First Federal of Northern Michigan Bancorp, Inc.
Form 10-Q
November 14, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from ______________________ to __________________________

Commission File Number 000-31957

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland	32-0135202
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 S. Second Avenue, Alpena, Michigan 49707

(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

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

Common Stock, Par Value $0.01	Outstanding at November 9, 2012
(Title of Class)	2,884,049 shares

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended September 30, 2012

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

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

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

PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheet

	September 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Cash and cash equivalents:		
Cash on hand and due from banks	$ 3,249,826	$ 2,713,701
Overnight deposits with FHLB	35,934	35,797
Total cash and cash equivalents	3,285,760	2,749,498
Securities AFS	52,483,641	53,048,503
Securities HTM	2,395,000	2,435,000
Loans held for sale	1,041,454	-
Loans receivable, net of allowance for loan losses of $1,683,731 and $1,517,695 as of September 30, 2012 and December 31, 2011, respectively	138,373,228	140,883,591
Foreclosed real estate and other repossessed assets	2,287,858	3,407,939
Federal Home Loan Bank stock, at cost	3,266,100	3,266,100
Premises and equipment	5,730,687	5,845,881
Accrued interest receivable	1,119,332	1,148,500
Intangible assets	187,962	334,855
Prepaid FDIC premiums	627,164	758,733
Deferred tax asset	1,194,873	387,065
Other assets	2,941,641	2,779,124
Total assets	$ 214,934,700	$ 217,044,789
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposits	$ 158,675,753	$ 150,649,073
Advances from borrowers for taxes and insurance	210,174	128,028
Federal Home Loan Bank Advances	25,000,000	34,500,000
REPO Sweep Accounts	4,245,047	5,592,326
Accrued expenses and other liabilities	1,511,098	1,606,568
Total liabilities	189,642,072	192,475,995
Stockholders' equity:		

Common stock ($0.01 par value 20,000,000 shares authorized 3,191,799 shares issued)	31,918	31,918
Additional paid-in capital	23,853,891	23,852,702
Retained earnings	3,583,678	2,980,176
Treasury stock at cost (307,750 shares)	(2,963,918)	(2,963,918)
Unearned compensation	-	(556)
Accumulated other comprehensive income	787,059	668,472
Total stockholders' equity	25,292,628	24,568,794
Total liabilities and stockholders' equity	$ 214,934,700	$ 217,044,789

See accompanying notes to consolidated financial statements

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First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries

Consolidated Statement of Income

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Interest income:				
Interest and fees on loans	$1,995,749	$2,196,300	$6,047,447	$6,786,817
Interest and dividends on investments				
Taxable	136,100	151,190	423,308	380,407
Tax-exempt	38,438	39,735	116,240	120,074
Interest on mortgage-backed securities	142,309	200,442	486,153	583,510
Total interest income	2,312,596	2,587,667	7,073,148	7,870,808
Interest expense:				
Interest on deposits	249,442	381,124	793,620	1,226,252
Interest on borrowings	144,584	183,030	491,872	523,785
Total interest expense	394,026	564,154	1,285,492	1,750,037
Net interest income	1,918,570	2,023,513	5,787,656	6,120,771
Provision for loan losses	234,005	(67,079)	1,188,588	(18,959)
Net interest income after provision for loan losses	1,684,565	2,090,592	4,599,068	6,139,730
Non-interest income:				
Service charges and other fees	205,592	197,267	563,084	542,986
Mortgage banking activities	441,445	218,671	876,090	637,116
Net loss on sale of premises and equipment	(698)	(544)	(698)	(544)
Net loss on real estate owned and other repossessed assets	(9,993)	(7,937)	(80,098)	(54,368)
Net gain on sale of investment securities	47,017	-	47,017	-
Other	119,519	61,845	234,961	186,447
Total non-interest income	802,882	469,302	1,640,356	1,311,637
Non-interest expense:				
Compensation and employee benefits	1,243,598	1,128,911	3,692,139	3,457,099
FDIC Insurance Premiums	47,190	54,061	141,314	176,448
Advertising	29,005	30,924	111,489	87,763
Occupancy	239,900	264,703	719,148	802,398
Amortization of intangible assets	29,646	73,113	146,893	219,338
Service bureau charges	73,495	69,383	229,149	224,881
Professional services	89,559	108,471	297,403	329,619
Other	324,903	595,594	1,183,209	1,495,664
Total non-interest expense	2,077,296	2,325,160	6,520,744	6,793,210
Income (loss) before income tax expense or benefit	410,151	234,734	(281,320)	658,157

Income tax expense (benefit)	137,375	-	(884,822)	-
Net income	$272,776	$234,734	$603,502	$658,157
Other comprehensive income:				
Net income	$272,776	$234,734	$603,502	$658,157
Change in unrealized gain on available-for-sale securities, net of tax	(48,099)	283,537	118,587	623,264
Comprehensive income	$224,677	$518,271	$722,089	$1,281,421
Per share data:				
Net income per share	$0.09	$0.08	$0.21	$0.23
Basic	$0.09	$0.08	$0.21	$0.23
Diluted				
Weighted average number of shares outstanding				
Basic	2,884,049	2,884,049	2,884,049	2,884,049
Including dilutive stock options	$-	$-	$-	$-
Dividends per common share	$-	$-	$-	$-

See accompanying notes to consolidated financial statements.

First Federal of Northern Michigan Bancorp Inc. and Subsidiaries

Consolidated Statement of Changes in Stockholders' Equity (Unaudited)

	Common Stock	Treasury Stock	Additional Paid-in Capital	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2011	$31,918	$(2,963,918)	$23,852,702	$ (556)	$2,980,176	$ 668,472	$24,568,794
Cash paid in lieu of fractional shares	-	-	(20)	-	-	-	(20)
Stock Options/MRP shares expensed	-	-	1,210	556	-	-	1,766
Net income for the period	-	-	-	-	603,502	-	603,502
Change in unrealized gain on available-for-sale securities (net of tax of $61,090)	-	-	-	-	-	118,587	118,587
Balance at September 30, 2012	$31,918	$(2,963,918)	$23,853,891	$ 0	$3,583,678	$ 787,059	$25,292,628

See accompanying notes to the consolidated financial statements.

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First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries

Consolidated Statement of Cash Flows

	For Nine Months Ended September 30,	
	2012	2011
	(Unaudited)	
Cash Flows from Operating Activities:		
Net income	$603,502	$658,157
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	378,619	525,446
Provision for loan loss	1,188,588	(18,959)
Amortization and accretion on securities	371,770	209,583
Gain on sale of investment securities	(47,017)	-
Stock-based compensation	1,766	67,695
Gain on sale of loans held for sale	(393,692)	(255,770)
Originations of loans held for sale	(26,174,538)	(18,479,727)
Proceeds from sale of loans held for sale	25,526,776	18,118,749
Loss on sale of fixed assets	698	544
Loss on sale of real estate owned and other repossessed assets	80,098	54,368
Net change in:		
Accrued interest receivable	29,168	60,267
Other assets	(223,607)	(461,249)
Prepaid FDIC insurance premiums	131,569	164,363
Deferred income tax (benefit) expense	(807,808)	328,808
Accrued expenses and other liabilities	(95,492)	27,381
Net cash provided by operating activities	570,400	999,656
Cash Flows from Investing Activities:		
Net decrease in loans (loans originated, net of principal payments)	47,965	12,853,481
Proceeds from maturity and sale of available-for-sale securities	16,906,748	9,390,032
Proceeds from sale of property and equipment	425	1,780
Purchase of securities	(16,446,962)	(23,407,417)
Purchase of premises and equipment	(117,655)	(213,638)
Proceeds from sale of real estate owned and other repossed assets	2,313,794	1,317,766
Proceeds from sale of Federal Home Loan Bank Stock	-	509,300
Net cash provided by investing activities	2,704,315	451,304
Cash Flows from Financing Activities:		
Net increase (decrease) in deposits	8,026,680	(2,650,956)
Net (decrease) increase in Repo Sweep accounts	(1,347,279)	3,244,869
Net increase in advances from borrowers	82,146	91,723
Advances from Federal Home Loan Bank and notes payable	32,250,000	8,350,000
Repayments of Federal Home Loan Bank advances and notes payable	(41,750,000)	(4,350,000)

Net cash (used for) provided by financing activities	(2,738,453)	4,685,636
Net increase in cash and cash equivalents	536,262	6,136,596
Cash and cash equivalents at beginning of period	2,749,498	1,962,657
Cash and cash equivalents at end of period	$3,285,760	$8,099,253
Supplemental disclosure of cash flow information:		
Cash paid during the period for		
Interest	$1,322,705	$1,783,848
Income taxes	-	-
Transfers of loans to foreclosed real estate and repossessed assets	1,273,811	3,013,142

See accompanying notes to the consolidated financial statements.

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FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1—BASIS OF FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited condensed consolidated interim financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q. Accordingly, certain information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The interim financial statements should be read in conjunction with the financial statements of First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries and the notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2011.

All adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary for a fair presentation of financial position, results of operations and cash flows, have been made. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

Note 2— PRINCIPLES OF CONSOLIDATION

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

Note 3—SECURITIES

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

	September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
	(in thousands)			
Securities Available for Sale				
U.S. Government and agency obligations	$10,700	$ 76	$ -	$10,776
Municipal obligations	7,806	377	(11)	8,172
Corporate bonds & other obligations	1,147	12	-	1,159
Mortgage-backed securities	31,635	783	(42)	32,376
Equity securities	3	-	(2)	1
Total	$51,291	$ 1,248	$ (55)	$52,484
Securities Held to Maturity				
Municipal obligations	$2,395	$ 227	$ -	$2,622

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
	(in thousands)			
Securities Available for Sale				
U.S. Government and agency obligations	$14,756	$ 108	$ (1)	$14,863
Municipal obligations	6,927	361	(12)	7,276
Mortgage-backed securities	30,350	603	(44)	30,909
Equity securities	3	-	(2)	1
Total	$52,036	$ 1,072	$ (59)	$53,049
Securities Held to Maturity				
Municipal obligations	$2,435	$ 230	$ -	$2,665

The amortized cost and estimated market value of securities at September 30, 2012, by contract maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities with no specified maturity date are separately stated.

	September 30, 2012	
	Amortized Cost	Market Value
	(in thousands)	
Available For Sale:		
Due in one year or less	$1,847	$1,859
Due after one year through five years	15,513	15,798
Due in five year through ten years	1,967	2,030
Due after ten years	326	420
Subtotal	19,653	20,107
Equity securities	3	1
Mortgage-backed securities	31,635	32,376
Total	$51,291	$52,484
Held To Maturity:		
Due in one year or less	$90	$91
Due after one year through five years	430	461
Due in five year through ten years	660	726
Due after ten years	1,215	1,344
Total	$2,395	$2,622

At September 30, 2012 and December 31, 2011, securities with a carrying value and fair value of $41,891,000 and $31,085,000, respectively, were pledged to secure certain deposit accounts, FHLB advances and our line of credit at the Federal Reserve.

Gross proceeds from the sale of securities for the nine-months ended September 30, 2012 and 2011 were $1,553,000 and $0, respectively, resulting in gross gains of $54,000 and $0, respectively and gross losses of $7,000 and $0, respectively.

The following is a summary of temporarily impaired investments that have been impaired for less than and more than twelve months as of September 30, 2012 and December 31, 2011:

	September 30, 2012			
	Fair Value	Gross Unrealized Losses <12 months	Fair Value	Gross Unrealized Losses > 12 months
	(in thousands)			
Available For Sale:				
U.S. Government and agency obligations	$-	$ -	$ -	$ -
Municipal obligations	584	(11)	-	-
Mortgage-backed securities	624	(11)	1,160	(31)
Equity securities	-	-	1	(2)
Total	$1,208	$ (22)	$ 1,161	$ (33)
Held to Maturity:				
Municipal obligations	$-	$ -	$ -	$ -

	December 31, 2011			
	Fair Value	Gross Unrealized Losses <12 months	Fair Value	Gross Unrealized Losses > 12 months
	(in thousands)			
Available For Sale:				
U.S. Government and agency obligations	$1,999	$ (1)	$ -	$ -
Municipal obligations	646	(12)	-	-
Mortgage-backed securities	8,137	(27)	1,458	(17)
Equity securities	-	-	1	(2)
Total	$10,782	$ (40)	$ 1,459	$ (19)
Held to Maturity:				
Municipal notes	$-	$ -	$ -	$ -

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

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Note 4—LOANS

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

	At September 30, 2012	At December 31, 2011
	(in thousands)	
Real estate loans:		
Residential mortgage	$65,552	$ 66,599
Commercial loans:		
Secured by real estate	53,568	54,202
Other	8,414	7,002
Total commercial loans	61,982	61,204
Consumer loans:		
Secured by real estate	11,562	13,395
Other	1,275	1,477
Total consumer loans	12,837	14,872
Total gross loans	$140,371	$ 142,675
Less:		
Net deferred loan fees	(314)	(273)
Allowance for loan losses	(1,684)	(1,518)
Total loans, net	$138,373	$ 140,884

The following table illustrates the contractual aging of the recorded investment in past due loans by class of loans as of September 30, 2012 and December 31, 2011:

Contractual Aging of Recorded Balance in Past Due Loans by Class of Loan
As of September 30, 2012

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	(in thousands)						

Commercial Real Estate:							
Commercial Real Estate - construction	$-	$ -	$ 173	$173	$314	$ 487	$ -
Commercial Real Estate - other	1,055	29	425	1,509	51,572	53,081	-
Commercial - non real estate	5	-	-	5	8,409	8,414	-
Consumer:							
Consumer - Real Estate	149	9	112	270	11,292	11,562	-
Consumer - Other	5	5	16	26	1,249	1,275	15
Residential:							
Residential	2,098	916	1,243	4,257	61,295	65,552	201
Total	$3,312	$ 959	$ 1,969	$6,240	$134,131	$ 140,371	$ 216

As of December 31, 2011

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	(in thousands)						
Commercial Real Estate:							
Commercial Real Estate - construction	$-	$ -	$ 173	$173	$91	$ 264	$ -
Commercial Real Estate - other	3,808	339	245	4,392	49,546	53,938	-
Commercial - non real estate	46	29	-	75	6,927	7,002	-
Consumer:							
Consumer - Real Estate	394	34	128	556	12,839	13,395	-
Consumer - Other	5	25	-	30	1,447	1,477	-
Residential:							
Residential	3,055	1,501	1,969	6,525	60,074	66,599	238
Total	$7,308	$ 1,928	$ 2,515	$11,751	$130,924	$ 142,675	$ 238

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

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

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

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

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

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

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

Risk Grade 6 (Substandard) - Loans are “substandard” whose full, final collectability does not appear to be a matter of serious doubt, but which nevertheless portray some form of well defined weakness that requires close supervision by Bank management. The noted weaknesses involve more than normal banking risk. One or more of the following

characteristics may be exhibited in loans classified Substandard: (1) Loans possess a defined credit weakness and the likelihood that the loan shall be paid from the primary source of repayment is uncertain; (2) Loans are not adequately protected by the current net worth and/or paying capacity of the obligor; (3) primary source of repayment is gone, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees; (4) distinct possibility that the Bank shall sustain some loss if deficiencies are not corrected; (5) unusual courses of action are needed to maintain a high probability of repayment; (6) the borrower is not generating enough cash flow to repay loan principal, however, continues to make interest payments; (7) the Bank is forced into a subordinated or unsecured position due to flaws in documentation; (8) loans have been restructured so that payment schedules, terms, and collateral represent concessions to the borrower when compared to normal loan terms; (9) the Bank is contemplating foreclosure or legal action due to the apparent deterioration in the loan; or (10) there is a significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

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

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

The following table presents the risk category of loans by class of loans based on the most recent analysis performed as of September 30, 2012 and December 31, 2011:

As of September 30, 2012

Loan Grade	Commercial Real Estate Construction	Commercial Real Estate Other	Commercial
	(dollars in thousands)		
1-2	$-	$ -	$ -
3	-	12,070	2,223
4	314	29,987	5,782
5	-	2,736	-
6	173	8,288	409
7	-	-	-
8	-	-	-
Total	$487	$ 53,081	$ 8,414

As of December 31, 2011

Loan Grade	Commercial Real Estate Construction	Commercial Real Estate Other	Commercial
	(dollars in thousands)		
1-2	$-	$ -	$ 7
3	-	10,911	2,178
4	91	31,926	4,512
5	-	1,078	-
6	173	10,023	305
7	-	-	-
8	-	-	-
Total	$264	$ 53,938	$ 7,002

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

The following tables present the risk category of loans by class based on the most recent analysis performed as of September 30, 2012 and December 31, 2011:

As of September 30, 2012		As of December 31, 2011	
	(dollars in thousands)		
	Residential		Residential
Grade		Grade	
Pass	$63,796	Pass	$ 63,941
Special Mention	-	Special Mention	-
Substandard	1,756	Substandard	2,658
Total	$65,552	Total	$ 66,599

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As of September 30, 2012

	(dollars in thousands)	
	Consumer - Real Estate	Consumer - Other
Performing	$ 11,440	$ 1,259
Nonperforming	122	16
Total	$ 11,562	$ 1,275

As of December 31, 2011

	(dollars in thousands)	
	Consumer - Real Estate	Consumer - Other
Performing	$ 13,248	$ 1,473
Nonperforming	147	4
Total	$ 13,395	$ 1,477

The following table presents the recorded investment in non-accrual loans by class as of September 30, 2012 and December 31, 2011:

	As of September 30, 2012	December 31, 2011
	(dollars in thousands)	
Commercial Real Estate:		
Commercial Real Estate - construction	$ 173	$ 173
Commercial Real Estate - other	975	356
Commercial	-	-
Consumer:		
Consumer - real estate	122	152
Consumer - other	1	-
Residential:		
Residential	1,556	2,420
Total	$ 2,827	$ 3,101

The key features of the Company's loan modifications are determined on a loan-by-loan basis. Generally, our restructurings have related to interest rate reductions and loan term extensions. In the past the Company has granted reductions in interest rates, payment extensions and short-term payment forbearances as a means to maximize collectability of troubled credits. The Company's loan modifications are typically short-term in nature, although the Company would consider a long-term modification to ensure the long-term collectability of the credit. At a minimum, a borrower must make at least six consecutive timely payments before the Company would consider a return of a restructured loan to accruing status in accordance with Federal Deposit Insurance Corporation guidelines regarding restoration of credits to accrual status.

The Bank has classified approximately $3.1 million of its impaired loans as troubled debt restructurings as of September 30, 2012, as noted in the table below:

For the Three Months Ended
September 30, 2012

	Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investment
		(dollars in thousands)	
Troubled Debt Restructurings			
Commercial Real Estate - Construction	-	$ -	$ -
Commercial Real Estate - Other	-	-	-
Commercial - non real estate	2	1,914	1,454
Residential	-	-	-

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For the Nine Months Ended
September 30, 2012

Troubled Debt Restructurings	Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investment
		(dollars in thousands)	
Commercial Real Estate - Construction	-	$ -	$ -
Commercial Real Estate - Other	-	-	-
Commercial - non real estate	4	3,542	3,052
Residential	-	-	-

The following table represents troubled debt restructurings that have subsequently defaulted for the nine-month period ended September 30, 2012. There were no such defaults during the three-month period ended September 30, 2012:

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts	Recorded Investment
		(dollars in thousands)
Commercial Real Estate - Construction	-	$ -
Commercial Real Estate - Other	1	55
Commercial - non real estate	-	-
Residential	-	-

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

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

further unsecured positions are recognized.

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The following tables present loans individually evaluated for impairment by class of loans as of September 30, 2012 and December 31, 2011:

Impaired Loans As of September 30, 2012				For the Three Months Ended September 30, 2012		For the Nine Months Ended September 30, 2012	
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(dollars in thousands)			(dollars in thousands)			
With no related allowance recorded:							
Commercial	$-	$ -	$ -	$-	$ -	$ -	$ -
Commercial Real Estate - Construction	1,589	173	-	173	-	173	-
Commercial Real Estate - Other	3,446	2,963	-	3,206	35	3,309	107
Consumer - Real Estate	31	26	-	29	-	31	-
Consumer - Other	2	1	-	3	-	4	-
Residential	1,831	1,511	-	1,657	-	1,666	-
With a specific allowance recorded:							
Commercial	-	-	-	-	-	-	-
Commercial Real Estate - Construction	-	-	-	-	-	-	-
Commercial Real Estate - Other	2,151	2,148	175	2,167	20	2,175	61
Consumer - Real Estate	96	96	21	96	-	96	-
Consumer - Other	-	-	-	-	-	-	-
Residential	45	45	5	45	-	45	-
Totals:							
Commercial	$-	$ -	$ -	$-	$ -	$ -	$ -
Commercial Real Estate - Construction	$1,589	$ 173	$ -	$173	$ -	$ 173	$ -
Commercial Real Estate - Other	$5,597	$ 5,111	$ 175	$5,373	$ 55	$ 5,484	$ 168
Consumer - Real Estate	$127	$ 122	$ 21	$125	$ -	$ 127	$ -
Consumer - Other	$2	$ 1	$ -	$3	$ -	$ 4	$ -
Residential	$1,876	$ 1,556	$ 5	$1,702	$ -	$ 1,711	$ -

Impaired Loans As of December 31, 2011				For the Three Months Ended September 30, 2011		For the Nine Months Ended September 30, 2011	
				Average	Interest	Average	Interest

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Recorded Investment	Income Recognized	Recorded Investment	Income Recognized
With no related allowance recorded:							
Commercial	$-	$ -	$ -	$-	$ -	$ -	$ -
Commercial Real Estate - Construction	1,589	173	-	286	-	286	-
Commercial Real Estate - Other	626	626	-	883	-	470	-
Consumer - Real Estate	171	152	-	83	-	71	-
Consumer - Other	0	0	-	6	-	10	-
Residential	2,017	1,640	-	1,967	-	1,899	-
With a specific allowance recorded:							
Commercial	-	-	-	-	-	-	-
Commercial Real Estate - Construction	-	-	-	-	-	687	-
Commercial Real Estate - Other	1,337	1,128	85	781	10	939	31
Consumer - Real Estate	-	-	-	10	-	72	-
Consumer - Other	-	-	-	-	-	-	-
Residential	813	780	199	675	-	875	-
Totals:							
Commercial	$-	$ -	$ -	$-	$ -	$ -	$ -
Commercial Real Estate - Construction	$1,589	$ 173	$ -	$286	$ -	$ 973	$ -
Commercial Real Estate - Other	$1,963	$ 1,754	$ 85	$1,664	$ 10	$ 1,409	$ 31
Consumer - Real Estate	$171	$ 152	$ -	$93	$ -	$ 143	$ -
Consumer - Other	$-	$ -	$ -	$6	$ -	$ 10	$ -
Residential	$2,830	$ 2,420	$ 199	$2,642	$ -	$ 2,774	$ -

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

Activity in the allowance for loan and lease losses was as follows for the quarter and year ended September 30, 2012 and December 31, 2011, respectively:

Allowance for Credit Losses and Recorded Investment in Financing Receivables
For the Three Months Ended September 30, 2012

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Allowance for credit losses:								
Beginning Balance	$ -	$ 770	$ 40	$ 140	$ 15	$ 808	$ -	$ 1,773
Charge-offs	-	(138)	-	(17)	(20)	(166)	-	$ (341)
Recoveries	-	2	-	6	3	7	-	$ 18
Provision	35	(13)	36	1	36	139	-	$ 234
Ending Balance	$ 35	$ 621	$ 76	$ 130	$ 34	$ 788	$ 0	$ 1,684

For the Nine Months Ended September 30, 2012

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Allowance for credit losses:								
Beginning Balance	$ 10	$ 393	$ 53	$ 146	$ 46	$ 870	$ -	$ 1,518
Charge-offs	-	(265)	-	(54)	(29)	(724)	-	$ (1,072)
Recoveries	-	10	-	14	8	17	-	$ 49
Provision	25	483	23	24	9	625	-	$ 1,189
Ending Balance	$ 35	$ 621	$ 76	$ 130	$ 34	$ 788	$ 0	$ 1,684

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

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

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

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For the Three Months Ended September 30, 2011

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Allowance for credit losses:								
Beginning Balance	$164	$ 1,062	$ 152	$ 218	$ 22	$ 573	$ -	$2,191
Charge-offs	-	(210)	-	(63)	(1)	(221)	-	$(495)
Recoveries	-	-	-	4	1	20	-	$25
Provision	(141)	(234)	(68)	35	(3)	344	-	$(67)
Ending Balance	$23	$ 618	$ 84	$ 194	$ 19	$ 716	$ -	$1,654

For the Nine Months Ended September 30, 2011

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Allowance for credit losses:								
Beginning Balance	$535	$ 1,281	$ 192	$ 228	$ 59	$ 536	$ -	$2,831
Charge-offs	(94)	(328)	(6)	(147)	(19)	(625)	-	$(1,219)
Recoveries	-	3	-	27	8	23	-	$61
Provision	(418)	(338)	(102)	86	(29)	782	-	$(19)
Ending Balance	$23	$ 618	$ 84	$ 194	$ 19	$ 716	$ -	$1,654

Loan Balances Individually Evaluated for Impairment
As of September 30, 2011

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Ending balance: individually evaluated for impairment	$-	$ 27	$ -	$ 2	$ -	$ 189	$ -	$218
Ending balance: loans collectively evaluated for impairment	$23	$ 591	$ 84	$ 192	$ 19	$ 527	$ -	$1,436
Ending balance: loans acquired with deteriorated credit quality	$-	$ -	$ -	$ -	$ -	$ -	$ -	$-
Financing Receivables: Ending Balance	$261	$ 54,434	$ 7,380	$ 14,147	$ 1,410	$ 65,582	$ -	$143,214
Ending balance: individually evaluated for impairment	$173	$ 1,658	$ -	$ 90	$ 5	$ 2,625	$ -	$4,551

Ending balance: loans collectively evaluated for impairment	$88	$ 52,777	$ 7,380	$ 14,057	$ 1,405	$ 62,957	$ -	$138,664
Ending balance: loans acquired with deteriorated credit quality	$-	$ -	$ -	$ -	$ -	$ -	$ -	$-

Note 5—DIVIDENDS

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

Note 6 – STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted FASB ASC 718-10, “Shareholder Based Payments”, which requires that the grant-date fair value of awarded stock options be expensed over the requisite service period. The Company’s 1996 Stock Option Plan (the “1996 Plan”), which was approved by shareholders, permits the grant of share options to purchase shares of common stock to its employees and directors for up to 127,491 shares of common stock (retroactively adjusted for the exchange ratio applied in the Company’s 2005 stock offering and related second-step conversion). The Company’s 2006 Stock-Based Incentive Plan (the “2006 Plan”), which was approved by shareholders, permits the award of up to 242,740 shares of common stock of which the maximum number to be granted as Stock Options is 173,386 and the maximum to be granted as Restricted Stock Awards is 69,354. Option awards are granted with an exercise price equal to the market price of the Company’s stock at the date of grant. These option awards generally vest based on five years of continual service and have ten-year contractual terms. Certain options provide for accelerated vesting if there is a change in control (as defined in the Plans).

During the three and nine months ended September 30, 2012 the Company awarded no shares under the 2006 Stock-Based Incentive Plan. Shares issued under the 2006 Plan and exercised pursuant to the exercise of stock options may be either authorized but unissued shares or reacquired shares held by the Company as treasury stock.

Stock Options - A summary of option activity under the Plan during the nine months ended September 30, 2012 is presented below:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2012	182,682	$ 9.47	4.3	$ -
Granted	-	N/A		
Exercised	-	N/A		
Forfeited or expired	(15,312)	$ 8.82		
Oustanding at September 30, 2012	167,370	$ 9.48	3.8	$ -
Options Exercisable at September 30, 2012	167,370	$ 9.48	3.8	$ -

The aggregate intrinsic value of outstanding options shown in the table above represents the total pretax intrinsic value (i.e. the difference between the Company’s closing stock price of $3.96 on September 30, 2012 and the exercise price times the number of shares) that would have been received by the option holder had all option holders exercised their options on September 30, 2012. This amount changes based on the fair market value of the stock.

As of September 30, 2012 there was no unrecognized compensation cost related to nonvested options under the Plans. The total fair value of shares vested during the nine months ended September 30, 2012 was $4,052.

A summary of the status of the Company’s nonvested options as of September 30, 2012, and changes during the nine months ended September 30, 2012, is presented below:

Weighted-Average
Grant-Date

Nonvested Shares	Shares	Fair Value	
Nonvested at January 1, 2012	1,240	$	2.19
Granted	-		N/A
Vested	(1,240)	$	2.19
Forfeited	-		N/A
Nonvested at September 30, 2012	-		N/A

Restricted Stock Awards - As of September 30, 2012 there was no unrecognized compensation cost related to nonvested restricted stock awards under the Plans.

Note 7 – COMMITMENTS TO EXTEND CREDIT

The Company is a party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit, and commercial lines of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheet. The Company's exposure to credit loss is represented by the contracted amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At September 30, 2012, the Company had outstanding commitments to originate loans of $33.7 million. These commitments include the following:

	As of September 30, 2012 (dollars in thousands)
Commitments to grant loans	$ 20,090
Unfunded commitments under lines of credit	13,221
Commercial and standby letters of credit	404

Note 8 – FAIR VALUE MEASUREMENTS

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

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

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

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

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, and the valuation techniques used by the Company to determine those fair values.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2012

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2012
	(dollars in thousands)			
Assets				
Investment securities- available-for-sale:				
US Treasury securities and obligations of U.S. government corporations and agencies	$-	$ 10,776	$ -	$ 10,776
Municipal obligations	-	8,172	-	8,172
Corporate bonds & other obligations		1,159		1,159
Mortgage-backed securities	-	32,376	-	32,376
Equity securities	-	1	-	1
Total investment securities - available-for-sale	$-	$ 52,484	$ -	$ 52,484

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Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2011

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2011
	(dollars in thousands)			
Assets				
Investment securities- available-for-sale:				
US Treasury securities and obligations of U.S. government corporations and agencies	$-	$ 14,863	$ -	$ 14,863
Municipal obligations	-	7,276	-	7,276
Mortgage-backed securities	-	30,909	-	30,909
Equity securities	-	1	-	1
Total investment securities - available-for-sale	$-	$ 53,049	$ -	$ 53,049

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

There were no transfers between Levels 1 and 2 of the fair value hierarchy from December 31, 2011 to September 30, 2012. For the available for sale securities, the Company obtains fair value measurements from an independent third-party service.

The Company has assets that, under certain conditions, are subject to measurement at fair value on a nonrecurring basis. At September 30, 2012 and December 31, 2011, such assets consist primarily of impaired loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2012

	Balance at September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans accounted for under FASB ASC 310-10	$3,380	-	-	$ 3,380
Other real estate owned -residential mortgages	$823	-	-	$ 823
Other Real estate owned - commercial	$344	-	-	$ 344
Other Repossessed Assets	$1,121			$ 1,121
Total assets at fair value on a non-recurring basis				$ 5,668

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2011

	Balance at December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans accounted for under FASB ASC 310-10	$1,927	-	-	$ 1,927
Other real estate owned -residential mortgages	$1,087	-	-	$ 1,087
Other Real estate owned - commercial	$1,015	-	-	$ 1,015
Other repossessed assets	$1,307			$ 1,307
Total assets at fair value on a non-recurring basis				$ 5,336

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

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

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

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

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

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

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

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

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

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

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

September 30, 2012	Carrying Value	Level 1	Level 2	Level 3	Total Estimated Fair Value
	(dollars in thousands)				
Financial assets:					
Cash and cash equivalents	$3,286	$3,286	$-	$-	$3,286
Securities available for sale	52,484	-	52,484	-	52,484
Securities held to maturity	2,395	-	2,622	-	2,622
Loans and loans held for sale - Net	139,414	-	-	144,718	144,718
Federal Home Loan Bank stock	3,266	-	3,266	-	3,266
Accrued interest receivable	1,119	-	1,119	-	1,119
Financial liabilities:					
Customer deposits	158,676	-	159,727	-	159,727
Federal Home Loan Bank advances	25,000	-	25,314	-	25,314
REPO sweep accounts	4,245	-	4,245	-	4,245
Accrued interest payable	111	-	111	-	111

December 31, 2011	Carrying Value	Total Estimated Fair Value
	(dollars in thousands)	
Financial assets:		
Cash and cash equivalents	$2,749	$2,749
Securities available for sale	53,049	53,049
Securities held to maturity	2,435	2,665
Loans and loans held for sale - Net	140,884	146,018
Federal Home Loan Bank stock	3,266	3,266
Accrued interest receivable	1,149	1,149
Financial liabilities:		
Customer deposits	150,649	151,693
Federal Home Loan Bank advances	34,500	34,827
REPO sweep accounts	5,592	5,592
Accrued interest payable	148	148

Note 9 – RECENT ACCOUNTING PRONOUNCEMENTS

ASC Topic 220: Comprehensive Income: Presentation of Comprehensive Income. On June 16, 2011, the FASB issued Accounting Standards Update (ASU) 2011-05. This ASU is intended to increase the prominence of other comprehensive income in financial statements. The new guidance does not change whether items are reported in net income or in other comprehensive income or whether and when items of other comprehensive income are reclassified to net income. ASU 2011-05 eliminates the option in current U.S. generally accepted accounting principles that permits the presentation of other comprehensive income in the statement of changes in equity. The new guidance in the ASU requires that an entity report comprehensive income in either a single continuous statement that presents the components of net income or a separate but consecutive statement. The new guidance is to be applied retrospectively and early adoption is permitted. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted this pronouncement as of the interim period ended June 30, 2012. The adoption of this pronouncement did not have a material impact on the Company's financial statements.

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

AND SUBSIDIARIES

PART - FINANCIAL INFORMATION

ITEM 2 - MANAGEMENT’S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion compares the consolidated financial condition of the Company at September 30, 2012 and December 31, 2011, and the results of operations for the three- and nine-month periods ended September 30, 2012 and 2011. This discussion should be read in conjunction with the interim financial statements and footnotes included herein.

OVERVIEW

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

For the quarter ended September 30, 2012, the Company reported net income of $273,000, or $0.09 per share, compared to $235,000 or $0.08 per share, for the year earlier period, an increase in earnings of $38,000. For the nine months ended September 30, 2012, net income was $604,000, or $0.21 per share, compared to $658,000, or $0.23 per share, for the nine months ended September 30, 2011.

Total assets decreased by $2.1 million, or 1.0%, to $214.9 million at September 30, 2012 from $217.0 million at December 31, 2011. Investment securities available-for-sale decreased by $565,000, or 1.1%, from December 31, 2011 to September 30, 2012. Net loans receivable decreased $2.5 million, or 1.8%, during that same time period. Foreclosed real estate and other repossessed assets decreased by $1.1 million from December 31, 2011 to September 30, 2012. Total deposits increased $8.0 million, or 5.3% from December 31, 2011 to September 30, 2012 while REPO

sweep accounts decreased by $1.3 million, or 24.1%, and Federal Home Loan Bank advances decreased by $9.5 million or 27.5% from December 31, 2011 to September 30, 2012. Equity increased by $724,000, or 3.0%, to $25.3 million during the nine-month period ended September 30, 2012.

CRITICAL ACCOUNTING POLICIES

As of September 30, 2012, there have been no changes in the critical accounting policies as disclosed in the Company's Form 10-K for the year ended December 31, 2011. The Company's critical accounting policies are described in the Management's Discussion and Analysis and financial sections of its 2011 Annual Report. Management believes its critical accounting policies relate to the Company's allowance for loan losses, valuation of deferred tax assets and mortgage servicing rights.

COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2012 AND DECEMBER 31, 2011

ASSETS: Total assets decreased $2.1 million, or 1.0%, to $214.9 million at September 30, 2012 from $217.0 million at December 31, 2011. During that nine-month period the following changes occurred: investment securities available for sale decreased $565,000, or 1.1%, to $52.5 million; cash and cash equivalents increased $536,000 or 19.5% to $3.3 million; and net loans receivable decreased $2.5 million, or 1.8%, to $138.4 million. Mortgage loans decreased by $1.0 million despite our efforts to continue to grow this portfolio by retaining in our portfolio certain high-quality 10- and 15-year fixed rate residential mortgages as opposed to selling them in the secondary market. In addition, our consumer loan portfolio, consisting mainly of home equity loans, decreased by $2.0 million and our commercial loans increased by $778,000.

LIABILITIES: Deposits increased $8.0 million, or 5.3%, to $158.7 million at September 30, 2012 from $150.6 million at December 31, 2011. We experienced increases in the following deposit products as we continued our focus on growing core deposits: $2.5 million in money market accounts; $6.8 million in non-interest bearing checking accounts; $1.5 million in savings deposit accounts; and $1.5 million in NOW accounts. Offsetting these increases were decreases in the following: our certificates of deposit decreased by $1.8 million and our liquid certificates of deposit (from which customers can take a penalty–free withdrawal with seven days advance written notice) decreased by $2.5 million during this time period as we lowered interest rates on those products in step with the market. During this same time period, REPO sweep accounts decreased $1.3 million or 24.1% to $4.2 million due primarily to timing of our customers' cash needs. FHLB advances decreased $9.5 million, or 27.5%, to $25.0 million at September 30, 2012 from $34.5 million at December 31, 2011 due mainly to increases in our deposit base.

EQUITY: Stockholders' equity increased to $25.3 million at September 30, 2012 from $24.6 million at December 31, 2011, an increase of $724,000. The increase in stockholders' equity was mainly attributable to net income for the nine-month period of $604,000 and an increase of $119,000 in the unrealized gain on available for sale securities net of tax from $668,000 at December 31, 2011 to $787,000 at September 30, 2012.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

General: Net income increased by $38,000 to $273,000 for the three months ended September 30, 2012 from $235,000 for the same period ended September 30, 2011.

Interest Income: Interest income was $2.3 million for the three months ended September 30, 2012, compared to $2.6 million for the comparable period in 2011. The decrease in interest income was due primarily to two factors: a decrease in the average balance of our interest-earning assets resulting from a decrease in the size of our loan portfolio and a decrease in the yield on interest-earning assets due primarily to lower market interest rates. The average balance of non-mortgage loans decreased $5.1 million quarter over quarter, as we continued to experience a decline in loan originations due to economic conditions in our market areas. The average balance of mortgage loans increased $2.3 million period over period as we have continued to retain certain 10- and 15-year mortgages in our loan portfolio. The declines in loan portfolios were partially offset by an increase in average balances of AFS investment securities of $3.6 million fro the 2012 period versus the 2011 period. In addition to declines in our loan portfolios, the average yield on our interest-earning assets declined 49 basis points from 5.08% for the three-month period ended September 30, 2011 to 4.59% for the same period in 2012.

Interest Expense: Interest expense was $394,000 for the three-month period ended September 30, 2012, compared to $564,000 for the same period in 2011. The decrease in interest expense for the three-month period was due in part to a $10.7 million decrease in the average balance of our interest-bearing liabilities and a decrease in our overall cost of funds of 32 basis points period over period. Most notably, the average balance of our certificates of deposit decreased $6.5 million from the three-month period ended September 30, 2011 to the same period in 2012 and the cost of those deposits decreased 48 basis points period over period. In addition, the average balance of our FHLB advances decreased $3.5 million from the three-month period ended September 30, 2011 to the same period in 2012 and the cost of our FHLB advances decreased 20 basis points period over period.

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

	Quarter ended September 30, 2012 Compared to Quarter ended September 30, 2011 Increase (Decrease) Due to:		
	Volume	Rate	Total
	(dollars in thousands)		
Interest-earning assets:			
Loans receivable	$ (41)	$ (160)	$ (201)
Investment securities	1	(85)	$ (84)
Other investments	(10)	20	$ 10
Total interest-earning assets	(50)	(225)	(275)
Interest-bearing liabilities:			
Money Market/NOW accounts	1	(16)	(15)
Certificates of Deposit	(32)	(85)	(117)
Deposits	(31)	(101)	(132)
Borrowed funds	(14)	(24)	(38)
Total interest-bearing liabilities	(45)	(125)	(170)
Change in net interest income	$ (5)	$ (100)	$ (105)

Net Interest Income: Net interest income remained relatively steady at $1.9 million (a slight decrease of $105,000) for the three-month period ended September 30, 2012 as compared to the same period in 2011. For the three months ended September 30, 2012, average interest-earning assets decreased $1.9 million, or 1.0%, to $201.0 million when compared to the same period in 2011. Average interest-bearing liabilities decreased $10.7 million, or 5.9%, to $170.8 million for the quarter ended September 30, 2012 from $181.5 million for the quarter ended September 30, 2011 as we experienced a shift from interest-bearing to non-interest bearing deposits during this time period. The yield on average interest-earning assets decreased to 4.59% for the three month period ended September 30, 2012 from 5.08% for the same period ended in 2011. The cost of average interest-bearing liabilities decreased to 0.91% from 1.23% for the three-month periods ended September 30, 2012 and September 30, 2011, respectively. The net interest margin decreased 17 basis points to 3.81% for the three-month period ended September 30, 2012 from 3.98% for same period in 2011.

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

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

The provision for loan losses for the three-month period ended September 30, 2012 was $234,000 as compared to income of $67,000 for the prior year period. Prior to 2012, our provision for loan losses was based on an eight-quarter rolling average of actual net charge-offs adjusted for environmental factors for each segment of loans in our portfolio. Management has decided that eight quarters is no longer reflective of the inherent loss in the loan portfolios. In 2012, we began moving towards a twelve-quarter rolling average of actual net charge-offs by adding an additional quarter of net charge-offs each quarter in 2012. By the end of 2012 we will be using a twelve-quarter rolling average. The provision was based on management's review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

Non-Interest Income: Non-interest income increased to $803,000 for the three months ended September 30, 2012 from $469,000 for the three months ended September 30, 2011, related primarily to an increase of $223,000 in mortgage banking activities income period over period as mortgage origination activity picked up in the latter part of 2012. Additionally, gain on sale of investments increased by $47,000 period over period as we sold municipal bonds for credit reasons during the quarter ended September 30, 2012. Lastly, other income increased by $58,000 for the three months ended September 30, 2012 compared to the same period in 2011, mainly as the result of a $65,000 settlement of a lawsuit related to a troubled credit.

Non-Interest Expense: Non-interest expense was $2.1 million for the three-month period ended September 30, 2012 as compared to $2.3 million for the same period in 2011. Compensation and employee benefit expense increased by $115,000 period over period due in part to the addition of a commercial lender and Treasury Management professional in late 2011 and due to increased lender commissions as a result of increased mortgage originations period over period. In addition, amortization of intangible assets expense was $43,000 lower period over period and other expenses decreased by $271,000 due mostly to reduced expenses associated with problem loans and bank-owned properties. In addition we experienced decreases in occupancy of $25,000 and professional services of $19,000 during the three months ended September 30, 2012 as compared to the same period in 2011.

Income Taxes: During the first quarter of 2012 management determined that it was more likely than not than the Deferred Tax Assets would be utilized in future years, therefore it reduced the valuation allowance against its Deferred Tax Assets by $866,000. For the three-month period ended September 30, 2012, the Company earned $410,000 of pre-tax profit which resulted in $137,000 in income tax expense, as compared to no federal income tax expense for the same period in 2011, as the income tax expense incurred during the period reduced the Deferred Tax Asset.

Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011

General: Net income decreased by $54,000 to $604,000 for the nine months ended September 30, 2012 from $658,000 for the same period ended September 30, 2011. The decrease in earnings period over period was primarily attributable an increase in provision for loan losses of $1.2 million for the nine months ended September 30, 2012 as

compared to income of $19,000 for the same period in 2011. The increased provision was partially offset by an increase in non-interest income of $328,000 and a decrease in non-interest expenses of $272,000 period over period.

Interest Income: Interest income was $7.1 million for the nine months ended September 30, 2012, compared to $7.9 million for the comparable period in 2011. This decrease of $798,000, or 10.1%, in interest income was due in large part to decreases of $8.9 million in average balances of mortgage loans period over period. In addition, the average yield on interest earning assets decreased 51 basis points to 4.70% for the nine-month period ended September 30, 2012 as compared to 5.21% for the same period in 2011.

Interest Expense: Interest expense was $1.3 million for the nine-month period ended September 30, 2012 compared to $1.8 million for the same period in 2011. The decrease in interest expense was due primarily to decreases in the average balance of and interest rates on our certificates of deposits period over period. We experienced a $6.8 million decrease in the average balance of certificates of deposits for the nine months ended September 30, 2012 when compared to the same period in 2011 and the average rate on those deposits decreased 50 basis points to 1.26% for the nine-month period ended September 30, 2012 as compared to the year-earlier period. In addition, our cost of funds relating to our FHLB advances decreased 25 basis points to 1.97% nine-month period over nine-month period.

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

	Nine Months ended September 30, 2012 Compared to Nine Months ended September 30, 2011 Increase (Decrease) Due to:		
	Volume	Rate	Total
	(dollars in thousands)		
Interest-earning assets:			
Loans receivable	$ (391)	$ (348)	$ (739)
Investment securities	1,810	(1,878)	(68)
Other investments	(34)	43	9
Total interest-earning assets	1,385	(2,183)	(798)
Interest-bearing liabilities:			
Money Market/NOW accounts	(4)	(59)	(63)
Certificates of Deposit	(105)	(265)	(370)
Deposits	(109)	(324)	(433)
Borrowed funds	35	(67)	(32)
Total interest-bearing liabilities	(74)	(391)	(465)
Change in net interest income	$ 1,459	$ (1,792)	$ (333)

Net Interest Income: Net interest income decreased by $333,000 to $5.8 million for the nine-month period ended September 30, 2012 compared to the same period in 2011. For the nine months ended September 30, 2012, average interest-earning assets decreased $1.0 million, or 0.5%, when compared to the same period in 2011. Average interest-bearing liabilities decreased $5.6 million, or 3.1%, for the same period. The yield on average interest-earning assets decreased to 4.70% for the nine months ended September 30, 2012 from 5.21% for the same period ended in 2011. The average cost of interest-bearing liabilities decreased to 0.98% from 1.30% for the nine month periods ended September 30, 2012 and September 30, 2011, respectively. The net interest rate margin decreased 21 basis points to 3.84% for the nine-month period ended September 30, 2012, from 4.05% for the same period in 2011.

Delinquent Loans and Nonperforming Assets: Nonperforming assets decreased by $1.4 million from December 31, 2011 to September 30, 2012 due primarily to sales of bank-owned properties during the nine months ended September 30, 2012.

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Total non-accrual loans	$ 2,827	$ 3,101
Accrual loans delinquent 90 days or more:		
One- to four-family residential	201	238
Other real estate loans	0	0
Construction	0	0
Purchased Out-of-State	0	0
Commerical	-	0
Consumer & other	15	-
Total accrual loans delinquent 90 days or more	$ 216	$ 238
Total nonperforming loans (1)	3,043	3,339
Total real estate owned-residential mortgages (2)	823	1,087
Total real estate owned-Commercial (2)	344	1,015
Total real estate owned-Consumer & other repossessed assets (2)	1,121	1,306
Total nonperforming assets	$ 5,331	$ 6,747
Total nonperforming loans to loans receivable	2.17 %	2.35 %
Total nonperforming assets to total assets	2.48 %	3.11 %

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

(2) Represents the net book value of property acquired by the Bank through foreclosure or deed in lieu of foreclosure. Upon acquisition, this property is recorded at the lower of its fair market value or the principal balance of the related loan.

Provision for Loan Losses: The provision for loan losses was $1.2 million for the nine-month period ended September 30, 2012 as compared to income of $19,000 for the comparable period in 2011. As discussed above in the discussion for the three-month period ended September 30, 2012, our provision for loan losses is based on an eleven-quarter rolling average of actual net charge-offs adjusted for various environmental factors for each pool of loans in our portfolio. During the nine-month period ended September 30, 2012, we added specific reserves of approximately $170,000 on two commercial credit relationships, one of which was reclassified as Troubled Debt Restructurings, had net charge-offs of approximately $250,000 on commercial credits, increased the general reserve factor applied to the entire portfolio of residential mortgages as a result of increased charge-off history in 2012, and increased our general reserve pool for special mention and substandard commercial credits based on the inherent increased risk in those credits. The provision was based on management’s review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

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

	Portfolio Balance	Delinquent Loans Over 90 Days	Non-Accrual Loans
	(dollars in thousands)		
At September 30, 2012			
Real estate loans:			
Construction	$1,092	$ -	$ 173
One - to four - family	64,947	201	1,556
Commercial Mortgages	53,081	-	975
Home equity lines of credit/ Junior liens	11,562	-	122
Commercial loans	8,414	-	-
Consumer loans	1,275	15	1
Total gross loans	140,371	216	2,827
Less:			
Net deferred loan fees.	(314)	(1)	(3)
Allowance for loan losses	(1,684)	-	(76)
Total loans, net	$138,373	$ 215	$ 2,748
At December 31, 2011			
Real estate loans:			
Construction	$762	$ -	$ 173
One - to four - family	66,101	282	2,420
Commercial Mortgages	53,938	82	356
Home equity lines of credit/Junior liens	13,395	-	148
Commercial loans	7,002	-	-
Consumer loans	1,477	2	4
Total gross loans	142,675	366	3,101
Less:			
Net deferred loan fees	(273)	(1)	(7)
Allowance for loan losses	(1,518)	-	(261)
Total loans, net	$140,884	$ 365	$ 2,833

Non-Interest Income: Non-interest income was $1.6 million for the nine-month period ended September 30, 2012, an increase of $329,000 or 25.1%, from the same period in 2011. The nine-month results in 2012 reflected an increase of $239,000 in mortgage banking activities due to sustained low mortgage rates which have increased refinance activity and also as a result of a small uptick in home sales in our markets, $47,000 gain on sale of investments as a result of the sale of municipal bond due to credit concerns, and a $49,000 increase in other income mainly as the result of receiving settlement proceeds on a lawsuit related to a troubled credit.

Non-Interest Expense: Non-interest expense decreased to $6.5 million for the nine months ended September 30, 2012 from $6.8 million for the nine months ended September 30, 2011. For the nine-month period ended September 30, 2012 we reduced other expense by $312,000 mainly related to lower costs associated with problem loans and bank-owned properties. Period over period we also experienced decreases in occupancy costs of $83,000 due mainly to decreases in depreciation expense and equipment maintenance, amortization of intangible assets of $72,000 and FDIC premiums of $35,000 due in part to improvement in our risk profile. These decreases were partially offset by an increase in compensation and employee expense of $235,000, as we added a commercial lender and Treasury Management professional and as lender commissions increased due to increased mortgage origination activity.

Income Taxes: A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. At March 31, 2012, management evaluated the Company's valuation allowance related to its deferred tax asset. An analysis of the deferred tax asset was made to determine the utilization of those tax benefits based upon projected future taxable income. Based upon management's determination and in accordance with the generally accepted accounting principles, management concluded that the utilization of this asset was "more likely than not." Accordingly, at March 31, 2012, $866,000 of the valuation allowance was credited to income tax expense. Among the criteria that management considered in evaluating the deferred tax asset were: improved core profitability of the Bank in 2010 and 2011; substantial improvement over the past two years in non-performing assets, which were driving losses in prior years; and positive forecast for taxable income looking forward over the next three years. A valuation allowance of $2.2 million remains on $3.4 million of the current deferred tax asset at September 30, 2012.

The valuation of deferred tax assets is a subjective calculation. Management reviewed several factors in determining the value of deferred tax assets the Company expects to realize over the next three years, including:

- For the three months ended September 30, 2012, we had pre-tax income of $410,000, and fully expect that trend to continue in future quarters.
- The level of our non-performing assets has decreased from $7.9 million at September 30, 2011 to $6.7 million at December 31, 2011 to $5.3 million at September 30, 2012. We expect that trend to continue, which will have a positive impact on earnings in future quarters.
- We sold our two largest pieces of REO property at the end of 2011, therefore future earnings will not be burdened with carrying costs on those properties.

As of September 30, 2012 the Company had a net operating loss carryforward for tax purposes of approximately $10.0 million and related deferred tax asset of $3.4 million. The Company will continue to evaluate the future benefits from these carryforwards and at such time as it becomes “more likely than not” that they would be utilized prior to expiration, the Company will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will expire in the year 2031.

LIQUIDITY

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

Liquidity represents the amount of an institution’s assets that can be quickly and easily converted into cash without significant loss. The most liquid assets are cash, short-term U.S. Government securities, U.S. Government agency securities and certificates of deposit. The Company is required to maintain sufficient levels of liquidity as defined by OCC regulations. This requirement may be varied at the direction of the OCC. Regulations currently in effect require that the Bank must maintain sufficient liquidity to ensure its safe and sound operation. The Company’s objective for liquidity is to be above 20% of total assets. Liquidity as of September 30, 2012 was $53.8 million, or 43.1%, compared to $44.6 million, or 39.9%, at December 31, 2011. The levels of these assets are dependent on the Company’s operating, financing, lending and investing activities during any given period. The liquidity calculated by the Company includes additional borrowing capacity available with the FHLB. This borrowing capacity is based on pledged collateral. As of September 30, 2012, the Bank had unused borrowing capacity totaling $35.8 million at the FHLB based on the pledged collateral.

The Company intends to retain in its portfolio certain originated residential mortgage loans (primarily adjustable rate, balloon and shorter-term fixed-rate mortgage loans) and to generally sell the remainder in the secondary market. The Bank will from time to time participate in or originate commercial real estate loans, including real estate development loans. During the nine month period ended September 30, 2012 the Company originated $36.7 million in residential mortgage loans, of which $10.5 million were retained in portfolio while the remainder were sold in the secondary market or are being held for sale. This compares to $23.0 million in originations during the first nine months of 2011 of which $4.5 million were retained in portfolio. The Company also originated $14.4 million of commercial loans and $1.5 million of consumer loans in the first nine months of 2011 compared to $10.5 million of commercial loans and $1.2 million of consumer loans for the same period in 2011. Of total loans receivable, excluding loans held for sale, mortgage loans comprised 46.7% and 45.8%, commercial loans 44.2% and 43.3% and consumer loans 9.2% and 10.9% at September 30, 2012 and December 31, 2011, respectively.

Deposits are a primary source of funds for use in lending and for other general business purposes. At September 30, 2012 deposits funded 73.8% of the Company's total assets compared to 69.4% at December 31, 2011. Certificates of deposit scheduled to mature in less than one year at September 30, 2012 totaled $39.3 million. Management believes that a significant portion of such deposits will remain with the Bank. The Bank monitors the deposit rates offered by competition in the area and sets rates that take into account the prevailing market conditions along with the Bank's liquidity position. Moreover, management believes that the growth in assets is not expected to require significant in-flows of liquidity. As such, the Bank does not expect to be a significant market leader in rates paid for liabilities.

Borrowings may be used to compensate for seasonal or other reductions in normal sources of funds or for deposit outflows at more than projected levels. Borrowings may also be used on a longer-term basis to support increased lending or investment activities. At September 30, 2012 the Company had $25.0 million in FHLB advances. FHLB borrowings as a percentage of total assets were 11.6% at September 30, 2012 as compared to 15.9% at December 31, 2011. The Company has sufficient available collateral to obtain additional advances of $35.8 million as of September 30, 2012.

CAPITAL RESOURCES

Stockholders' equity at September 30, 2012 was $25.3 million, or 11.8% of total assets, compared to $24.6 million, or 11.3% of total assets, at December 31, 2011 (See "Consolidated Statement of Changes in Stockholders' Equity"). The Bank is subject to certain capital-to-assets requirements in accordance with OCC regulations. The Bank exceeded all regulatory capital requirements at September 30, 2012. The following table summarizes the Bank's actual capital with the regulatory capital requirements and with requirements to be "Well Capitalized" under prompt corrective action provisions, as of September 30, 2012:

	Actual		Regulatory Minimum		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(dollars in thousands)					
Tier 1 (Core) capital (to adjusted assets)	$22,117	10.36%	$8,540	4.00%	$10,675	5.00 %
Total risk-based capital (to risk- weighted assets)	$23,800	17.40%	$10,941	8.00%	$13,676	10.00%
Tier 1 risk-based capital (to risk weighted assets)	$22,117	16.17%	$5,470	4.00%	$8,206	6.00 %
Tangible Capital (to tangible assets)	$22,117	10.36%	$3,203	1.50%	$4,270	2.00 %

ITEM 3 - QUANTITATIVE AND QUALITITIVE DISCLOSURES ABOUT MARKET RISK

Not applicable to smaller reporting companies.

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ITEM 4 - CONTROLS AND PROCEDURES

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

There has been no change in the Company’s internal control over the financial reporting during the Company’s third quarter of fiscal year 2012 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended September 30, 2012

PART II – OTHER INFORMATION

Item 1 - Legal Proceedings:

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

Item 1A - Risk Factors:
Not applicable to smaller reporting companies

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

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

Item 3 - Defaults upon Senior Securities:
Not applicable.

Item 4 - Mine Safety Disclosures
Not applicable.

Item 5 - Other Information:

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

Item 6 - Exhibits:

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

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

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

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

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

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended September 30, 2012

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FEDERAL OF
NORTHERN MICHIGAN
BANCORP, INC.

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

Date: November 14, 2012

By: /s/Amy E. Essex
Amy E. Essex, Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: November 14, 2012

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