type of loan and related collateral, classification status, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and a discount rate reflecting the Corporation's assessment of risk inherent in the cash flow estimates. Covered loans were grouped together according to similar characteristics and were treated in the aggregate when applying various valuation techniques.

At purchase, certain covered loans had evidence of credit deterioration since origination. These loans are accounted for individually. The Corporation estimates the amount and timing of expected cash flows for each purchased loan, and the expected cash flows in excess of amount paid is recorded as interest income over the remaining life of the loan or pool (accretable yield). The excess of the loan's or pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Over the life of the loan or pool, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, a loss is recorded. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable, incurred credit losses, increased by the provision for loan losses and decreased by charge offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non classified loans and is based on historical loss experience adjusted for current factors.

A loan is impaired when full payment under the loan terms is not expected. Non-homogeneous loan classes such as commercial and commercial real estate loans and homogeneous loan segments, such as mortgage and consumer, are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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.

Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The general component covers non impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Corporation over the most recent three years. For the commercial land development segment of loans, an actual loss history of one year is used. For all segments, the actual loss experience is supplemented with other 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. The following portfolio segments have been identified:

Commercial – Loans to businesses that are sole proprietorships, partnerships, limited liability companies and corporations. These loans are for commercial, industrial, or professional purposes. The risk characteristics of these loans vary based on the borrowers' business and industry as repayment is typically dependent on cash flows generated from the underlying business. Within this loan segment, the Corporation has identified loan classes of commercial and industrial, commercial real estate and commercial land development.

Real Estate – Loans to purchase or refinance single family residences. The risks associated with this segment are generally dependent on the overall real estate value environment and individual payment obligations. Real estate is subject to changes in market valuation and can be unstable for a variety of reasons. Within this segment the Corporation has identified classes of residential and home equity loans.

Consumer – Term loans or lines of credit for the purchase of consumer goods, vehicles or home improvement. The risk characteristics of the loans in this segment vary depending on the type of collateral but generally repayment is expected from a customer continuing to generate a cash flow that supports the calculated payment obligation. Secondary support could involve liquidation of collateral.

FDIC Indemnification Asset: The FDIC indemnification asset results from the loss share agreements in the FDIC-assisted transaction. The asset is measured separately from the related covered assets as they are not contractually embedded in the assets and are not transferable with the assets should the Corporation choose to dispose of them and represent the acquisition date fair value of expected reimbursements from the FDIC. Pursuant to the terms of the loss sharing agreement, covered loans are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. These expected reimbursements do not include reimbursable amounts related to future covered expenditures. These cash flows are discounted to reflect a metric of uncertainty of the timing and receipt of the loss sharing reimbursement from the FDIC. This asset decreases when losses are realized and claims are submitted to the FDIC or when customers repay their loans in full and expected losses do not occur. This asset increases when estimated future losses increase and decreases when estimated future losses decrease.

Core Deposit Intangibles (CDIs): CDIs represent the value of acquired relationships with core deposit customers. The fair value of CDIs is estimated at acquisition based on a discounted cash flow methodology that gives consideration to expected customer attrition rates, cost of the deposit base compared to alternative funding sources, reserve requirements and the net maintenance cost attributable to customer deposits. CDIs are amortized over the estimated lives of the deposit relationships. The Corporation recorded a CDI of $202 during 2010 and the unamortized balance at year-end 2011 and 2010 was $137 and $177.

Other Real Estate Owned (OREO): Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed.

OREO acquired by the Corporation through loan defaults by clients on covered loans or acquired by the Corporation as part of its acquisition of New Liberty Bank are covered under the loss sharing agreement discussed above. Pursuant to the terms of the loss sharing agreement, covered assets are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. Any gains or losses realized at the time of disposal are partially offset by the FDIC loss share and are reflected in income. At year-end 2011 and 2010, $3,498 and $3,195 of the Corporation's OREO was subject to the loss sharing agreement.

Premises, Equipment and Leasehold Improvements: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation, generally computed on the straight-line basis over the assets' useful lives, and over the terms of the lease or the estimated useful lives for leasehold improvements, whichever is shorter.

Long-Term Assets: Premises and equipment, other intangible assets and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Repurchase Agreements: Substantially all repurchase agreement liabilities represent amounts advanced by various customers. These balances are not deposits and are not covered by federal deposit insurance. Securities are pledged to cover these liabilities.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Corporation, 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 the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options.

Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.

Off-Balance Sheet Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Earnings Per Share: Basic earnings per share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under equity based plans. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale which are also recognized as separate components of equity.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of $992 and $840 was required to meet regulatory reserve and clearing requirements at year end 2011 and 2010.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Dividend Restriction: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank to the holding company or by the holding company to shareholders.

Adoption of New Accounting Standards: In April 2011, the FASB amended existing guidance for assisting a creditor in determining whether a restructuring is a troubled debt restructuring. The amendments clarify the guidance for a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. With regard to determining whether a concession has been granted, the ASU clarifies that creditors are precluded from using the effective interest method to determine whether a concession has been granted. In the absence of using the effective interest method, a creditor must now focus on other considerations such as the value of the underlying collateral, evaluation of other collateral or guarantees, the debtor's ability to access other funds at market rates, interest rate increases and whether the restructuring results in a delay in payment that is insignificant. This guidance is effective for annual reporting periods ending after December 15, 2012, including interim reporting periods within those annual periods. The adoption of this guidance is not expected to have a material impact on the Corporation.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholder's equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective for annual reporting periods beginning after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted. The adoption of this amendment will change the presentation of the components of comprehensive income for the Corporation as part of the consolidated statement of shareholder's equity.

NOTE 2 – BUSINESS COMBINATION

On May 14, 2010, the Corporation entered into a purchase and assumption agreement (New Liberty Agreement) with the Federal Deposit Insurance Corporation (FDIC), as receiver, pursuant to which the Corporation acquired certain assets and assumed substantially all of the deposits and certain liabilities of New Liberty Bank (New Liberty). New Liberty operated one banking center in Plymouth, Michigan.

In connection with the New Liberty acquisition, the Corporation entered into a loss sharing agreement, described above, with the FDIC that covers most of New Liberty's assets, based upon the seller's records, including single family residential mortgage loans, commercial real estate and commercial and industrial loans, and OREO (collectively, covered assets). The Corporation acquired certain other New Liberty assets not covered by the loss sharing agreement with the FDIC, including cash and securities purchased at fair value.

The amounts covered by the loss sharing agreements are the pre-acquisition book values of the underlying covered assets, the contractual balance of unfunded commitments that were acquired, and include certain future net direct costs. The loss sharing agreements applicable to single family residential mortgage loans provide for FDIC loss sharing and Corporation reimbursement to the FDIC, in each case as described above, for ten years. The loss sharing agreements applicable to all other covered assets provide for FDIC loss sharing for five years and Corporation reimbursement of recoveries to the FDIC for eight years.

The loss sharing agreements are subject to certain servicing procedures as specified in agreements with the FDIC. The expected reimbursements under the loss sharing agreements were recorded as indemnification assets at an estimated fair value of $15,949 on the acquisition date. The indemnification assets reflect the present value of the expected net cash reimbursement related to the loss sharing agreements described above.

The Corporation determined that the acquisition of the net assets of New Liberty constituted a business combination, as defined by the FASB's Accounting for Business Combinations. Accordingly, the assets acquired and liabilities assumed are recorded at their fair values at acquisition. Fair values were determined based on the requirements of FASB's accounting guidance for Fair Value Measurements. In many cases the determination of these fair values required management to make estimates about discount rates, future expected cash flows, market conditions and other future events that are highly subjective in nature and subject to change.

NOTE 2 – BUSINESS COMBINATION (Continued)

The table below presents a summary of the assets and liabilities purchased in the New Liberty acquisition recorded at fair value.

	As Recorded by FDIC	Fair Value Adjustments	As Recorded by Arbor Bancorp
Assets			
Cash and due from banks	$ 9,819	$ –	$ 9,819
Securities	1,009	–	1,009
Covered loans	91,772	(22,703)	69,069
Core deposit intangible	–	202	202
Covered foreclosed assets	2,988	(892)	2,096
FDIC indemnification asset	–	15,949	15,949
Other assets	751	-	751
Total assets acquired	$ 106,339	$ (7,444)	98,895
Liabilities			
Noninterest-bearing deposit accounts	$ 28,584	$ –	28,584
Interest-bearing deposit accounts	61,533	–	61,533
Total deposits	90,117	–	90,117
Advances from Federal Home Loan Bank	7,801	533	8,334
Other liabilities	212	918	1,130
Total liabilities assumed	$ 98,130	$ 1,451	99,581
Bargain purchase gain recorded			(2,265)
Cash due from FDIC for net liabilities assumed			$ (2,951)

The estimated fair value of assets acquired exceeded the estimated fair value of liabilities assumed, resulting in a bargain purchase gain of $2,265 and the recognition of a $1,495 after-tax gain.

The operating results of Arbor Bancorp, Inc. include the operating results produced by the acquired assets and assumed liabilities from May 14, 2010 forward. Due primarily to the Corporation acquiring only certain assets and liabilities in the acquisition, the significant amount of fair value adjustments, and the loss sharing agreements with the FDIC, historical results from New Liberty are not meaningful to the Corporation's results, and thus no pro forma information is presented.

Subsequent to the acquisition date, in 2011 the Corporation acquired New Liberty's main office facility and equipment as part of the purchase and assumption agreement at fair value from the FDIC. This acquisition was approximately $1,500.

The following is a brief description of the methods used to determine the fair values of the significant assets and liabilities presented above.

Cash and due from banks – Carrying amount is a reasonable estimate of fair value.

Securities – Securities were acquired from the FDIC at fair value based on the market prices of similar securities.

Loans – Fair values for loans were based on a discounted cash flow methodology that considered various factors including the type of loan and related collateral, classification status, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and current discount rates. The discount rates used for loans are based on current market rates for new originations of comparable loans and include adjustments for liquidity concerns. The discount rates do not include significant factors for credit losses as that has been included in determining the estimated cash flows.

Core deposit intangible – This intangible asset represents the value of the relationships that New Liberty had with its deposit customers. The fair value of this intangible asset was estimated based on a discounted cash flow methodology that gave appropriate consideration to expected customer attrition rates, cost of the deposit base, and the net maintenance cost attributable to customer deposits.

Foreclosed assets – Foreclosed assets (or other real estate owned) is presented at the estimated present value that management expects to receive when the property is sold, net of related costs of disposal. Pursuant to the terms of the loss sharing agreements, covered assets are subject to reimbursement from the FDIC to the extent of 80% of losses.

NOTE 2 – BUSINESS COMBINATION (Continued)

FDIC indemnification asset – This loss sharing asset is measured separately from the related covered assets as it is not contractually embedded in the covered assets and is not transferable with the covered assets should the Corporation choose to dispose of them. Fair value was estimated using projected cash flows related to the loss sharing agreements based on the expected reimbursements for losses and the applicable loss sharing percentages. These cash flows were discounted to reflect a metric of uncertainty of the timing and receipt of the loss sharing reimbursement from the FDIC.

Deposits – The fair values used for the demand and savings deposits that comprise the transaction accounts acquired, by definition, equal the amount payable on demand at the acquisition date. No fair value adjustment was applied for time deposits as the Corporation was provided with the option, upon acquisition, to reset deposit rates to market rates currently offered.

Advances from Federal Home Loan Banks – The fair values of Federal Home Loan Bank (FHLB) advances were based on pricing of new, acquisition date advances, as determined by the FHLB.

Other Liabilities – Other liabilities includes a $918 liability which represents the present value of a payment expected to be due to the FDIC at the end of the loss share period (ten years). The loss share agreements establish by formula a refund that will be due to the FDIC should realized losses not occurr to the extent estimated by the FDIC prior to the acquisition.

NOTE 3 – SECURITIES

The fair value of available-for-sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2011				
U.S. Government and federal agency	$ 18,050	$ 54	$ 11	$ 18,093
Mortgage-backed securities: residential	20,760	147	31	20,876
Mortgage-backed securities: commercial	8,415	9	25	8,399
State and municipal	59,966	2,268	42	62,192
Corporate	1,265	–	8	1,257
	$ 108,456	**$ 2,478**	**$ 117**	**$ 110,817**
2010				
U.S. Government and federal agency	$ 20,614	$ 478	$ 174	$ 20,918
State and municipal	31,769	252	1,296	30,725
Corporate	1,279	–	16	1,263
	$ 53,662	**$ 730**	**$1,486**	**$ 52,906**

Sales of available-for-sale securities were as follows:

	2011	2010
Proceeds	$ 25,832	$ –
Gross gains	494	–
Gross losses	–	–

The fair value of available-for-sale securities at year-end 2011 by contractual maturity were as follows:

Due in one year or less	$ 3,054
Due from one to five years	14,856
Due from five to ten years	9,316
Due after ten years	54,316
Mortgage-backed securities	29,275
	$ 110,817

Securities pledged at year-end 2011 and 2010 had a carrying amount of $36,184 and $30,174, and were pledged to secure repurchase agreements, FHLB borrowings and trust account deposits. At year-end 2011 and 2010, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

NOTE 3 – SECURITIES (Continued)

Securities with unrealized losses at year-end 2011 and 2010 not recognized in income are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2011						
U.S. Government and federal agency bonds	$ 2,989	$ 11	$ –	$ –	$ 2,989	$ 11
Mortgage-backed: residential	6,867	31	–	–	6,867	31
Mortgage-backed: commercial	6,112	25	–	–	6,112	25
Corporate bonds	1,157	8	–	–	1,157	8
State and municipal	5,248	42	–	–	5,248	42
Total temporarily impaired	**$ 22,373**	**$ 117**	**$ –**	**$ –**	**$ 22,373**	**$ 117**
2010						
U.S. Government and federal agency bonds	$ 7,337	$ 174	$ –	$ –	$ 7,337	$ 174
Corporate bonds	1,163	16	–	–	1,163	16
State and municipal	13,884	812	3,844	484	17,728	1,296
Total temporarily impaired	**$ 22,384**	**$ 1,002**	**$ 3,844**	**$ 484**	**$ 26,228**	**$ 1,486**

Unrealized losses on securities have not been recognized into income because the issuers are generally of high credit quality, management does not intend to sell and it is not more likely than not that management would be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in interest rates. The fair value is expected to recover as the securities approach maturity and/or market rates decline.

NOTE 4 – LOANS, including covered loans

Loans at year-end were as follows:

	2011	2010
Commercial:		
Commercial/Industrial	$ 139,340	$ 125,836
Commercial real estate	244,650	204,887
Commercial land development	3,071	5,120
Real estate:		
Residential	65,938	43,066
Home equity	32,690	25,610
Consumer	5,987	13,896
	491,676	418,415
Less allowance for loan losses	(8,398)	(8,254)
Loans, net	**$ 483,278**	**$ 410,161**

Loans to principal officers, directors, and their affiliates at year-end 2011 and 2010 were $13,381 and $13,423.

NOTE 4 – LOANS (Continued)

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ending December 31, 2011 and in total for 2010:

	Commercial	Real Estate	Consumer	Total
December 31, 2011				
Allowance for loan losses:				
Beginning balance	$ 6,625	$ 1,355	$ 274	$ 8,254
Provision for loan losses	2,637	672	41	3,350
Loans charged-off	(3,156)	(459)	(18)	(3,633)
Recoveries	219	207	1	427
Total ending allowance balance	**$ 6,325**	**$ 1,775**	**$ 298**	**$ 8,398**

	2010
Beginning balance	$ 5,428
Provision for loan losses	6,000
Loans charged-off	(3,226)
Recoveries	52
Ending balance	**$ 8,254**

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2011:

	Commercial	Real Estate	Consumer	Total
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,931	$ 35	$ 10	$ 1,976
Collectively evaluated for impairment	3,868	1,740	288	5,896
Acquired with deteriorated credit quality	526	–	–	526
Total ending allowance balance	**$ 6,325**	**$ 1,775**	**$ 298**	**$ 8,398**
Loans:				
Loans individually evaluated for impairment	$ 8,560	$ 1,009	$ 25	$ 9,594
Loans collectively evaluated for impairment	368,630	97,619	5,962	472,211
Loans acquired with deteriorated credit quality	9,871	–	–	9,871
Total ending loans balance	**$ 387,061**	**$ 98,628**	**$5,987**	**$ 491,676**

NOTE 4 – LOANS (Continued)

The following table presents information related to impaired loans by class of loans as of and for the year ended December 31, 2011:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
December 31, 2011						
With no related allowance recorded:						
Commercial:						
Commercial/Industrial	$ 845	$ 361	$ –	$ 468	$ –	$ –
Commercial real estate	1,172	716	–	1,002	9	6
Commercial land development	4,721	1,130	–	1,641	–	–
Real estate:						
Residential	635	509	–	575	4	2
Home equity	34	3	–	18	–	–
Consumer	8	3	–	14	2	2
Subtotal	7,415	2,722	–	3,718	15	10
With an allowance recorded:						
Commercial:						
Commercial/Industrial	1,809	1,638	471	1,826	70	69
Commercial real estate	4,830	4,374	1,432	4,528	209	196
Commercial land development	7,981	2,548	28	3,319	59	58
Real estate:						
Residential	1,128	1,001	27	1,076	3	2
Home equity	8	8	8	9	–	–
Consumer	69	25	10	43	1	1
Subtotal	15,825	9,594	1,976	10,801	342	326
Total	**$ 23,240**	**$12,316**	**$ 1,976**	**$14,519**	**$ 357**	**$ 336**

The recorded investment in loans excludes accrued interest receivable which is not material. For purposes of this disclosure, the unpaid principal balance is not reduced for partial charge-offs taken to date.

Loans with aggregate balances of $4,846 were considered impaired at year-end 2010. At year-end 2010, $482 of the allowance was allocated to 10 impaired loans with $1,973 in balances. The average balance of impaired loans during 2010 was $4,464. No income was recognized on any impaired loan during 2010.

Nonperforming loans include nonaccrual loans and loans past due 90 days still on accrual. Nonperforming loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table presents the recorded investment in nonperforming loans by class of loans as of December 31, 2011:

	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial:		
Commercial/Industrial	$ 471	$ –
Commercial real estate	939	–
Commercial land development	1,909	–
Real estate:		
Residential	1,001	–
Home equity	8	–
Consumer	10	–
Total	**$ 4,338**	**$ –**

Nonperforming loans at year-end were as follows:

	2010
Loans past due over 90 days still on accrual	$ –
Nonaccrual loans	4,846

NOTE 4 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
December 31, 2011						
Commercial:						
Commercial/Industrial	$ –	$ –	$ 222	$ 222	$139,118	$139,340
Commercial real estate	126	93	713	932	243,718	244,650
Commercial land development	–	115	955	1,070	2,001	3,071
Real estate:						
Residential	–	492	249	741	65,197	65,938
Home Equity	37	202	–	239	32,450	32,690
Consumer	3	–	–	3	5,985	5,987
Total	**$ 166**	**$ 902**	**$ 2,139**	**$ 3,207**	**$488,469**	**$491,676**

Troubled Debt Restructurings:

The Corporation has allocated $1,152 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2011. Of this amount, approximately $1,000 relates to one loan relationship for which impairment is measured using the fair value of underlying collateral. The Corporation has not committed to lend material additional amounts to customers under troubled debt restructurings as of December 31, 2011. Specific reserve allocations and loan commitments as indicated above were not material for the year ended December 31, 2010.

During the year ending December 31, 2011, the terms of certain loans were modified in troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 2 months to 3 years. Modifications involving an extension of the maturity date were for similar periods.

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ending December 31, 2011:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Commercial:			
Commercial/Industrial	6	$ 2,804	$ 2,804
Commercial real estate	3	1,273	1,273
Commercial land development	4	1,288	1,288
Real estate:			
Residential real estate	–	–	–
Home equity	1	4	4
Consumer	–	–	–
Total	**14**	**$ 5,369**	**$ 5,369**

The troubled debt restructurings described above increased the allowance for loan losses by $1,123. The restructurings did not result in a material amount of charge offs during the year ending December 31, 2011. During 2011, the Bank did not offer concessions to borrowers that reduced their accrued interest or principal amount owed.

There were no payment defaults on troubled debt restructurings during the year ended December 31, 2011.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Corporation's internal underwriting policy.

NOTE 4 – LOANS (Continued)

Credit Quality Indicators:

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes homogeneous and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a monthly basis. The Corporation uses the following definitions for risk ratings:

Watch. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution 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 liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Loans listed as not rated are included in groups of homogeneous loans.

Based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

	Pass	Watch	Substandard	Doubtful	Not Rated
December 31, 2011					
Commercial:					
Commercial/Industrial	$ 129,097	$ 7,859	$ 2,261	$ 122	$ –
Commercial real estate	240,274	469	3,706	201	–
Commercial land development	–	825	1,474	772	–
Real estate:					
Residential real estate	–	–	1,001	–	64,937
Home equity	–	–	13	–	32,677
Consumer	–	–	10	14	5,962
Total	**$ 369,371**	**$ 9,153**	**$ 8,465**	**$ 1,109**	**$ 103,576**

The Corporation considers the performance of the homogeneous loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity:

	Real Estate		
	Residential	Home Equity	Consumer
December 31, 2011			
Performing	$ 64,937	$ 32,682	$ 5,977
Nonperforming	1,001	8	10
Total	**$ 65,938**	**$ 32,690**	**$ 5,987**

NOTE 5 – COVERED LOANS

The Corporation evaluated covered loans purchased in conjunction with the acquisition of New Liberty pursuant to the provisions of FASB's accounting guidance for Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased impaired loans are subject to this guidance if there is determined to be evidence of credit deterioration, since origination, and if it is probable that not all contractually required payments will be collected. At the acquisition date, such loans had a contractual balance due of $30,132 and an estimated fair value of $19,800. The discount, substantially all of which was determined to be non-accretable based on the expected short-term resolution of the loans, represents expected credit impairment on the loans and is only recognized in income if the payments on the loan exceed the estimated payments.

Purchased loans not deemed to be impaired had an acquisition date contractual balance due of $61,640 and an estimated fair value of $49,269.

All of these loans are subject to the loss share agreement with the FDIC pursuant to which 80% of contractual principal and up to 90 days of accrued interest is guaranteed.

The following table reflects the carrying value of covered loans, by type, as of December 31, 2010:

	Purchased Impaired	Non-Impaired	Total Covered Loans
Commercial	$ 8,775	$ 9,201	$ 17,976
Real estate - commercial	6,404	28,007	34,411
Real estate - residential	–	664	664
Consumer	347	4,418	4,765
Total covered loans	**$ 15,526**	**$ 42,290**	**$ 57,816**

Purchased impaired loans at year end 2010 had a contractual principal balance of $23,670 and substantially all the $8,145 discount is non-accretable. As of December 31, 2011, these loans had a contractual balance of $13,332 and a non-accretable discount of $3,461.

Allowances for loan losses related to the purchased impaired and non-impaired loans at December 31, 2010 were not significant. Purchased impaired and non-impaired loan allowances for loan losses are illustrated in Note 4.

The FDIC Indemnification Asset represents the Corporation's estimate of the amount that will be due from the FDIC for its share of losses on covered loans and other real estate. The balance determined at acquisition was $15,949 and the balance at December 31, 2010 is $12,627. As of December 31, 2011, the balance was $7,726. This asset decreases when losses are realized and claims are submitted to the FDIC or when customers repay their loans in full and expected losses do not occur. This asset will also change when estimated future losses increase or decrease. From the date of acquisition, through December 31, 2011, the Corporation's expected covered losses have not been revised and the decline in the indemnification asset is substantially due to losses realized and loss share claims paid by the FDIC.

NOTE 6 – FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Corporation used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

<u>Securities:</u> Fair values are calculated based on market prices of similar securities (Level 2).

NOTE 6 – FAIR VALUE (Continued)

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Assets and Liabilities Measured on a Recurring Basis: Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Corporation has elected the fair value option, are summarized below:

		Fair Value Measurements at December 31, 2011 Using:		
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
Securities available-for-sale				
U.S. government-sponsored entities and agencies	$ 18,093	$ –	$ 18,093	$ –
Mortgage backed securities: residential	20,876	–	20,876	–
Mortgage-backed securities: commercial	8,399	–	8,399	–
States and political subdivisions	62,192	–	62,192	–
Other securities	1,257	–	1,257	–
Total securities available-for-sale	**$ 110,817**	**$ –**	**$ 110,817**	**$ –**

		Fair Value Measurements at December 31, 2010 Using:		
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
Securities available-for-sale				
U.S. government-sponsored entities and agencies	$ 20,918	$ –	$ 20,918	$ –
States and political subdivisions	30,725	–	30,725	–
Other securities	1,262	–	1,262	–
Total securities available-for-sale	**$ 52,905**	**$ –**	**$ 52,905**	**$ –**

NOTE 6 – FAIR VALUE (Continued)

Assets and Liabilities Measured on a Non-Recurring Basis: Assets measured at fair value on a non-recurring basis are summarized below:

	Carrying Value	Fair Value Measurements at December 31, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans:				
Commercial:				
Commercial/Industrial	$ 936	$ –	$ –	$ 936
Commercial real estate	2,226	–	–	2,226
Commercial land development	1,390	–	–	1,390
Real Estate:				
Residential	466	–	–	466
Consumer	15	–	–	15
	$ 5,033	**$ –**	**$ –**	**$ 5,033**
Other real estate owned, net				
Commercial/Industrial	$ 1,485	$ –	$ –	$ 1,485
Commercial real estate	1,100	–	–	1,100
Commercial land development	1,602	–	–	1,602
	$ 4,187	**–**	**–**	**4,187**

	Carrying Value	Fair Value Measurements at December 31, 2010 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 1,491	$ –	$ –	$ 1,491
Other real estate owned, net	4,603	–	–	4,603

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had carrying amounts of $5,033 and $1,491 at year-end 2011 and 2010, which amounts are net of valuation allowances of $1,976 and $482 at year end 2011 and 2010, resulting in additional provisions for loan losses of similar amounts for the years.

Other real estate owned which is measured at the lower of carrying or fair value less costs to sell, had a carrying amount of $4,187 and $4,603 at year end 2011 and 2010. Write downs in 2011 and 2010 were $503 and $444.

NOTE 6 – FAIR VALUE (Continued)

Fair Value of Financial Instruments

Carrying amount and estimated fair values of financial instruments, not previously presented, at year-end were as follows:

	2011		2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets				
Cash and cash equivalents	$ 124,041	$ 124,041	$ 101,760	$ 101,760
Loans held for sale	13,420	13,457	71,516	71,773
Loans, net	483,278	482,566	410,161	408,806
Federal Home Loan Bank stock	2,634	n/a	2,927	n/a
FDIC indemnification asset	7,726	n/a	12,627	n/a
Accrued interest receivable	1,599	1,599	1,662	1,662
Financial liabilities				
Deposits	$ 685,834	$ 686,204	$ 609,235	$ 609,532
Repurchase agreements	21,652	21,652	18,048	18,048
Federal Home Loan Bank advances	7,496	7,539	9,936	9,982
Subordinated debentures	5,155	5,155	5,155	5,155
Accrued interest payable	276	276	309	309

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits, accrued interest receivable and payable, demand deposits, short term debt, and variable rate loans or deposits that reprice frequently and fully. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk, including estimated liquidity discounts for certain loans. Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock or the FDIC indemnification asset, due to restrictions placed on their transferability. The fair value of off balance sheet items is not considered material.

NOTE 7 – PREMISES AND EQUIPMENT

Year-end premises and equipment were as follows:

	2011	2010
Land	$ 2,287	$ 1,777
Buildings	7,455	6,364
Leasehold improvements	3,472	3,426
Furniture, fixtures and equipment	5,864	5,503
	19,078	17,070
Less: accumulated depreciation	(8,544)	(7,927)
	$ 10,534	**$ 9,143**

Rent expense was $576 and $601 for 2011 and 2010. The main office and a branch facility are leased from a related party. Rental expense of $223 and $219 was attributable to a related party in 2011 and 2010. Rent commitments under noncancelable operating leases were as follows, before considering renewal options that generally are present.

2012	$ 281
2013	266
2014	180
2015	105
2016	–
	$ 832

NOTE 8 – DEPOSITS

Time deposits of $100 or more were $121,133 and $100,564 at year-end 2011 and 2010.

Scheduled maturities of time deposits for the next five years were as follows:

2012	$ 158,898
2013	7,962
2014	3,217
2015	4,666
2016	1,246
Thereafter	–
	$ 175,989

NOTE 9 – FEDERAL HOME LOAN BANK ADVANCES AND SUBORDINATED DEBENTURES

At year-end, advances from the Federal Home Loan Bank were as follows:

	2011	2010
Maturities March 2011 through December 2016, primarily with fixed rates ranging from 0.93% to 4.75%, averaging 1.99%.	$ –	$ 9,936
Maturities April 2012 through December 2016, with fixed rates ranging from 0.93% to 1.96%, averaging 1.26%.	7,496	–
	$ 7,496	$ 9,936

Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. Certain advances may be converted from a fixed rate to a variable rate, at certain points at the option of the Federal Home Loan Bank. These advances can be repaid, without penalty, at the time of such conversion. The advances were collateralized by $61,988 and $125,844 of mortgage loans at year end 2011 and 2010. Based on this collateral and the Corporation's holdings of FHLB stock, the Corporation is eligible to borrow up to a total of $54,652 at year-end 2011.

FHLB advances at year-end 2011 include principal due of $7,336 and a yield adjustment related to the New Liberty acquisition of $160.

Contractual principal payment due are as follows:

2012	$ 6,000
2013	–
2014	–
2015	–
2016	1,336
2017	–
	$ 7,336

Subordinated Debentures and Trust Preferred Securities: During 2003, a trust formed by the Corporation issued $5,000 of floating rate trust as part of a pooled offering. The Corporation issued $5,155 in subordinated debentures to the trust in exchange for ownership of all of the common securities of the trust and the proceeds of the preferred securities issued by the trust. Interest is payable quarterly at a rate of LIBOR plus 3.15%, with a cap of 11.75%. The Corporation must repay the debentures prior to March 2033, but may call the debentures, without penalty, after March 2008. The trust is not consolidated into the Corporation's financial statements, but rather the subordinated debentures are shown as a liability. The Corporation's investment in the common stock of the trust is included in other assets.

NOTE 10 – INCOME TAXES

Income tax expense (benefit) was as follows:

	2011	2010
Current	$ 3,077	$ 3,595
Deferred	(858)	(1,769)
	$ 2,219	$ 1,826

Federal income tax expense differs from the amount computed by applying the U.S. federal statutory tax rate of 34% to income before taxes primarily due to the effect of tax-exempt interest income and increases in cash surrender value of life insurance.

NOTE 10 – INCOME TAXES (Continued)

A reconciliation of the differences between the federal income tax expense (benefit) recorded and the amount computed by applying the federal statutory rate to income before income taxes is as follows:

	2011	2010
Tax at statutory rate (34%)	$ 2,993	$ 2,354
Increase (decrease) from tax-exempt interest	(624)	(407)
Bank owned life insurance	(136)	(139)
Other	(14)	18
Tax expense (benefit)	**$ 2,219**	**$ 1,826**

Year-end deferred tax assets and liabilities were due to the following.

	2011	2010
Deferred tax assets:		
Net unrealized loss on securities available-for-sale	$ –	$ 257
Allowance for loan losses	2,530	2,238
Deferred compensation	279	258
Depreciation	232	323
Post-retirement benefits	74	74
Purchase accounting adjustments	238	336
Other real estate	508	835
Repurchased mortgage loan settlements	998	–
Accrued retirement	161	125
Other	100	85
	5,120	4,531
Deferred tax liabilities:		
Loan fees	65	50
FHLB stock dividends	81	81
Net unrealized gain on securities available-for-sale	803	–
Prepaid expenses and other	38	65
	987	196
Net deferred tax asset	**$ 4,133**	**$ 4,335**

The Corporation and its subsidiaries are subject to U.S. federal income tax as well as income tax in the states of Michigan and Illinois. The Corporation is no longer subject to examination by taxing authorities for years before 2008.

The Corporation did not incur any income tax related interest or penalties for the years ended December 31, 2011 or 2010.

NOTE 11 – BENEFIT PLAN

The Corporation has a 401(k) plan that is a defined contribution savings plan for employees. Eligible employees may defer a portion of their salary. Employer contributions are discretionary and are determined annually by the Board of Directors. The Corporation's contribution expense was $442 and $327 for 2011 and 2010.

NOTE 12 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Management believes as of December 31, 2011, the Corporation and Bank meet all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year end 2011 and 2010, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

NOTE 12 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (Continued)

The New Liberty FDIC-assisted transaction, which was accounted for as a business combination, resulted in the recognition of an FDIC Indemnification Asset, which represents the fair value of estimated future payments by the FDIC for losses on covered assets. The FDIC Indemnification Asset is risk weighted at 0% and the covered assets are risk-weighted at 20% for risk based regulatory capital requirement purposes.

Actual and required capital amounts and ratios are presented below at year end:

	Actual		Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2011						
Total Capital to risk weighted assets:						
Consolidated	$ 59,464	11.89%	$ 40,017	8.00%	$ n/a	n/a
Bank	59,035	11.81%	39,977	8.00%	49,972	10.00%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	53,183	10.63%	20,008	4.00%	n/a	n/a
Bank	52,760	10.56%	19,989	4.00%	29,983	6.00%
Tier 1 (Core) Capital to average assets:						
Consolidated	53,183	6.95%	30,605	4.00%	n/a	n/a
Bank	52,760	6.90%	30,605	4.00%	38,256	5.00%

	Actual		Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2010						
Total Capital to risk weighted assets:						
Consolidated	$ 52,056	11.63%	$ 35,793	8.00%	$ n/a	n/a
Bank	51,566	11.59%	35,817	8.00%	44,771	10.00%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	46,427	10.38%	17,897	4.00%	n/a	n/a
Bank	45,969	10.33%	17,908	4.00%	26,863	6.00%
Tier 1 (Core) Capital to average assets:						
Consolidated	46,427	6.83%	27,197	4.00%	n/a	n/a
Bank	45,969	6.82%	26,971	4.00%	33,714	5.00%

NOTE 13 – LOAN COMMITMENTS AND RELATED ACTIVITIES

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance sheet risk was as follows at year-end:

	2011	2010
Commitments to make loans (at market rates)	$ 82,483	$ 97,094
Unused lines of credit and letters of credit	42,278	42,487

Commitments to make loans are generally made for periods of 60 days or less.

NOTE 13 – LOAN COMMITMENTS AND RELATED ACTIVITIES (Continued)

Loans are sold with servicing released. Buyers do not have recourse against the Corporation for subsequent loan losses related to credit deterioration. However, in certain situations, the buyer can require the Corporation to repurchase loans based on underwriting exceptions. The Corporation reviews each repurchase request and asserts various defenses when such requests are made. A liability is established, included in accrued expense and other liabilities on the balance sheet, for the estimated risk of repurchase based both on past repurchase experience and on repurchase requests in the process of being evaluated.

Repurchase losses and expense for 2011 and 2010 was as follows:

	2011	2010
Beginning balance	$ 1,364	$ 1,000
Provision charged to expense	2,967	1,500
Losses on loans repurchased	(1,396)	(1,136)
Ending balance	$ 2,935	$ 1,364

NOTE 14 – EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

	2011	2010
Basic		
Net income	$ 6,583	$ 5,097
Weighted average common shares outstanding	872,243	863,947
Basic earnings per common share	$ 7.55	$ 5.90
Diluted		
Net income	$ 6,583	$ 5,097
Weighted average common shares outstanding for basic earnings per common share	872,243	863,947
Add: Dilutive effects of potential common stock equivalents	40,801	18,908
Average shares and dilutive potential common shares	913,044	882,855
Diluted earnings per common share	$ 7.21	$ 5.77

For 2011 and 2010, 66,192 and 135,453 options granted are not dilutive and have not been considered in computing earnings per share.

NOTE 15 – OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) components and related taxes were as follows:

	2011	2010
Unrealized holding gains and losses on available-for-sale securities	$ 3,611	$ (707)
Less reclassification adjustments for gains and losses later recognized in income	(494)	–
Net unrealized gains and losses	3,117	(707)
Tax effect	(1,060)	240
Other comprehensive income (loss)	$ 2,057	$ (467)

NOTE 16 – STOCK-BASED COMPENSATION

Share Award Plan

The Corporation maintains a deferred shares plan for directors which allows eligible directors to elect to defer all of their directors fees in return for Corporation stock. Under the Plan, deferred fees are used to accumulate shares of the Corporation's stock based on the stock price in effect at the time the fees are earned. Shares vest and are expensed immediately upon service provided, therefore there is no unrecognized compensation costs or unvested shares. Upon retirement or resignation, the stock is issued and distributed to the directors. At year-end 2011, 18,022 shares of Corporation stock (17,461 shares at year-end 2010) with an aggregate cost of $799 ($760 at year-end 2010) have been reserved for issuance. During 2011 and 2010, 441 and 750 shares were distributed.

NOTE 16 – STOCK-BASED COMPENSATION (Continued)

Stock Option Plan

The Corporation has two stock option plans approved by shareholders. The Employee Share Option Plan permits the grant of share options to its employees for up to 285,000 shares of common stock. The 2011 Director Stock Compensation Plan permits the grant of share options to directors for up to 50,000 shares of common stock. The Corporation believes that such awards better align the interests of its employees and directors with those of its shareholders. The stock option plans are also designed to allow employees and directors to participate in the Corporation's future, as well as to enable it to attract, retain and award such employees and directors. Option awards are granted with an exercise price equal to the market price of the Corporation's common stock at the date of the grant, vesting periods of 3 year and 10 year contractual terms. The Corporation has a policy of using authorized, but unissued, shares to satisfy share option exercises. The Corporation has a right of first refusal to buy back option shares.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination and forfeiture behavior. The Corporation expects that all options granted will vest and become exercisable. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of options granted was determined using the following weighted average assumptions as of grant date:

	2011	2010
Risk free interest rate	2.09%	2.01%
Expected term	5.0 years	5.0 years
Expected stock price volatility	24.30%	24.44%
Dividend yield	1.0%	0%

A summary of the activity in the stock option plan for 2011 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at beginning of year	136,623	$ 48.70		
Granted	55,095	39.00		
Exercised	(9,863)	33.01		
Forfeited or expired	(7,046)	46.96		
Outstanding at end of year	174,809	$ 46.40	6.5	$ 3,103
Exercisable at end of year	91,449	$ 57.34	4.4	$ 711

Information related to the stock option plan during each year follows:

	2011	2010
Intrinsic value of options exercised	$ 122	$ 6
Cash received from option exercises	326	240
Tax benefit realized from option exercises	–	–
Weighted average per share fair value of options granted	8.68	7.68

During 2010, the Corporation offered option holders the opportunity to exchange unexercised options granted in 2007, 2008 and 2009 for new options with an exercise price based on current market vale. Pursuant to the modification offer, all options held needed to be exchanged and the new options were subject to a three year vesting period, with a ten year term. Holders of 42,150 options accepted this offer. At modification, the value of the new options exceeded the value of the exchanged options by approximately $137 and the options surrendered had unrecognized compensation cost of approximately $84. This combined amount will be amortized over the new three year vesting period.

Total compensation cost that has been charged against income for this plan was $191 and $189 for 2011 and 2010, respectively. No income tax benefit was recognized. As of December 31, 2011, there was $541 of unrecognized compensation cost related to non-vested stock options granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.5 years. All options granted are expected to vest.

The Bank of Ann Arbor Team

Executive Management
Timothy G. Marshall
President &
Chief Executive Officer

Charles E. Crone, Jr.
First Vice President,
Commercial Banking
Group Manager

Lyle F. Dahlberg
First Vice President,
Trust & Investment
Group Manager

Patti H. Judson
First Vice President,
Branch Administration,
Operations &
Cash Management

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First Vice President,
Credit Administration

Mark J. Slade
First Vice President &
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First Vice President,
Branch Administration,
Operations &
Cash Management

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Vice President,
Cash Management

Kristina Mayer
Vice President &
Plymouth Branch Manager

Joan C. Hendricks
Assistant Vice President &
Main Office Branch Manager

Rhoshebie N. Argo
Ypsilanti Office Branch Manager

Russell D. Hines
Stadium Office Branch Manager

Dennis D. Ticknor
Ellsworth Office Branch Manager
& Health Savings
Account Specialist

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Deposit Operations Officer

Sandra M. Ross
Senior Relationship Banking
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Kimberly K. Snow
Relationship Banking &
Cash Management Officer

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Vice President &
Mortgage Department Manager

Collyer A. Smith
Vice President &
Retail Mortgage Sales Manager

Kimberly A. Clugston
Vice President &
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Carl D. Ent
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Barbara L. Morrison
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Mortgage Loan Officer

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Vice President,
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Credit Administration

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Sara L. Simon
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Pamela J. Wetzel
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Timothy G. Marshall
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Ernest G. Perich
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Bank
OF ANN ARBOR

TIMOTHY G. MARSHALL
PRESIDENT & CEO

October 19, 2012

Board of Governors of the Federal Reserve System
Jennifer J. Johnson Secretary
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

As the President of a community bank that will be directly impacted I urge you to reject the Basel III standards. The impact of the Basel III proposal will be substantial, especially for community banks. I feel strongly that if implemented as written, Basel III will substantially curtail lending and contribute to pressures on the viability of smaller institutions. This will negatively impact credit availably and weaken economic growth.

Put simply, a "one size fits all" approach to correct the capital deficiencies highlighted by the recent financial crisis will not work. Basel III was designed to apply to the largest, internationally active banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. We clearly fill a very important niche not addressed by our larger non-local competitors. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. Subjecting community banks to the standards designed to address the problems created by the largest banks will cause undue hardship and unintended consequences.

As a relatively new bank, opened in 1996, we have maintained well capitalized capital levels since our inception and throughout the downturn but do not have large excess capital levels as we have experienced significant growth over the past several years and have been able to fund that growth through record-level earnings in 2010, 2011, and year to date 2012 results without having to raise additional capital. Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and would require my bank to reduce growth or attempt to raise external capital. Community banks do not have ready access to

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capital that the larger banks have through the capital markets. The most effective way for community banks to increase capital is through the accumulation of retained earnings over time. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted (at least five years beyond 2019) in order for banks that need the additional capital to retain and accumulate earnings accordingly.

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property.

Higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE further curtailing the availability of mortgage loans to consumers.

Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. HELOC and other junior liens are at worst unsecured lines of credit and should be risk rated no higher than unsecured commercial or consumer debt. This is contrary to banks' efforts to restore consumer confidence generally and expand economic activity. It will unreasonably impede lending.

In order to attempt to deal with the complexity issues, banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages and impact on capital ratios. Over the past few years, we have grown from one person in our compliance area to over five full time equivalents working to keep our compliance ratings at a satisfactory or above rating where we have always performed.

Inclusion of accumulated other comprehensive income (OCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. OCI for most community banks represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation.

Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of OCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At my bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio would show a paper loss of $8.6 million. This would mean that my bank's tier one ratio would drop from 6.96% to 5.93%, a significant decline requiring short term corrective action that would not be in the best interests of the bank or the communities we serve.

I also object to the proposed ten year phase-out of the tier one treatment of instruments like trust preferred securities (TRUPS) because it is a reliable source of capital for community banks that would be very difficult to replace. I believe it was the intent of the Collins amendment of the Dodd-Frank Act to permanently grandfather tier one treatment of TRUPS issued by bank holding companies between $500 million and $15 billion. Phasing out this important source of capital would be a particular burden for many privately-held banks and bank holding companies that are facing greatly reduced alternatives in raising capital.

I feel that with such sweeping changes, not enough time has been spent to properly study and test all the potential impacts. The proposal is not flexible enough to be amended as the markets and capital providers respond to the changes and the economy evolves. Finally, if adopted as proposed, I am concerned with the short implementation period for such major changes as it will take a significant lead time for the industry and my bank to implement significant balance sheet changes, revise lending and investment procedures, amend many of our historical processes, and update information systems for reporting purposes.

In summary, I feel very strongly that as written BASEL III does not correct the problems caused by the last financial crisis. Capital standards should be strengthened and the issues that contributed to the financial crisis should be addressed, however more time and analysis is needed to make sure the right changes are made. BASEL III does not accomplish the goals intended and causes undue hardship on community banks and the communities we serve. We remain in a very precarious economic time and limiting community banks ability to lend will directly hurt economic activity.

Thank you for your consideration and for providing an opportunity for additional comment on this critically issue for all community banks across the country.

Sincerely,

Timothy G. Marshall
President & CEO

cc: (Via Email)
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