MACATAWA BANK CORP
Form 10-K
February 24, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2010

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______ to ________

Commission file number 000-25927

MACATAWA BANK CORPORATION
(Exact name of registrant as specified in its charter)

MICHIGAN	**38-3391345**
(State of other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444
Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes [ ] No [X]

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 past 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [ ] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained in this form and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [ ]

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

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [ ]   Smaller reporting company [X]
(Do not check if smaller reporting company)

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, as of June 30, 2010, was $21,029,964 based on the closing sale price of $1.20 as reported on the Nasdaq Stock Market. There were 17,679,621 outstanding shares of the Company's common stock as of February 23, 2011.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held May 10, 2011 are incorporated by reference into Part III of this report.

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Forward-Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Macatawa Bank Corporation. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "may", "should", "will", "is likely", or is "probably" to occur or "continue", has "begun" or "is scheduled" or "on track" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "intends", "predicts", "projects", or "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "near term", "going forward", "starting" and variations of such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, statements related to real estate valuation, future levels of non-performing loans, the rate of asset dispositions, capital raising activities, dividends, future growth and funding sources, future liquidity levels, future profitability levels, our ability to continue as a going concern, the effects on earnings of changes in interest rates and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including goodwill, mortgage servicing rights and deferred tax assets) and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to fully comply with our Consent Order and Written Agreement, raise capital, improve regulatory capital ratios, successfully implement new programs and initiatives, increase efficiencies, address regulatory issues, improve internal controls over financial reporting, maintain our current level of deposits and other sources of funding, maintain liquidity, respond to declines in collateral values and credit quality, increase loan volume, maintain mortgage banking income, realize the benefit of our deferred tax assets, resume payment of dividends and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Macatawa Bank Corporation, specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extend, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Macatawa Bank Corporation does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of this report. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

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PART I

ITEM 1: Business.

As used in this report, the terms "we," "us," "our" and "Company" mean Macatawa Bank Corporation and its subsidiaries, unless the context indicates another meaning. The term "Bank" means Macatawa Bank.

Overview

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. Our business is concentrated in a single industry segment - commercial banking. Through our wholly-owned subsidiary, Macatawa Bank, we offer a full range of commercial and personal banking services, including checking, savings and certificates of deposit accounts, cash management, safe deposit boxes, trust services and commercial, mortgage and consumer loans through our twenty-six branch offices and a lending and operation service facility in Ottawa County, Kent County and northern Allegan County, Michigan. Other services we offer include ATMs, internet banking, telephone banking and debit cards. The Bank provides various brokerage services, including discount brokerage through Infinex, personal financial planning and consultation regarding mutual funds.

The Bank was formed in 1997 and until 2009 our strategy has been to profitably grow our business based upon our mission to attract clients who prefer to conduct business with a locally managed institution that demonstrates an active interest in their business and personal financial affairs, places high priority on local decision-making and contributes financial and employee support to community initiatives. Within the past year, our strategy has been modified as discussed below.

At December 31, 2010, we had total assets of $1.58 billion, total deposits of $1.28 billion, approximately 73,000 deposit accounts and shareholders' equity of $67.8 million. For the year ended December 31, 2010, we reported operating losses totaling $17.9 million. The last three quarters of 2010 were profitable. Additional information about our consolidated financial condition as of December 31, 2010 and 2009 and the results of our operations for the two years ended December 31, 2010, may be found throughout this report, including in Item 7 of this report in "Management's Discussion and Analysis of Results of Operations and Financial Condition" and Item 8 of this report in the Consolidated Financial Statements and related notes, and such information is here incorporated by reference.

During 2008 and 2009, we reported operating losses of $38.9 million and $63.6 million, respectively. The losses for 2008 and 2009 were largely attributable to loan losses, lost interest on nonperforming assets and rising costs of administering problem assets associated with the rapid increase in problem loans and other real estate assets. Losses in 2009 included the establishment of a tax valuation allowance and 2008 losses included the write-off of goodwill. The loan and problem asset related losses continued in the first quarter of 2010, as we reported a net loss of $21.1 million.

In February 2010, the Bank entered into a Consent Order with the Federal Deposit Insurance Corporation ("FDIC") and the Michigan Office of Financial and Insurance Regulation ("OFIR"), in which the Bank agreed to increase management and board oversight, improve process and controls, limit lending to certain borrowers, obtain regulatory approval of future dividends, and improve regulatory capital ratios. Please see "Consent Order with the Bank and its Regulators" below for more information regarding the Consent Order. In July 2010, Macatawa Bank Corporation entered into a Written Agreement with the Federal Reserve Bank of Chicago ("FRB"). Among other things, the Written Agreement provides that Macatawa Bank Corporation must take appropriate steps to utilize its financial and managerial resources to serve as a source of strength to the Bank and Macatawa Bank Corporation may not declare or pay any dividends without the prior written consent of the FRB. Please see "Written Agreement with Macatawa Bank Corporation and its Regulator" below for more information regarding the Written Agreement.

Our Board of Directors has significantly changed our strategic direction and focus to improve our internal operations and to work out of our problem loans and assets. During the fourth quarter of 2009, our Board of Directors elected a new independent Chairman of the Board. We have since worked closely with the FRB, the FDIC and OFIR to put in place improved controls and procedures. The Board of Directors has implemented more robust corporate governance practices and disciplined business and banking principles, implemented more conservative lending principles that comply with regulatory standards, and appointed experienced and disciplined lending and compliance personnel. The focus of our management team has turned from growth in our business to executing these disciplined business and banking procedures and policies, limiting future losses, preserving capital and improving operational efficiencies.

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As a result of these efforts, we have achieved significantly improved results:

- Our three most recently completed quarters were profitable;
- Our liquidity has improved dramatically since the end of 2009 primarily through large reductions in volatile funding balances;
- The Bank's capital ratios have improved since March 31, 2010; and
- We have reduced our level of delinquent and nonperforming loans and have achieved lower levels of loan charge offs for 2010 compared to the preceding two years, allowing for reductions in the provision for loan losses in 2010.

During the course of the audit procedures for 2009, our independent registered accounting firm for the year ended December 31, 2009, Crowe Horwath LLP, identified certain deficiencies in our credit administration and allowance for loan loss process that we and they determined constituted a "material weakness" in internal control over financial reporting at December 31, 2009. Also at December 31, 2009, Crowe Horwath LLP determined that there was substantial doubt about our ability to continue as a going concern. As discussed above and throughout this document, significant improvements in our processes and our financial results and financial condition occurred during the year ended December 31, 2010. We do not have substantial doubt about our ability to continue as a going concern, and our independent public accounting firm for the year ended December 31, 2010, BDO USA LLP, has issued an unqualified report on its audit of our financial statements as of and for the year ended December 31, 2010 in Item 8 of this report, and did not include a paragraph in its report expressing substantial doubt about the Company's ability to continue as a going concern. We have determined that the improved controls instituted in response to the material weakness identified at December 31, 2009 have remediated the deficiencies and have concluded that there are no material weaknesses in internal control over financial reporting at December 31, 2010. BDO USA LLP has also issued an unqualified report on its audit of our internal control over financial reporting as of December 31, 2010 in Item 9A of this report, which states that Macatawa Bank Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010.

We have no material foreign loans, assets or activities. No material part of our business is dependent on a single customer or very few customers.

Our headquarters and administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424, and our telephone number is (616) 820-1444. Our internet website address is www.macatawabank.com. We make available free of charge through this website our annual report on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after filing such reports with the Securities and Exchange Commission. The information on our website address is not incorporated by reference into this report, and the information on the website is not part of this report.

Regulatory Developments

Consent Order with the Bank and its Regulators

On February 22, 2010, the Bank entered into a Consent Order (the "Consent Order") with the FDIC and OFIR, the primary banking regulators of the Bank. The Bank agreed to the terms of the Consent Order without admitting or denying any charges of unsafe or unsound banking practices. The Consent Order imposes no fines or penalties on the Bank. The Consent Order will remain in effect and enforceable until it is modified, terminated, suspended, or set aside by the FDIC and the OFIR. The Bank's customer deposits remain fully insured to the highest limit set by the FDIC. The Board of Directors views the requirements of the Consent Order as necessary components of its efforts to return us to profitability and pursue the long term success of the Company for our shareholders, depositors, and customers.

The Consent Order includes the following requirements, among others:

The Consent Order requires the Bank, within 90 days, to have and maintain a Tier 1 Leverage Capital Ratio of at least 8% and a Total Risk Based Capital Ratio of at least 11%. The Bank has not yet met these capital requirements. See further discussion below and in Item 8 of this report in Note 2 of the Consolidated Financial Statements.

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The Consent Order requires the Bank to charge off all assets or portions of assets classified "Loss" in the most recent FDIC Report of Examination ("ROE") that have not been previously collected or charged off. This was accomplished subsequent to the examination in October, 2009.

The Consent Order prohibits the Bank from extending additional credit to, or for the benefit of, any borrower who is already obligated to the Bank on any loan that has been charged off by the Bank, so long as the amount charged off remains uncollected. In addition, the Consent Order prohibits the Bank from extending any additional credit to a borrower who has an uncollected loan that has been classified "Substandard" or "Doubtful", unless the Bank's Board of Directors has determined that extending additional credit to the borrower is in the best interest of the Bank. The Bank has adhered with this requirement.

The Consent Order requires the Board of Directors of the Bank upon the issuance of the order and before each quarterly Report of Condition and Income to review the adequacy of the Bank's Allowance for Loan and Lease Losses ("ALLL") and make adjustments needed to provide for an adequate ALLL. The Board has adhered with this requirement.

While the Consent Order is in effect, the Bank may not declare or pay any cash dividend without the prior written consent of the FDIC and the OFIR. The Bank did not pay dividends to Macatawa Bank Corporation during 2009 or 2010. In previous periods, dividends from the Bank to Macatawa Bank Corporation were primarily utilized by it to pay dividends on its common and preferred stock and interest on its trust preferred securities. Macatawa Bank Corporation has suspended payment of dividends on common and preferred stock and has deferred interest payments on its trust preferred securities.

The Consent Order also requires the Bank and its Board of Directors to adopt and implement a variety of policies, plans, procedures and practices intended to aid in the safe and sound conduct of the Bank's business. Throughout 2010, the Bank has addressed or taken steps to address the requirements of the Consent Order.

We are implementing a capital plan with various alternatives to reach and maintain the capital levels required by the Consent Order. While the Bank was not able to meet the timeline prescribed by the Consent Order for reaching the required capital levels, tangible progress has been made. Through a combination of improving earnings, effective balance sheet management and disciplined administration non performing assets, we have improved the Bank's total risk-based capital ratio since its low-point at March 31, 2010. The amount of additional qualifying capital needed to comply with the Consent Order has been reduced from $43.2 million at March 31, 2010 to $17.2 million at December 31, 2010. Our goal remains to return the Bank to "well-capitalized" status, and we continue to work closely with the Bank's regulators in our efforts to comply with the terms of the Consent Order. Achievement of the required capital levels could be impacted, positively or negatively, as a result of certain uncertainties, including, but not limited to, earnings levels, changing economic conditions, asset quality and property values.

On February 2, 2011, the Company filed a Form S-1 Registration Statement to register shares of our common stock that we intend to offer to our shareholders in a shareholder rights offering and to other investors in a public offering. For more information, see below under the heading "Strategies for Complying with the Consent Order - Capital Raising."

Written Agreement with Macatawa Bank Corporation and its Regulator

Macatawa Bank Corporation has formally entered into a Written Agreement with the Federal Reserve Bank of Chicago ("FRB") with an effective date of July 23, 2010. Among other things, the Written Agreement provides that Macatawa Bank Corporation: (i) must take appropriate steps to fully utilize its financial and managerial resources to serve as a source of strength to the Bank; (ii) may not declare or pay any dividends without prior FRB approval; (iii) may not take dividends or any other payment representing a reduction in capital from the Bank without prior FRB approval; (iv) may not make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities without prior FRB approval; (v) may not incur, increase or guarantee any debt without prior FRB approval; (vi) may not purchase or redeem any shares of its stock without prior FRB approval; (vii) must submit a written capital plan to the FRB within 60 days of the Written Agreement; and (viii) may not appoint any new director or senior executive officer, or change the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position, without prior regulatory approval. Macatawa Bank Corporation requested and received approval from the FRB to make its third and fourth quarter 2010 interest payments on its $1.65 million in outstanding subordinated debt. Macatawa Bank Corporation has requested approval from the FRB to make its first quarter 2011 interest payment on its subordinated debt, but has not yet received approval. Each quarter Macatawa Bank Corporation intends to continue to submit requests for approval from the FRB to make the next quarter's interest payment on its subordinated debt and is continuing to accrue the interest amounts due. Macatawa Bank Corporation submitted a written capital plan to the FRB for approval in November 2010, but has not yet received approval of the plan.

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Deposit Gathering Activities

During 2009 the Bank's regulatory capital ratios fell below levels required to be categorized as "well capitalized" under applicable regulatory guidelines. In addition, because the Bank is subject to the Consent Order, the Bank cannot be categorized as "well-capitalized," regardless of actual capital levels. As a result, the Bank is subject to the following restrictions regarding its deposit gathering activities:

Effective January 1, 2010, the interest rate paid for deposits by institutions that are categorized as less than "well capitalized" is limited to 75 basis points above the national rate for similar products unless the institution can support to the FDIC that prevailing rates in its market area exceed the national average. During the first quarter of 2010, the Company received notification from the FDIC that the prevailing rates in our market area exceeded the national average. Accordingly, the interest rates paid for deposits by the Bank are limited to 75 basis points above the average rate for similar products within our market area. Although this may impact our ability to compete for more rate sensitive deposits, we expect to continue to reduce our need to utilize rate sensitive deposits.

The Bank cannot accept, renew or rollover any brokered deposit unless it has applied for and been granted a waiver of this prohibition by the FDIC. The Bank has not accepted or renewed brokered deposits since November of 2008. A maturity table of deposits issued through brokers is included in Item 8 of this report in Note 8 of the Consolidated Financial Statements. The Bank expects it will be able to fund maturing brokered deposits under its current liquidity contingency program.

Strategies for Complying with the Consent Order

Our strategies to increase the Bank's capital ratios in order to comply with the capital requirements of the Consent Order include the following:

Earnings improvements. Our steps to reduce and manage our expenses have included:

We reduced staff during 2008 and 2009.
We paid no senior management bonuses for 2007 through 2010.
We have suspended merit pay increases.
We suspended 401(k) plan matching contributions at the beginning of 2010.

These steps, along with other expense reduction measures, have resulted in the removal of approximately $9.0 million from our annualized operating costs since 2008. During 2010, controllable noninterest expenses, excluding nonperforming asset costs and FDIC assessments, were at their lowest quarterly levels in over five years. The management team remains active at exploring on-going cost reduction opportunities as we continue to "right-size" our operations.

***Suspension of dividends*.** The Bank did not pay dividends to Macatawa Bank Corporation during 2009 and 2010. In previous periods, dividends from the Bank to Macatawa Bank Corporation were primarily utilized by it to pay dividends on its common and preferred stock and interest on its trust preferred securities. To preserve Bank capital, the Company has suspended dividend payments on its common and preferred stock and the deferral of interest payments on its trust preferred securities.

Risk Management and Improvement of Asset Quality. Despite the strain that a continuing soft economy places on the loan portfolio, the Company is committed to managing risk and mitigating loan losses. Tangible steps have been taken to reduce exposure within certain credit concentrations, establish more conservative lending principles that comply with regulatory standards, implement new lending and compliance policies and procedures, and enhance problem loan identification and resolution plans. These steps include increased Board of Directors oversight, specific plans to reduce substandard assets, Audit Committee oversight of the loan review process, establishment of lender accountability procedures, and enhanced loan policies and procedures.

***Asset Reduction*.** Total assets were reduced by $251.9 million to $1.58 billion at December 31, 2010 from $1.83 billion at December 31, 2009. The decrease in total assets was largely from a reduction in our loan portfolio from efforts to reduce concentration in certain loan types. We are implementing a concentration reduction plan to measure and monitor concentrations of credit on an ongoing basis. Execution of that plan included curtailing the origination of residential land development loans, the portfolio primarily responsible for loan losses in 2008 and 2009. Increased emphasis has been placed on obtaining updated property valuations and "right- sizing" of loan balances either through pay downs or by obtaining additional collateral in order to protect us.

We expect further asset reductions in these areas as we continue to execute this plan.

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Securities Portfolio Changes. During the second quarter of 2010, we completed the disposition of nearly all of the municipal, corporate and U.S. agency securities in our available-for-sale investment portfolio through sales in the open market. The securities were sold for a total of approximately $105.6 million. The sales were executed as part of our overall strategy to increase our regulatory capital ratios and liquidity. The majority of the proceeds have been initially invested in liquid money market balances with money center banks. We intend to ultimately reinvest the proceeds in higher yielding investment securities when market conditions improve.

Capital Raising. We previously increased our capital through the sale of $31.3 million of Series A Preferred Stock in the fourth quarter of 2008. During the second and third quarters of 2009, we increased our capital by $5.9 million through the issuance of Series B Preferred Stock, common stock and the subordinated debt. See Item 8 of this report in Note 18 of the Consolidated Financial Statements for more information regarding these capital raises.

We also remain active at exploring alternatives to raise new capital. During the fourth quarter of 2009, we engaged an independent consulting firm to assess the risk in our loan portfolio, an important step in supporting our capital planning efforts. On February 2, 2011, we filed a Form S-1 Registration Statement to register shares of our common stock that we intend to offer to our shareholders in a shareholder rights offering and to other investors in a public offering. We have not yet determined the final terms of the offering, including the number and price of shares that we intend to offer and sell in the offering.

This report is not an offer to sell or the solicitation of an offer to buy shares of our common stock or any other securities. Offers and sales of common stock issuable in connection with the offering will only be made by means of a prospectus meeting the requirements of the Securities Act of 1933, as amended, and applicable state securities laws, on the terms and subject to the conditions set forth in such prospectus.

Products and Services

Loan Portfolio

We have historically offered a broad range of loan products to business customers, including commercial and industrial and commercial real estate loans, and to retail customers, including residential mortgage and consumer loans. Given current weak economic conditions and the provisions of the Consent Order, new commercial loan origination activity is significantly lower than it was when economic conditions were stronger. However, select well-managed loan renewal activity for non-real estate loans is taking place. Following is a discussion of our various types of lending activities.

Commercial and Industrial Loans

Our commercial and industrial lending portfolio contains loans with a variety of purposes and security, including loans to finance operations and equipment. Generally, our commercial and industrial lending has been limited to borrowers headquartered, or doing business, in our primary market area. These credit relationships typically require the satisfaction of appropriate loan covenants and debt formulas, and generally require that the Bank be the primary depository bank of the business. These loan covenants and debt formulas are monitored through periodic, required reporting of accounts receivable aging schedules and financial statements, and in the case of larger business operations, reviews or audits by independent professional firms.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself, as well as economic conditions. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial Real Estate Loans

Because of the risks associated with this type of lending, combined with the sharp decline in demand for and resulting values of real estate in our market in the last two years, we experienced a significant increase in non-performing loan levels during 2008 and 2009 and the first quarter of 2010 primarily associated with commercial real estate loans. The increase in nonperforming loan balances is more fully discussed in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Our commercial real estate loans consist primarily of construction and development loans and multi-family and other non-residential real estate loans.

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Construction and Development Loans. These consist of construction loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments.

This portfolio has been particularly adversely affected by job losses, declines in real estate value, declines in home sale volumes, and declines in new home building. Declining real estate values have resulted in sharp increases in losses, particularly in the land development and construction loan portfolios to residential developers. We curtailed this type of lending in 2008. During 2009 and 2010, we also made a significant effort to reduce exposure to residential land development and other construction and development loans. We have also established goals to further reduce this exposure in 2011.

Multi-Family and Other Non-Residential Real Estate Loans. These are permanent loans secured by multi-family and other non-residential real estate and include loans secured by apartment buildings, condominiums, small office buildings, small business facilities, medical facilities and other non-residential building properties, substantially all of which are located within our primary market area.

Multi-family and other non-residential real estate loans generally present a higher level of risk than loans secured by owner occupied one- to four-family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of these loans is typically dependent upon the successful operation of the related real estate project. For example, if leases are not obtained or renewed, or a bankruptcy court modifies a lease term, or a major tenant is unable to fulfill its lease obligations, cash flow from the project will be reduced. If cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Retail Loans

Our retail loans are loans to consumers and consist primarily of residential mortgage loans and consumer loans.

Residential Mortgage Loans. We originate construction loans to individuals for the construction of their residences and owner-occupied residential mortgage loans, which are generally long-term with either fixed or adjustable interest rates. Our general policy is to sell the majority of our fixed rate residential mortgage loans in the secondary market due primarily to the interest rate risk associated with these loans.

During 2010, we sold the majority of our loan originations in the secondary market to support our goal of shrinking the loan portfolio and preserving capital. We retained loans representing only approximately 10% of the dollar volume originated. During 2009, our ability to originate and sell mortgages was limited to some extent by disruptions in the secondary market and our loss of business relationships with certain companies that have historically purchased our mortgages. However, relationships were established with new investors in 2010, allowing us to continue our historical practice of originating and selling most of our fixed rate mortgage loan volume.

Our borrowers generally qualify and are underwritten using industry standards for quality residential mortgage loans. We do not originate loans that are considered "sub-prime". Residential mortgage loan originations derive from a number of sources, including advertising, direct solicitation, real estate broker referrals, existing borrowers and depositors, builders and walk-in customers. Loan applications are accepted at most of our offices. The substantial majority of these loans are secured by one-to-four family properties in our market area.

Consumer Loans. We originate a variety of different types of consumer loans, including automobile loans, home equity lines of credit and installment loans, home improvement loans, deposit account loans and other loans for household and personal purposes. We also originate home equity lines of credit utilizing the same underwriting standards as for home equity installment loans. Home equity lines of credit are revolving line of credit loans. The majority of our existing home equity line of credit portfolio has variable rates with floors and ceilings, interest only payments and a maximum maturity of ten years.

The underwriting standards that we employ for consumer loans include a determination of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes a comparison of the value of the security, if any, in relation to the proposed loan amount. Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan

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collections are dependent on the borrower's continuing financial stability, and are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Loan Portfolio Composition

The following table reflects the composition of our loan portfolio and the corresponding percentage of our total loans represented by each class of loans as of the dates indicated.

(Dollars in thousands)	Year Ended December 31									
	2010		2009		2008		2007		2006	
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
Real estate - construction (1)	$ 133,228	11%	$ 162,615	11%	$ 237,108	13%	$ 258,205	15%	$ 277,486	16%
Real estate - mortgage	535,961	44%	640,437	42%	690,525	39%	676,879	38%	659,643	39%
Commercial and industrial	264,679	22%	369,523	24%	451,826	26%	451,863	26%	442,563	26%
Total Commercial	933,868	77%	1,172,575	77%	1,379,459	78%	1,386,947	79%	1,379,692	81%
Residential mortgage	135,227	11%	163,074	11%	203,954	11%	174,729	10%	142,739	8%
Consumer	148,101	12%	175,167	12%	190,650	11%	188,956	11%	189,019	11%
Total loans	$ 1,217,196	100%	$ 1,510,816	100%	$ 1,774,063	100%	$ 1,750,632	100%	$ 1,711,450	100%
Less:										
Allowance for loan losses	(47,426)		(54,623)		(38,262)		(33,422)		(23,259)	
Total loans receivable, net	$ 1,169,770		$ 1,456,193		$ 1,735,801		$ 1,717,210		$ 1,688,191	

(1) Consists of construction and development loans.

At December 31, 2010, there was no concentration of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the table above.

Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table shows the amount of total loans outstanding at December 31, 2010 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

(Dollars in thousands)	Maturing			
	Within One Year	After One, But Within Five Years	After Five Years	Total
Real estate - construction (1)	$ 116,158	$ 14,919	$ 2,151	$ 133,228
Real estate - mortgage	155,454	311,576	68,931	535,961
Commercial and industrial	142,709	109,421	12,549	264,679
Total Commercial	414,321	435,916	83,631	933,868

Residential mortgage	9,211	4,742	121,274	135,227
Consumer	15,333	60,295	72,473	148,101
Total Loans	$ 438,865	$ 500,953	$ 277,378	$ 1,217,196
Loans above:				
With predetermined interest rates	$ 204,498	$ 311,258	$ 45,774	$ 561,530
With floating or adjustable rates	556,189	23,941	775	580,905
Total (excluding nonaccrual loans)	$ 760,687	$ 335,199	$ 46,549	$ 1,142,435
Nonaccrual loans				74,761
Total Loans				$ 1,217,196

(1) Consists of construction and development loans.

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Nonperforming Assets

The following table shows the composition and amount of our nonperforming assets.

	December 31				
(Dollars in thousands)	2010	2009	2008	2007	2006
Nonaccrual loans	$ 74,761	$ 95,725	$ 89,049	$ 70,999	$ 5,811
Loans 90 days or more delinquent and still accruing	600	8,160	3,200	2,872	16,479
Total nonperforming loans (NPLs)	75,361	103,885	92,249	73,871	22,290
Foreclosed assets	57,984	37,184	19,516	5,704	3,212
Repossessed assets	50	124	306	172	81
Total nonperforming assets (NPAs)	133,395	141,193	112,071	79,747	$ 25,583
Accruing restructured loans (ARLs) (1)	25,395	18,000	---	---	---
Total NPAs and ARLs	$ 158,790	$ 159,193	$ 112,071	$ 79,747	$ 25,583
NPLs to total loans	6.19%	6.88%	5.20%	4.22%	1.30%
NPAs to total assets	8.45%	7.71%	5.21%	3.75%	1.23%

(1) Comprised of approximately $12.1 million and $7.9 million of commercial loans and $13.3 million and $10.1 million of residential mortgage loans at December 31, 2010 and 2009 whose terms have been restructured. Interest is being accrued on these loans under their restructured terms as they are less than 90 days past due.

Interest income totaling $2.7 million was recorded in 2010 on loans that were on a non-accrual status or classified as restructured as of December 31, 2010. Additional interest income of $2.8 million would have been recorded during 2010 on these loans had they been current in accordance with their original terms. The elevated levels of nonperforming loan balances in 2010 and 2009 and information about our policy for placing loans on non-accrual status may be found in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Loans at December 31, 2010 that were classified as substandard or worse per our internal risk rating system not included in the nonperforming assets table above that would cause management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms are discussed in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition." At December 31, 2010, there were no other interest-bearing assets that would be required to be disclosed under Industry Guide 3, Item III, C. 1. or 2. if such assets were loans.

Loan Loss Experience

The following is a summary of our loan balances at the end of each period and the daily average balances of these loans. It also includes changes in the allowance for loan losses arising from loans charged-off and recoveries on loans previously charged-off, and additions to the allowance which we have expensed.

	December 31				
(Dollars in thousands)	2010	2009	2008	2007	2006

Loans:								
Average daily balance of loans for the year	$	1,360,548		$	1,637,143	$1,762,102	$1,725,453	$1,635,391
Amount of loans outstanding at end of period		1,217,196			1,510,816	1,774,063	1,750,632	1,711,450
Allowance for loan losses:								
Balance at beginning of year	$	54,623		$	38,262	$ 33,422	$ 23,259	$ 20,992
Addition to allowance charged to operations		22,460			74,340	37,435	15,750	7,715
Loans charged-off:								

	Cash	328,703	0.04%	
Swap	7-May-2019	Cash	274,507	0.04%
CFD	17-Jul-2020	Cash	272,685	0.03%
CFD	24-Mar-2028	Cash	259,000	0.03%
CFD	19-May-2027	Cash	253,415	0.03%
Swap	3-Feb-2023	Cash	250,801	0.03%
CFD	17-Jul-2020	Cash	247,317	0.03%
CFD	10-Apr-2028	Cash	246,251	0.03%
Call Option	15-Jan-2019	Cash	242,411	0.03%
CFD	27-Sep-2028	Cash	217,594	0.03%
CFD	9-Sep-2021	Cash	208,879	0.03%
CFD	23-Aug-2028	Cash	204,000	0.03%
Swap	28-Jul-2021	Cash	203,317	0.03%
Swap	2-Feb-2023	Cash	198,606	0.03%
Call Option	11-Jan-2019	Cash	170,856	0.02%
Swap	28-Jul-2021	Cash	170,231	0.02%
CFD	12-Jul-2023	Cash	158,153	0.02%

CFD	12-Jun-2028	Cash	156,757	0.02%
Swap	28-Jul-2021	Cash	131,070	0.02%
Swap	7-May-2019	Cash	128,958	0.02%
CFD	25-Apr-2019	Cash	124,313	0.02%
CFD	25-Feb-2027	Cash	122,707	0.02%
Swap	17-Sep-2020	Cash	120,551	0.02%
Swap	5-Sep-2019	Cash	120,300	0.02%
Swap	3-Feb-2023	Cash	117,797	0.02%
Swap	13-Oct-2023	Cash	113,548	0.01%
Swap	22-Mar-2019	Cash	113,300	0.01%
CFD	17-Jul-2028	Cash	103,200	0.01%
Swap	2-Feb-2023	Cash	93,281	0.01%
CFD	1-Mar-2028	Cash	92,210	0.01%
CFD	10-Mar-2028	Cash	89,128	0.01%
Swap	14-Jun-2023	Cash	86,565	0.01%
Swap	12-Jul-2023	Cash	84,590	0.01%
CFD	26-Nov-2021	Cash	80,948	0.01%
Swap	7-May-2019	Cash	74,747	0.01%
CFD	11-Aug-2023	Cash	74,396	0.01%
Swap	7-Jul-2023	Cash	73,094	0.01%
Swap	5-Sep-2019	Cash	72,000	0.01%
CFD	25-Apr-2019	Cash	69,385	0.01%
Swap	3-Feb-2023	Cash	68,758	0.01%
CFD	5-Nov-2027	Cash	64,825	0.01%
CFD	10-Jul-2019	Cash	63,409	0.01%
Swap	7-May-2019	Cash		0.01%

CFD	11-Oct-2028	Cash	59,699	0.01%
Swap	15-Jun-2023	Cash	59,383	0.01%
CFD	1-Mar-2028	Cash	57,709	0.01%
Swap	5-Sep-2019	Cash	56,462	0.01%
CFD	17-Jul-2028	Cash	55,700	0.01%
Swap	2-Feb-2023	Cash	55,000	0.01%
CFD	14-Jan-2021	Cash	54,448	0.01%
CFD	27-Feb-2023	Cash	51,561	0.01%
CFD	25-Apr-2019	Cash	51,426	0.01%
Swap	1-Feb-2023	Cash	50,000	0.01%
CFD	14-Jan-2021	Cash	43,214	0.01%
Swap	21-Nov-2018	Cash	42,705	0.01%
CFD	25-Apr-2019	Cash	42,200	0.01%
CFD	20-Oct-2021	Cash	41,002	0.01%
Swap	14-Jun-2023	Cash	40,600	0.01%
CFD	27-Feb-2023	Cash	40,052	0.01%
CFD	17-Jul-2023	Cash	39,396	0.01%
Swap	12-Jul-2023	Cash	39,200	0.005%
CFD	10-Mar-2028	Cash	37,897	0.004%
CFD	21-Jul-2028	Cash	34,758	0.004%
Swap	7-Jul-2023	Cash	34,000	0.004%
CFD	14-Jul-2023	Cash	32,746	0.004%
Swap	12-Jun-2023	Cash	30,500	0.004%
CFD	25-Feb-2027	Cash	30,225	0.004%
CFD	25-Apr-2019	Cash	29,702	0.004%

CFD	30-Oct-2028	Cash	29,469	0.004%
Swap	15-Jun-2023	Cash	28,773	0.003%
CFD	1-Nov-2028	Cash	26,702	0.003%
CFD	13-Sep-2028	Cash	26,197	0.003%
CFD	6-Jul-2023	Cash	26,000	0.003%
CFD	1-Nov-2028	Cash	25,488	0.003%
CFD	25-Apr-2019	Cash	25,474	0.003%
CFD	26-Nov-2021	Cash	24,541	0.003%
Swap	14-Jun-2023	Cash	24,179	0.003%
CFD	21-Jan-2028	Cash	23,383	0.003%
Swap	12-Jul-2023	Cash	23,330	0.003%
CFD	17-Jul-2023	Cash	22,173	0.003%
Swap	1-Feb-2023	Cash	20,900	0.003%
CFD	27-Feb-2023	Cash	20,297	0.003%
Swap	7-Jul-2023	Cash	19,800	0.002%
Swap	5-Sep-2019	Cash	19,160	0.002%
Swap	7-May-2019	Cash	18,900	0.002%
Swap	28-Mar-2019	Cash	16,302	0.002%
Swap	22-May-2020	Cash	16,200	0.002%
Swap	30-Apr-2019	Cash	16,129	0.002%
Swap	22-May-2020	Cash	15,800	0.002%
Swap	15-Jun-2023	Cash	15,796	0.002%
CFD	2-Nov-2028	Cash	15,589	0.002%
CFD	21-Jul-2028	Cash	15,311	0.002%
CFD	18-Sep-2019	Cash	15,000	0.002%

CFD	19-Oct-2028	Cash	15,000	0.002%
Swap	28-Nov-2018	Cash	15,000	0.002%
Swap	17-Sep-2020	Cash	14,300	0.002%
Swap	12-Jun-2023	Cash	14,153	0.002%
Swap	3-Nov-2021	Cash	13,985	0.002%
Swap	22-May-2020	Cash	12,609	0.002%
CFD	25-Sep-2028	Cash	12,597	0.002%
Swap	1-Feb-2023	Cash	12,000	0.002%
CFD	26-Jun-2019	Cash	11,847	0.001%
Swap	29-Nov-2018	Cash	11,475	0.001%
CFD	27-Feb-2023	Cash	10,900	0.001%
CFD	28-Oct-2020	Cash	10,829	0.001%
Swap	5-Sep-2019	Cash	10,812	0.001%
Swap	6-Feb-2019	Cash	10,800	0.001%
Swap	12-Oct-2023	Cash	10,500	0.001%
Swap	12-Jun-2023	Cash	8,622	0.001%
Swap	22-May-2020	Cash	8,165	0.001%
CFD	25-Apr-2019	Cash	7,925	0.001%
CFD	21-Oct-2021	Cash	7,650	0.001%
Swap	22-May-2020	Cash	7,596	0.001%
Call Option	19-Nov-2018	Cash	7,437	0.001%
Swap	22-May-2020	Cash	7,349	0.001%
CFD	27-Jan-2028	Cash	6,834	0.001%
CFD	25-Oct-2028	Cash	6,390	0.001%
Swap	22-May-2020	Cash	6,257	0.001%

CFD	15-Dec-2027	Cash	6,153	0.001%
CFD	8-Mar-2028	Cash	5,000	0.001%
CFD	12-May-2028	Cash	5,000	0.001%
CFD	3-Nov-2028	Cash	5,000	0.001%
Swap	22-May-2020	Cash	4,984	0.001%
CFD	27-Oct-2028	Cash	4,774	0.001%
Swap	22-May-2020	Cash	4,511	0.001%
Swap	5-Sep-2019	Cash	3,941	0.0005%
Swap	3-Nov-2021	Cash	3,900	0.0005%
CFD	25-Apr-2019	Cash	3,634	0.0004%
Swap	22-May-2020	Cash	3,060	0.0004%
CFD	2-Nov-2028	Cash	3,050	0.0004%
Swap	22-May-2020	Cash	2,900	0.0004%
Swap	3-Nov-2021	Cash	2,857	0.0003%
CFD	29-Sep-2028	Cash	2,556	0.0003%
CFD	28-Oct-2020	Cash	2,500	0.0003%
CFD	28-Oct-2020	Cash	2,350	0.0003%
Swap	3-Nov-2021	Cash	2,350	0.0003%
Call Option	20-Nov-2018	Cash	2,214	0.0002%
Call Option	21-Nov-2018	Cash	1,931	0.0002%
Swap	22-May-2020	Cash	1,860	0.0002%
CFD	27-Jan-2028	Cash	1,768	0.0002%
CFD	26-Oct-2028	Cash	1,634	0.0002%
CFD	27-Jan-2028	Cash	1,547	0.0002%
CFD	27-Apr-2020	Cash	1,452	0.0002%

			1,445	
CFD	18-Sep-2028	Cash	907	0.0001%
CFD	27-Oct-2028	Cash	700	0.0001%
CFD	27-Jan-2028	Cash	683	0.0001%
Swap	22-May-2020	Cash	461	0.0001%
Swap	22-May-2020	Cash	419	0.0001%
CFD	8-Nov-2028	Cash	400	0.0001%
Swap	22-May-2020	Cash	329	0.00004%
Swap	22-May-2020	Cash	323	0.00004%
CFD	27-Sep-2028	Cash	200	0.00003%
CFD	27-Sep-2028	Cash	123	0.00002%
CFD	5-Oct-2028	Cash	122	0.00002%
CFD	27-Sep-2028	Cash	90	0.00001%
CFD	6-Oct-2028	Cash	82	0.00001%
CFD	2-Oct-2028	Cash	61	0.00001%
CFD	23-Oct-2028	Cash	19	0.000002%
Total Number of voting rights and percentage of voting rights			27,655,570	3.54%

Additional information: Please note, total amount of voting rights have been rounded to 2 decimal places therefore there is a possibility of a rounding error.

SIGNATURE

Pursuant to the requirements 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.

PEARSON plc

Date: 09 November 2018

By: /s/ NATALIE WHITE

Natalie White
Deputy Company Secretary