MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2012
Table of Contents

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

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

For the transition period from to

Commission file number: 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MICHIGAN (State or other jurisdiction of incorporation or organization)	**38-2062816** (I.R.S. Employer Identification No.)
130 SOUTH CEDAR STREET, MANISTIQUE, MI (Address of principal executive offices)	**49854** (Zip Code)

Registrant s telephone number, including area code: **(888) 343-8147**

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 periods 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 o

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 x No o

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o	Accelerated Filer o
Non-accelerated Filer o	Smaller reporting company x

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

As of September 30, 2012, there were outstanding 5,559,914 shares of the registrant s common stock, no par value.

Table of Contents

MACKINAC FINANCIAL CORPORATION

INDEX

Table of Contents

MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	September 30, 2012 (Unaudited)	December 31, 2011	September 30, 2011 (Unaudited)
ASSETS			
Cash and due from banks	**$ 31,403**	$ 20,071	$ 30,122
Federal funds sold	**16,002**	13,999	12,000
Cash and cash equivalents	**47,405**	34,070	42,122
Interest-bearing deposits in other financial institutions	**10**	10	10
Securities available for sale	**42,476**	38,727	37,022
Federal Home Loan Bank stock	**3,060**	3,060	3,060
Loans:			
Commercial	**329,891**	311,215	299,135
Mortgage	**93,446**	83,106	86,500
Consumer	**10,621**	6,925	6,268
Total Loans	**433,958**	401,246	391,903
Allowance for loan losses	**(5,186)**	(5,251)	(5,838)
Net loans	**428,772**	395,995	386,065
Premises and equipment	**10,744**	9,627	9,507
Other real estate held for sale	**3,511**	3,162	5,212
Deferred tax asset	**9,670**	8,427	8,349
Other assets	**5,469**	5,233	7,251
TOTAL ASSETS	**$ 551,117**	$ 498,311	$ 498,598
LIABILITIES AND SHAREHOLDERS EQUITY			
LIABILITIES:			
Deposits:			
Noninterest bearing deposits	**$ 62,306**	$ 51,273	$ 53,736
NOW, money market, interest checking	**152,286**	152,563	157,596
Savings	**15,783**	14,203	15,618
CDs<$100,000	**142,125**	130,685	119,893
CDs>$100,000	**25,390**	23,229	24,138
Brokered	**41,473**	32,836	34,077
Total deposits	**439,363**	404,789	405,058

Borrowings	**35,925**	35,997	35,997
Other liabilities	**2,884**	2,262	2,064
Total liabilities	**478,172**	443,048	443,119
SHAREHOLDERS EQUITY:			
Preferred stock - No par value:			
Authorized 500,000 shares, Issued and outstanding - 11,000 shares	**11,000**	10,921	10,866
Common stock and additional paid in capital - No par value			
Authorized - 18,000,000 shares			
Issued and outstanding - **5,559,914**, 3,419,736, and 3,419,736 shares respectively	**55,047**	43,525	43,525
Retained earnings	**6,028**	492	607
Accumulated other comprehensive income	**870**	325	481
Total shareholders equity	**72,945**	55,263	55,479
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 551,117**	$ 498,311	$ 498,598

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(Unaudited)		(Unaudited)	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	**$ 5,803**	$ 5,584	**$ 17,256**	$ 15,918
Tax-exempt	**28**	35	**90**	114
Interest on securities:				
Taxable	**226**	304	**728**	878
Tax-exempt	**6**	7	**20**	21
Other interest income	**41**	26	**96**	89
Total interest income	**6,104**	5,956	**18,190**	17,020
INTEREST EXPENSE:				
Deposits	**1,011**	1,091	**2,986**	3,540
Borrowings	**163**	156	**492**	452
Total interest expense	**1,174**	1,247	**3,478**	3,992
Net interest income	**4,930**	4,709	**14,712**	13,028
Provision for loan losses	**150**	400	**795**	1,000
Net interest income after provision for loan losses	**4,780**	4,309	**13,917**	12,028
OTHER INCOME:				
Deposit service fees	**155**	180	**538**	616
Income from secondary market loans sold	**320**	195	**844**	394
SBA/USDA loan sale gains	**506**	283	**1,126**	1,469
Mortgage servicing income	**92**	300	**292**	300
Other	**76**	48	**260**	152
Total other income	**1,149**	1,006	**3,060**	2,931
OTHER EXPENSE:				
Salaries and employee benefits	**2,063**	1,811	**6,041**	5,441
Occupancy	**370**	334	**1,050**	1,048
Furniture and equipment	**213**	197	**660**	612
Data processing	**253**	177	**739**	532
Professional service fees	**210**	165	**700**	550
Loan and deposit	**195**	288	**674**	719
Writedowns and losses on other real estate held for sale	**265**	296	**450**	728
FDIC insurance assessment	**36**	215	**354**	755
Telephone	**56**	51	**168**	160
Advertising	**96**	93	**292**	292
Other	**610**	333	**1,280**	912
Total other expenses	**4,367**	3,960	**12,408**	11,749

Income before provision for income taxes		**1,562**		1,355		**4,569**		3,210
Provision for (benefit of) income taxes		**528**		455		**(1,458)**		1,071
NET INCOME		**1,034**		900		**6,027**		2,139
Preferred dividend and accretion of discount		**137**		193		**491**		573
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	**$**	**897**	$	707	**$**	**5,536**	$	1,566
INCOME PER COMMON SHARE:								
Basic	**$**	**.19**	$	.21	**$**	**1.44**	$	.46
Diluted	**$**	**.18**	$	.20	**$**	**1.39**	$	.45

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income	**$ 1,034**	$ 900	**$ 6,027**	$ 2,139
Net change in net unrealized gains and losses on securities available for sale:				
Unrealized gains (losses) arising during the period	**264**	(103)	**827**	(197)
Less: reclassification adjustment for gains(losses) included in net income				
Net securities gain (loss) during the period	**264**	(103)	**827**	(197)
Tax effect	**(90)**	35	**(282)**	67
Net of tax	**174**	(68)	**545**	(130)
Comprehensive income	**$ 1,208**	$ 832	**$ 6,572**	$ 2,009

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(Dollars in Thousands)

(Unaudited)

	Three Months Ended September 30, 2012 Preferred Stock	2012 Common Shareholders Equity	2012 Total Shareholders Equity	2011 Preferred Stock	2011 Common Shareholders Equity	2011 Total Shareholders Equity
Balance, beginning of period	**$ 11,000**	**$ 49,352**	**$ 60,352**	$ 10,811	$ 43,973	$ 54,784
Net income for period		**1,034**	**1,034**		900	900
Net unrealized gain (loss) on securities available for sale		**174**	**174**		(68)	(68)
Total comprehensive income (loss)		**1,208**	**1,208**		832	832
Issuance of common stock		**11,506**	**11,506**			
Stock option compensation		**16**	**16**			
Dividend on preferred stock		**(137)**	**(137)**		(138)	(138)

Rounding					1	1
Accretion of preferred stock discount				55	(55)	
Balance, end of period	**$ 11,000**	**$ 61,945**	**$ 72,945**	$ 10,866	$ 44,613	$ 55,479

	Nine Months Ended September 30,					
	2012			2011		
	Preferred Stock	**Common Shareholders Equity**	**Total Shareholders Equity**	**Preferred Stock**	**Common Shareholders Equity**	**Total Shareholders Equity**
Balance, beginning of period	**$ 10,921**	**$ 44,342**	**$ 55,263**	$ 10,706	$ 43,176	$ 53,882
Net income for period		**6,027**	**6,027**		2,139	2,139
Net unrealized gain (loss) on securities available for sale		**545**	**545**		(130)	(130)
Total comprehensive income (loss)		**6,572**	**6,572**		2,009	2,009
Issuance of common stock		**11,506**	**11,506**			
Stock option compensation		**16**	**16**			
Dividend on preferred stock		**(412)**	**(412)**		(413)	(413)
Rounding					1	1
Accretion of preferred stock discount	**79**	**(79)**		160	(160)	
Balance, end of period	**$ 11,000**	**$ 61,945**	**$ 72,945**	$ 10,866	$ 44,613	$ 55,479

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30, 2012	2011
Cash Flows from Operating Activities:		
Net income	$ **6,027**	$ 2,139
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	**1,152**	1,094
Provision for loan losses	**795**	1,000
Provision (benefit of) for income taxes	**(1,458)**	1,071
(Gain) on sale of secondary market loans	**(641)**	(260)
Origination of secondary market loans held for sale	**(45,605)**	(21,619)
Proceeds from secondary market loans held for sale	**46,246**	22,013
(Gain) loss on sale of premises, equipment, and other real estate held for sale	**12**	178
Writedown of other real estate held for sale	**474**	550
Stock option compensation	**16**	
Change in other assets	**(315)**	(2,315)
Change in other liabilities	**622**	98
Net cash provided by operating activities	**7,325**	3,949
Cash Flows from Investing Activities:		
Net increase in loans	**(34,652)**	(14,855)
Net increase in interest-bearing deposits in other financial institutions		703
Purchase of securities available for sale	**(11,031)**	(15,206)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	**7,848**	11,567
Capital expenditures	**(1,929)**	(663)
Redemption of FHLB stock		363
Proceeds from sale of premises, equipment, and other real estate	**178**	3,751
Net cash provided by (used in) investing activities	**(39,586)**	(14,340)
Cash Flows from Financing Activities:		
Net increase in deposits	**34,574**	18,279
Net proceeds from stock issuance	**11,506**	
Principal payments on borrowings	**(72)**	(72)
Dividend on preferred stock	**(412)**	(413)
Net cash provided by financing activities	**45,596**	17,794
Net increase (decrease) in cash and cash equivalents	**13,335**	7,403
Cash and cash equivalents at beginning of period	**34,070**	34,719
Cash and cash equivalents at end of period	$ **47,405**	$ 42,122
Supplemental Cash Flow Information:		
Cash paid during the year for:		

Interest	**$**	**3,020**	$	3,525
Income taxes		**75**		75
Noncash Investing and Financing Activities:				
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale		**1,013**		4,129
(net of adjustments made through the allowance for loan losses)				

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the Corporation) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2011.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The net other income and other expenses was not changed due to these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets, mortgage servicing rights and other real estate held for sale.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to commercial loans, when they have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan s initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The Corporation continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for possible loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation s past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management s opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Compensation Plans

The Corporation has three various stock compensation plans which are now expired. One plan was approved during 2000 and applied to officers, employees, and nonemployee directors. This plan was amended as a part of the December 2004 stock offering and recapitalization. The amendment, approved by shareholders, increased the shares available under this plan by 428,587 shares from the original 25,000 (adjusted for the 1:20 reverse stock split), to a total authorized share balance of 453,587. The other two plans, one for officers and employees and the other for nonemployee directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 split), were made available for grant under these plans. Options under all of the plans were granted at the discretion of a committee of the Corporation s Board of Directors. Options to purchase shares of the Corporation s stock were granted at a price equal to the market price of the stock at the date of grant. The committee determined the vesting of the options when they were granted as established under the plan.

In May 22, 2012, the Company s shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, shares of restricted stock units (RSUs), or stock appreciation rights. The aggregate number of shares of the Company s common stock issuable under the plan is 757,848.

On August 31, 2012, the Company granted 148,500 RSUs to certain members of management and all outside directors at the market value of the stock, which was $7.91. The RSUs were awarded at no cost to the employee and vest ratably over a four-year period. Compensation cost to be recognized over the four year vesting period, net of income tax, is $.736 million. As of September 30, 2012, none of the RSUs were vested and unrecognized compensation expense, net of income tax, is approximately $.711 million.

2. EARNINGS PER SHARE

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options and warrants were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our earnings, is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, after giving effect for dilutive shares issued.

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands, except per share data):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
(Numerator):				
Net income	**$ 1,034**	$ 900	**$ 6,027**	$ 2,139
Preferred stock dividends and accretion of discount	**137**	193	**491**	573
Net income available to common shareholders	**$ 897**	$ 707	**$ 5,536**	$ 1,566
(Denominator):				
Weighted average shares outstanding - basic	**4,722,029**	3,419,736	**3,857,002**	3,419,736
Dilutive effect of stock options				
Dilutive effect of common stock warrants	**136,186**	89,845	**119,850**	83,611
Weighted average shares outstanding - diluted	**4,858,215**	3,509,581	**3,976,852**	3,503,347
Income per common share:				
Basic	**$ .19**	$ .21	**$ 1.44**	$ .46
Diluted	**$ .18**	$ .20	**$ 1.39**	$ .45

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2012, December 31, 2011 and September 30, 2011 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 30, 2012				
US Agencies - MBS	**$ 8,282**	**$ 388**	**$**	**$ 8,670**
US Agencies	**10,303**	**154**		**10,457**
Corporate Bonds	**17,180**	**232**	**(9)**	**17,403**
Obligations of states and political subdivisions	**5,391**	**557**	**(2)**	**5,946**
Total securities available for sale	**$ 41,156**	**$ 1,331**	**$ (11)**	**$ 42,476**
December 31, 2011				
US Agencies - MBS	$ 11,111	$ 387	$	$ 11,498
US Agencies	10,407	168		10,575
Corporate Bonds	8,314		(136)	8,178
Obligations of states and political subdivisions	5,448	110	(2)	5,556
Other asset backed	2,954		(34)	2,920
Total securities available for sale	$ 38,234	$ 665	$ (172)	$ 38,727
September 30, 2011				
US Agencies - MBS	$ 15,087	$ 523	$	$ 15,610
US Agencies	10,443	190		10,633
Corporate Bonds	5,256		(99)	5,157
Obligations of states and political subdivisions	5,507	118	(3)	5,622
Total securities available for sale	$ 36,293	$ 831	$ (102)	$ 37,022

When gross unrealized losses exist within the portfolio, the Corporation considers them temporary in nature and related to interest rate fluctuations. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $7.377 million and $7.786 million, respectively, at September 30, 2012.

4. LOANS

The composition of loans is as follows (dollars in thousands):

	September 30, 2012	**December 31, 2011**	**September 30, 2011**
Commercial real estate	**$ 224,061**	$ 199,201	$ 195,079
Commercial, financial, and agricultural	**84,073**	92,269	84,285
One to four family residential real estate	**86,643**	77,332	78,759
Construction :			
Consumer	**6,803**	5,774	7,741
Commerical	**21,757**	19,745	19,771
Consumer	**10,621**	6,925	6,268
Total loans	**$ 433,958**	$ 401,246	$ 391,903

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

An analysis of the allowance for loan losses for the three and nine months ended September 30, 2012, and 2011 is as follows (dollars in thousands):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Balance at beginning of period	**$ 5,083**	$ 6,155	**$ 5,251**	$ 6,613
Recoveries on loans previously charged off	**13**	22	**231**	43
Loans charged off	**(60)**	(739)	**(1,091)**	(1,818)
Provision	**150**	400	**795**	1,000
Balance at end of period	**$ 5,186**	$ 5,838	**$ 5,186**	$ 5,838

In the first nine months of 2012, net charge off activity was $.860 million, or .28% of average loans outstanding compared to net charge-offs of $1.775 million, or .62% of average loans, in the same period in 2011. In the first nine months of 2012, the Corporation recorded a provision for loan loss of $.795 million compared to $1.000 million in the first nine months of 2011. The Corporation s allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2012 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Three Months Ended September 30, 2012								
Allowance for loan loss reserve:								
Beginning balance ALLR	**$ 2,784**	**$ 888**	**$ 218**	**$ 1,083**	**$**	**$**	**$ 110**	**$ 5,083**
Charge-offs	**(36)**			**(23)**		**(1)**		**(60)**
Recoveries	**10**	**1**				**2**		**13**
Provision	**90**	**(114)**	**(33)**	**177**		**(1)**	**31**	**150**
Ending balance ALLR	**$ 2,848**	**$ 775**	**$ 185**	**$ 1,237**	**$**	**$**	**$ 141**	**$ 5,186**

Nine Months Ended September 30, 2012								
Allowance for loan loss reserve:								
Beginning balance ALLR	**$ 2,823**	**$ 1,079**	**$ 207**	**$ 1,114**	**$**	**$**	**$ 28**	**$ 5,251**
Charge-offs	**(726)**	**(24)**	**(6)**	**(319)**		**(16)**		**(1,091)**
Recoveries	**27**	**188**		**5**		**11**		**231**
Provision	**724**	**(468)**	**(16)**	**437**		**5**	**113**	**795**
Ending balance ALLR	**$ 2,848**	**$ 775**	**$ 185**	**$ 1,237**	**$**	**$**	**$ 141**	**$ 5,186**
At September 30,2012								
Loans:								
Ending balance	**$ 224,061**	**$ 84,073**	**$ 21,757**	**$ 86,643**	**$ 6,803**	**$ 10,621**	**$**	**$ 433,958**
Ending balance ALLR	**(2,848)**	**(775)**	**(185)**	**(1,237)**			**(141)**	**(5,186)**
Net loans	**$ 221,213**	**$ 83,298**	**$ 21,572**	**$ 85,406**	**$ 6,803**	**$ 10,621**	**$ (141)**	**$ 428,772**
Ending balance ALLR:								
Individually evaluated	**$ 1,198**	**$ 145**	**$ 11**	**$ 277**	**$**	**$**	**$**	**$ 1,631**
Collectively evaluated	**1,650**	**630**	**174**	**960**			**141**	**3,555**
Total	**$ 2,848**	**$ 775**	**$ 185**	**$ 1,237**	**$**	**$**	**$ 141**	**$ 5,186**
Ending balance Loans:								
Individually evaluated	**$ 22,571**	**$ 5,997**	**$ 858**	**$ 1,248**	**$**	**$ 10**	**$**	**$ 30,684**
Collectively evaluated	**201,490**	**78,076**	**20,899**	**85,395**	**6,803**	**10,611**		**403,274**
Total	**$ 224,061**	**$ 84,073**	**$ 21,757**	**$ 86,643**	**$ 6,803**	**$ 10,621**	**$**	**$ 433,958**

Impaired loans, by definition, are individually evaluated.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2011 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Charge-offs	(2,267)	(579)	(412)	(490)		(52)		(3,800)
Recoveries	32	21	75	1		9		138
Provision	1,598	619	155	(19)		43	(96)	2,300
Ending balance ALLR	$ 2,823	$ 1,079	$ 207	$ 1,114	$	$	$ 28	$ 5,251
Loans:								
Ending balance	$ 199,201	$ 92,269	$ 19,745	$ 77,332	$ 5,774	$ 6,925	$	$ 401,246
Ending balance ALLR	(2,823)	(1,079)	(207)	(1,114)			(28)	(5,251)
Net loans	$ 196,378	$ 91,190	$ 19,538	$ 76,218	$ 5,774	$ 6,925	$ (28)	$ 395,995
Ending balance ALLR:								
Individually evaluated	$ 926	$ 160	$	$ 114	$	$	$	$ 1,200
Collectively evaluated	1,897	919	207	1,000			28	4,051
Total	$ 2,823	$ 1,079	$ 207	$ 1,114	$	$	$ 28	$ 5,251
Ending balance Loans:								
Individually evaluated	$ 13,628	$ 1,707	$	$ 1,930	$	$	$	$ 17,265
Collectively evaluated	185,573	90,562	19,745	75,402	5,774	6,925		383,981
Total	$ 199,201	$ 92,269	$ 19,745	$ 77,332	$ 5,774	$ 6,925	$	$ 401,246

A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2011 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Three Months Ended September 30, 2011								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 2,952	$ 1,154	$ 263	$ 1,786	$	$	$	$ 6,155
Charge-offs	(539)	(155)		(11)		(34)		(739)
Recoveries	7	12				3		22
Provision	1,039	(175)	(63)	(432)		31		400

Ending balance ALLR	$ 3,459	$ 836	$ 200	$ 1,343	$	$	$	$ 5,838
Nine Months Ended September 30, 2011								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Charge-offs	(883)	(562)	(62)	(266)		(45)		(1,818)
Recoveries	21	14				8		43
Provision	861	366	(127)	(13)		37	(124)	1,000
Ending balance ALLR	$ 3,459	$ 836	$ 200	$ 1,343	$	$	$	$ 5,838
At September 30, 2011								
Loans:								
Ending balance	$ 195,079	$ 84,285	$ 19,771	$ 78,759	$ 7,741	$ 6,268	$	$ 391,903
Ending balance ALLR	(3,459)	(836)	(200)	(1,343)				(5,838)
Net loans	$ 191,620	$ 83,449	$ 19,571	$ 77,416	$ 7,741	$ 6,268	$	$ 386,065
Ending balance ALLR:								
Individually evaluated	$ 1,583	$ 26	$ 16	$ 367	$	$	$	$ 1,992
Collectively evaluated	1,876	810	184	976				3,846
Total	$ 3,459	$ 836	$ 200	$ 1,343	$	$	$	$ 5,838
Ending balance Loans:								
Individually evaluated	$ 15,090	$ 1,730	$ 1,236	$ 2,285	$	$	$	$ 20,341
Collectively evaluated	179,989	82,555	18,535	76,474	7,741	6,268		371,562
Total	$ 195,079	$ 84,285	$ 19,771	$ 78,759	$ 7,741	$ 6,268	$	$ 391,903

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan s credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

Excellent (1)

Borrower is not vulnerable to sudden economic or technological changes and is in a non-seasonal business or industry. These loans generally would be characterized by having good experienced management and a strong liquidity position with minimal leverage.

Good (2)

Borrower shows limited vulnerability to sudden economic change with modest seasonal effect. Borrower has above average financial statements and an acceptable repayment history with minimal leverage and a profitability that exceeds peers.

Average (3)

Generally, a borrower rated as average may be susceptible to unfavorable changes in the economy and somewhat affected by seasonal factors. Some product lines may be affected by technological change. Borrowers in this category exhibit stable earnings, with a satisfactory payment history.

Acceptable (4)

The loan is an otherwise acceptable credit that warrants a higher level of administration due to various underlying weaknesses. These weaknesses, however, have not and may never deteriorate to the point of a Special Mention rating or Classified status. This rating category may include new businesses not yet having established a firm performance record.

Special Mention (5)

The loan is not considered as a Classified status, however may exhibit material weaknesses that, if not corrected, may cause future problems. Borrowers in this category warrant special attention but have not yet reached the point of concern for loss. The borrower may have deteriorated to the point that they would have difficulty refinancing elsewhere. Similarly, purchasers of these businesses would not be eligible for bank financing unless they represent a significantly lessened credit risk.

Substandard (6)

The loan is Classified and exhibits a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans within this category clearly represent troubled and deteriorating credit situations requiring constant supervision and an action plan must be developed and approved by the appropriate officers to mitigate the risk.

Doubtful (7)

Loans in this category exhibit the same weaknesses used to describe the substandard credit; however, the traits are more pronounced. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

Charge-off/Loss (8)

Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

General Reserves:

For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. Within the commercial loan portfolio, the historical loss rates are used for specific industries such as hospitality, gaming, petroleum, and forestry. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Commercial construction loans in the amount of $3.882 million and $3.694 million a periods ended September 30, 2012 and December 31, 2011 respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases. Below is a breakdown of loans by risk category as of September 30, 2012 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	**$ 3,372**	**$ 19,939**	**$ 72,647**	**$ 105,736**	**$ 16,784**	**$ 5,374**	**$ 209**	**$**	**$ 224,061**
Commercial, financial and agricultural	**4,306**	**5,517**	**25,932**	**42,097**	**4,320**	**1,901**			**84,073**
Commercial construction		**988**	**5,039**	**9,995**	**761**	**1,092**		**3,882**	**21,757**
One to four family residential real estate		**1,979**	**3,586**	**4,703**		**709**		**75,666**	**86,643**
								6,803	**6,803**

Consumer construction									
Consumer		**362**	**71**	**233**		**3**		**9,952**	**10,621**
Total loans	**$ 7,678**	**$ 28,785**	**$ 107,275**	**$ 162,764**	**$ 21,865**	**$ 9,079**	**$ 209**	**$ 96,303**	**$ 433,958**

Below is a breakdown of loans by risk category as of December 31, 2011 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,083	$ 16,946	$ 47,154	$ 118,259	$ 5,198	$ 7,642	$ 919	$	$ 199,201
Commercial, financial and agricultural	4,416	7,875	17,738	60,498	201	1,541			92,269
Commercial construction	209	552	4,542	10,415	313	20		3,694	19,745
One-to-four family residential real estate			3,359	5,910	2,023			66,040	77,332
Consumer construction								5,774	5,774
Consumer			105	599				6,221	6,925
Total loans	$ 7,708	$ 25,373	$ 72,898	$ 195,681	$ 7,735	$ 9,203	$ 919	$ 81,729	$ 401,246

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

Below is a breakdown of loans by risk category as of September 30, 2011 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,555	$ 16,988	$ 46,123	$ 113,406	$ 5,032	$ 7,971	$ 2,239	$ (235)	$ 195,079
Commercial, financial and agricultural	2,927	9,242	18,403	51,559	206	1,556		392	84,285
Commercial construction	212	556	5,968	11,482	1,553				19,771
One to four family residential real estate		3,330	3,163	5,992		2,289		63,985	78,759
Consumer construction						20		7,721	7,741
Consumer			113	583				5,572	6,268
Total loans	$ 6,694	$ 30,116	$ 73,770	$ 183,022	$ 6,791	$ 11,836	$ 2,239	$ 77,435	$ 391,903

Impaired Loans

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. The interest income recorded during impairment and that which would have been recognized was $.017 million and $.072 million for the three months ended September 30, 2012, and $.054 and $.246 for the nine months ended September 30, 2012. For the three months ended September 30, 2011, the amounts were $.030 million and $.099 million and for the nine month period in 2011, the amounts were $.098 million and $.370 million.

The accrual of interest on loans is discontinued when, in management s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

						Three Months Ended		Nine Months Ended	
	Nonaccrual Basis	Accrual Basis	QTD Average Investment	YTD Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
September 30, 2012									
With no valuation reserve:									
Commercial real estate	$ 530	$	$ 533	$ 1,135	$	$	$ 9	$	$ 32
Commercial, financial and agricultural				1,063					18
Commercial construction	676		676	676			5		9
One to four family residential real estate	156		384	818			4		28
Consumer construction	15		15	16					1
Consumer									
With a valuation reserve:									
Commercial real estate	$ 3,161	$	$ 3,177	$ 3,663	$ 937	$ 17	$ 42	$ 54	$ 136
Commercial, financial and agricultural	287		281	398	90		4		12
Commercial construction									
One to four family residential real estate	462		267	463	188		8		10
Consumer construction									
Consumer	3		1	3	3				
Total:									
Commercial real estate	$ 3,691	$	$ 3,710	$ 4,798	$ 937	$ 17	$ 51	$ 54	$ 168
Commercial, financial and	287		281	1,461	90		4		30

agricultural									
Commercial construction	**676**		**676**	**676**			**5**		**9**
One to four family residential real estate	**618**		**651**	**1,281**	**188**		**12**		**38**
Consumer construction	**15**		**15**	**16**					**1**
Consumer	**3**		**1**	**3**	**3**				
Total	**$ 5,290**	**$**	**$ 5,334**	**$ 8,235**	**$ 1,218**	**$ 17**	**$ 72**	**$ 54**	**$ 246**

						Three Months Ended		Nine Months Ended	
	Nonaccrual Basis	Accrual Basis	QTD Average Investment	YTD Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
September 30, 2011									
With no valuation reserve:									
Commercial real estate	$ 438	$	$ 269	$ 438	$	$	$ 2	$ 24	$ 16
Commercial, financial and agricultural							(2)		
Commercial construction									11
One to four family residential real estate	109		111	79			1		3
Consumer construction	20		15	6					
Consumer									
With a valuation reserve:									
Commercial real estate	$ 3,195	$ 2,531	$ 3,313	$ 4,856	$ 1,414	$	$ 100	$ 43	$ 187
Commercial, financial and agricultural	36	1,084	1,395	1,357	41	29	2	29	35
Commercial construction				229					
One to four family residential real estate	2,156	104	3,461	3,103	342	1	(4)	2	118
Consumer construction				5					
Consumer			7	3					
Total:									
Commercial real estate	$ 3,633	$ 2,531	$ 3,582	$ 5,294	$ 1,414	$	$ 102	$ 67	$ 203
Commercial, financial and agricultural	36	1,084	1,395	1,357	41	29		29	35
Commercial construction				229					11
One to four family residential real estate	2,265	104	3,572	3,182	342	1	(3)	2	121
Consumer construction	20		15	11					
Consumer			7	3					
Total	$ 5,954	$ 3,719	$ 8,571	$ 10,076	$ 1,797	$ 30	$ 99	$ 98	$ 370

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A summary of past due loans at September 30, 2012, December 31, 2011 and September 30, 2011 is as follows (dollars in thousands):

	September 30, 2012			December 31, 2011			September 30, 2011		
	30-89 days Past Due (accruing)	**90+ days Past Due/ Nonaccrual**	**Total**	**30-89 days Past Due (accruing)**	**90+ days Past Due/ Nonaccrual**	**Total**	**30-89 days Past Due (accruing)**	**90+ days Past Due/ Nonaccrual**	**Total**
Commercial real estate	**$ 427**	**$ 3,691**	**$ 4,118**	$ 15	$ 2,362	$ 2,377	$ 338	$ 3,633	$ 3,971
Commercial, financial and agricultural	**64**	**287**	**351**	137	1,111	1,248		36	36
Commercial construction	**47**	**676**	**723**				30		30
One to four family residential real estate	**582**	**618**	**1,200**	188	1,997	2,185	124	2,265	2,389
Consumer construction		**15**	**15**		20	20		20	20
Consumer	**99**	**3**	**102**	14		14	6		6
Total past due loans	**$ 1,219**	**$ 5,290**	**$ 6,509**	$ 354	$ 5,490	$ 5,844	$ 498	$ 5,954	$ 6,452

A roll-forward of nonaccrual activity for the three months ended September 30, 2012 (dollars in thousands):

	For the Three Months Ended September 30, 2012						
NONACCRUAL	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer Construction**	**Consumer**	**Total**
Beginning balance	**$ 3,749**	**$ 278**	**$ 676**	**$ 657**	**$ 15**	**$**	**$ 5,375**
Principal payments	**(89)**	**(1)**		**(2)**			**(92)**
Charge-offs				**(14)**			**(14)**
Advances							
Class transfers				**(329)**			**(329)**

Transfers to OREO							
Transfers to accruing							
Transfers from accruing		**7**		**304**		**3**	**314**
Other	**31**	**3**		**2**			**36**
Ending balance	**$ 3,691**	**$ 287**	**$ 676**	**$ 618**	**$ 15**	**$ 3**	**$ 5,290**

A roll-forward of nonaccrual activity for the three months ended September 30, 2011 (dollars in thousands):

	For the Three Months Ended September 30, 2011						
NONACCRUAL	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer Construction**	**Consumer**	**Total**
Beginning balance	$ 3,116	$ 615	$	$ 3,881	$	$ 27	$ 7,639
Principal payments	(345)	(185)		(23)			(553)
Charge-offs	(240)	(144)		(293)			(677)
Advances						(27)	(27)
Class transfers							
Transfers to OREO	(195)	(262)		(1,569)	(1)		(2,027)
Transfers to accruing							
Transfers from accruing	1,277	12		97	20		1,406
Other	20			172	1		193
Ending balance	$ 3,633	$ 36	$	$ 2,265	$ 20	$	$ 5,954

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of nonaccrual activity for the nine months ended September 30, 2012 (dollars in thousands):

	For the Nine Months Ended September 30, 2012						
NONACCRUAL	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer Construction**	**Consumer**	**Total**
Beginning balance	**$ 2,362**	**$ 1,111**	**$**	**$ 1,997**	**$ 20**	**$**	**$ 5,490**
Principal payments	**(1,101)**	**(1,383)**		**(1,054)**			**(3,538)**
Charge-offs	**(463)**			**(307)**	**(5)**		**(775)**
Advances							
Class transfers							
Transfers to OREO	**(465)**			**(548)**			**(1,013)**
Transfers to accruing							
Transfers from accruing	**3,288**	**566**	**676**	**524**		**3**	**5,057**
Other	**70**	**(7)**		**6**			**69**
Ending balance	**$ 3,691**	**$ 287**	**$ 676**	**$ 618**	**$ 15**	**$ 3**	**$ 5,290**

A roll-forward of nonaccrual activity for the nine months ended September 30, 2011 (dollars in thousands):

	For the Nine Months Ended September 30, 2011						
NONACCRUAL	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer Construction**	**Consumer**	**Total**
Beginning balance	$ 3,522	$ 760	$ 458	$ 1,129	$ 52	$	$ 5,921
Principal payments	(1,283)	(766)	(14)	(43)			(2,106)
Charge-offs	(566)	(551)	(62)	(382)		(27)	(1,588)
Advances							

Class transfers							
Transfers to OREO	(1,184)	(609)	(382)	(1,901)	(53)		(4,129)
Transfers to accruing	(892)						(892)
Transfers from accruing	4,001	856		3,273	20	27	8,177
Other	35	346		189	1		571
Ending balance	$ 3,633	$ 36	$	$ 2,265	$ 20	$	$ 5,954

A roll-forward of nonaccrual activity during the year ended December 31, 2011 (dollars in thousands):

NONACCRUAL	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
Beginning balance	$ 3,522	$ 760	$ 458	$ 1,129	$ 52	$	$ 5,921
Principal payments	(1,458)	(767)	(14)	(47)			(2,286)
Charge-offs	(1,950)	(557)	(62)	(601)		(27)	(3,197)
Advances							
Class transfers							
Transfers to OREO	(1,203)	(262)	(382)	(1,948)	(53)		(3,848)
Transfers to accruing	(892)						(892)
Transfers from accruing	4,301	1,938		3,273	20	27	9,559
Other	42	(1)		191	1		233
Ending balance	$ 2,362	$ 1,111	$	$ 1,997	$ 20	$	$ 5,490

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

Troubled Debt Restructuring

Troubled debt restructurings (TDR) are determined on a loan-by-loan basis. Generally restructurings are related to interest rate reductions, loan term extensions and short term payment forbearance as means to maximize collectability of troubled credits. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring. In general, a borrower must make at least six consecutive timely payments before the Corporation would consider a return of a restructured loan to accruing status in accordance with FDIC guidelines regarding restoration of credits to accrual status.

The Corporation has, in accordance with generally accepted accounting principles and per recently enacted accounting standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan s original rate, or for collateral dependent loans, to the fair value of the collateral.

A summary of troubled debt restructurings is as follows (dollars in thousands):

	September 30, 2012		December 31, 2011		September 30, 2011	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial real estate	**4**	**$ 5,799**	1	$ 2,400	2	$ 2,531
Commercial, financial and agricultural	**1**	**1,221**			1	1,084
Commercial construction	**3**	**858**				
One to four family residential real estate	**1**	**102**	1	103	1	104
Consumer construction						
Consumer						
Total troubled debt restructurings	**9**	**$ 7,980**	2	$ 2,503	4	$ 3,719

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the three months ended September 30, 2012 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	**$ 3,645**	**$ 1,221**	**$ 858**	**$ 102**	**$**	**$ 5,826**
Principal payments	**(14)**					**(14)**
Charge-offs						
Advances						
New restructured						
Transferred out of TDR						
Transfers to nonaccrual						
Ending Balance	**$ 3,631**	**$ 1,221**	**$ 858**	**$ 102**	**$**	**$ 5,812**
NONACCRUAL						
Beginning balance	$ 2,188	$	$	$	$	**$ 2,188**
Principal payments	(47)					**(47)**
Charge-offs						
Advances	27					**27**
New restructured						
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	**$ 2,168**	**$**	**$**	**$**	**$**	**$ 2,168**
TOTALS						
Beginning balance	$ 5,833	$ 1,221	$ 858	$ 102	$	8,014
Principal payments	(61)					(61)
Charge-offs						
Advances	27					27
New restructured						
Transfers out of TDRs						
Tansfers to nonaccrual						

Transfers to foreclosed properties											
Transfers from accruing											
Ending Balance	**$**	**5,799**	**$**	**1,221**	**$**	**858**	**$**	**102**	**$**	**$**	**7,980**

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the three months ended September 30, 2011 (dollars in thousands):

ACCRUING	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer and Consumer Construction**	**Total**
Beginning balance	$ 600	$ 1,098	$	$ 104	$	$ 1,802
Principal payments	(1)	(14)				(15)
Charge-offs						
Advances						
New restructured	2,401					2,401
Transferred out of TDRs						
Transfers to nonaccrual	(469)					(469)
Ending Balance	$ 2,531	$ 1,084	$	$ 104	$	$ 3,719
NONACCRUAL						
Beginning balance	$	$	$	$	$	$
Principal payments						
Charge-offs						
Advances						
New restructured						
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	$	$	$	$	$	$
TOTALS						
Beginning balance	$ 600	$ 1,098	$	$ 104	$	$ 1,802
Principal payments	(1)	(14)				(15)
Charge-offs						
Advances						
New restructured	2,401					2,401
Transfers out of TDRs						
Tansfers to nonaccrual	(469)					(469)

Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	$ 2,531	$ 1,084	$	$ 104	$	$ 3,719

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the nine months ended September 30, 2012 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	$ 2,400	$	$	$ 103	$	$ 2,503
Principal payments	(64)		(2)	(1)		(67)
Charge-offs						
Advances						
New restructured	3,695	1,221	860			5,776
Transferred out of TDRs						
Transfers to nonaccrual	(2,400)					(2,400)
Ending Balance	$ 3,631	$ 1,221	$ 858	$ 102	$	$ 5,812
NONACCRUAL						
Beginning balance	$	$	$	$	$	$
Principal payments	(426)					(426)
Charge-offs	(772)					(772)
Advances	47					47
New restructured	919					919
Transfers to foreclosed properties						
Transfers from accruing	2,400					2,400
Ending Balance	$ 2,168	$	$	$	$	$ 2,168
TOTALS						
Beginning balance	$ 2,400	$	$	$ 103	$	$ 2,503
Principal payments	(490)		(2)	(1)		(493)
Charge-offs	(772)					(772)
Advances	47					47
New restructured	4,614	1,221	860			6,695
Transfers out of TDR						
Transfers to nonaccrual	(2,400)					(2,400)

Transfers to foreclosed properties						
Transfer from accruing	**2,400**					**2,400**
Ending Balance	**$ 5,799**	**$ 1,221**	**$ 858**	**$ 102**	**$**	**$ 7,980**

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the nine months ended September 30, 2011 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	$ 4,537	$	$	$ 105	$	$ 4,642
Principal payments	(6)	(14)		(1)		(21)
Charge-offs						
Advances						
New restructured	3,001	1,098				4,099
Transferred out of TDRs	(577)					(577)
Transfers to nonaccrual	(4,424)					(4,424)
Ending Balance	$ 2,531	$ 1,084	$	$ 104	$	$ 3,719
NONACCRUAL						
Beginning balance						$
Principal payments						
Charge-offs						
Advances						
New restructured						
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	$	$	$	$	$	$
TOTALS						
Beginning balance	4,537			105		4,642
Principal payments	(6)	(14)		(1)		(21)
Charge-offs						
Advances						
New restructured	3,001	1,098				4,099
Transfers out of TDRs	(577)					(577)
Transfers to nonaccrual	(4,424)					(4,424)

Transfers to foreclosed properties											
Transfers from accruing											
Ending Balance	$	2,531	$	1,084	$		$	104	$		$ 3,719

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the year ended December 31, 2011 (dollars in thousands):

ACCRUING	**Commercial Real Estate**	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer and Consumer Construction**	**Total**
Beginning balance	$ 4,537	$	$	$ 105	$	$ 4,642
Principal payments				(2)		(2)
Charge-offs						
Advances						
New restructured	2,400					2,400
Transferred out of TDRs	(582)					(582)
Transfers to nonaccrual	(3,955)					(3,955)
Ending Balance	$ 2,400	$	$	$ 103	$	$ 2,503
NONACCRUAL						
Beginning balance						$
Principal payments						
Charge-offs						
Advances						
New restructured						
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	$	$	$	$	$	$
TOTALS						
Beginning balance	4,537			105		4,642
Principal payments				(2)		(2)
Charge-offs						
Advances						
New restructured	2,400					2,400
Transfers out of TDRs	(582)					(582)
Transfers to nonaccrual	(3,955)					(3,955)

Transfers to foreclosed properties											
Transfers from accruing											
Ending Balance	$	2,400	$		$		$	103	$		$ 2,503

Insider Loans

The Bank, in the ordinary course of business, grants loans to the Corporation s executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

	September 30, 2012	December 31, 2011	September 30, 2011
Loans outstanding, beginning of period	**$ 8,827**	$ 9,532	$ 9,532
New loans	**3,401**	933	933
Net activity on revolving lines of credit	**17**	69	27
Principal payments	**(1,490)**	(1,707)	(1,630)
Loans outstanding, end of period	**$ 10,755**	$ 8,827	$ 8,862

There were no loans to related parties classified substandard as of September 30, 2012, December 31, 2011 or September 30, 2011. In addition to the outstanding balances above, there were unfunded commitments of $.369 million to related parties at September 30, 2012.

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. MORTGAGE SERVICING RIGHTS

Mortgage servicing rights (MSRs) are recorded when loans are sold in the secondary market with servicing retained. As of September 30, 2012, the Corporation had obligations to service approximately $78 million of residential first mortgage loans. The valuation is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 15.90 and a discount rate of 7.50% for September 30, 2012.

The following summarizes mortgage servicing rights capitalized and amortized, along with the aggregate activity in related valuation allowances (dollars in thousands):

	September 30, 2012	December 31, 2011
Balance at beginning of period	**$ 400**	**$**
Additions from loans sold with servicing retained	**245**	**415**
Amortization	**(74)**	**(15)**
Fair value of MSRs at end of period	**$ 571**	**$ 400**

6. BORROWINGS

Borrowings consist of the following at September 30, 2012, December 31, 2011 and September 30, 2011 (dollars in thousands):

	September 30, 2012	December 31, 2011	September 30, 2011
Federal Home Loan Bank fixed rate advances at September 30, 2012 with a weighted average rate of 1.82% maturing in 2013, 2014 and 2016	**$ 35,000**	$ 35,000	$ 35,000
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024, interest payable at 1%	**925**	997	997

	$ 35,925	$ 35,997	$ 35,997

The Federal Home Loan Bank borrowings are collateralized at September 30, 2012 by the following: a collateral agreement on the Corporation s one to four family residential real estate loans with a book value of approximately $43.600 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $7.126 million and $7.536 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.060 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of September 30, 2012.

The USDA Rural Development borrowing is collateralized by loans totaling $.155 million originated and held by the Corporation s wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of $.856 million, and guaranteed by the Corporation.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. STOCK COMPENSATION PLANS

A summary of stock option transactions for the nine months ended September 30, 2012 and 2011, and the year ended December 31, 2011, is as follows:

	September 30, 2012	**December 31, 2011**	**September 30, 2011**
Outstanding shares at beginning of year	**392,152**	394,072	394,072
Granted during the period			
Exercised during the period			
Expired / forfeited during the period		(1,920)	
Surrendered/Echanged for restricted stock	**(150,000)**		
Outstanding shares at end of period	**242,152**	392,152	394,072
Exercisable shares at end of period	**107,561**	148,861	150,781
Weighted average exercise price per share at end of period	**$ 9.88**	$ 10.27	$ 10.98
Shares available for grant at end of period			

Following is a summary of the options outstanding and exercisable at September 30, 2012:

Exercise Price	**Number Outstanding**	**Exercisable**	**Unvested Options**	**Weighted Average Remaining Contractual Life-Years**
$ 9.16	2,500	1,000	1,500	3.21
$ 9.75	217,152	102,061	115,091	2.21
$ 10.65	12,500	2,500	10,000	3.00
$ 12.00	10,000	2,000	8,000	2.71
	242,152	107,561	134,591	2.31

The Corporation, in August 2012, granted 148,500 Restricted Stock Units (RSU s) to outside members of the Board of Directors and Management. These RSU s were granted at a market value of $7.91 and will vest equally over a four year term. In exchange for the grant of RSU s various previously issued stock option awards were surrendered.

8. 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. The Corporation, as of September 30, 2012 had a net operating loss and tax credit carryforwards for tax purposes of approximately $23.8 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $15.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation recognized a deferred tax benefit of approximately $1.458 million for the September 30, 2012 nine month period and a deferred tax liability of $1.071 million for the nine months ended September 30, 2011. The valuation allowance at September 30, 2012 was approximately $3.3 million. Management evaluated the deferred tax valuation allowance as of September 30, 2012 and determined that an adjustment to the valuation was not warranted. The Corporation reduced the valuation allowance by $3.0 million since it was determined that it was more likely than not that these benefits would be realized. The Corporation made this determination after a thorough review of projected earnings and the composition and sustainability of those earnings over the projected tax carryover period. This analysis substantiated the ability to utilize these deferred tax assets. The Corporation 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 will recognize the additional benefits as an adjustment to the valuation allowance.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS

Fair value estimates, methods, and assumptions are set forth below for the Corporation s financial instruments:

Cash, cash equivalents, and interest-bearing deposits - The carrying values approximate the fair values for these assets.

Securities - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Federal Home Loan Bank stock Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

Loans - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan s effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

Borrowings - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

Accrued interest - The carrying amount of accrued interest approximates fair value.

Off-balance-sheet instruments - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS (Continued)

The following table presents information for financial instruments at September 30, 2012, December 31, 2011 and September 30, 2011(dollars in thousands):

		September 30, 2012		December 31, 2011		September 30, 2011	
	Level in Fair Value Hierarchy	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
Financial assets:							
Cash and cash equivalents	Level 1	**$ 47,405**	**$ 47,405**	$ 34,070	$ 34,070	$ 42,122	$ 42,122
Interest-bearing deposits	Level 2	**10**	**10**	10	10	10	10
Securities available for sale	Level 2	**42,476**	**42,476**	38,727	38,727	37,022	37,022
Federal Home Loan Bank stock	Level 2	**3,060**	**3,060**	3,060	3,060	3,060	3,060
Net loans	Level 3	**428,772**	**425,406**	395,995	394,463	386,065	385,242
Accrued interest receivable	Level 2	**1,574**	**1,574**	1,261	1,261	1,266	1,266
Total financial assets		**$ 523,297**	**$ 519,931**	$ 473,123	$ 471,591	$ 469,545	$ 468,722
Financial liabilities:							
Deposits	Level 2	**$ 439,363**	**$ 439,139**	$ 404,789	$ 404,821	$ 405,058	$ 407,120
Borrowings	Level 2	**35,925**	**35,681**	35,997	35,634	35,997	35,591
Accrued interest payable	Level 2	**238**	**238**	202	202	209	209
Total financial liabilties		**$ 475,526**	**$ 475,058**	$ 440,988	$ 440,657	$ 441,264	$ 442,920

***Limitations* -** Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The following is information about the Corporation s assets and liabilities measured at fair value on a recurring basis at June 30, 2012, and the valuation techniques used by the Corporation to determine those fair values.

Level 1: In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

Level 2: Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS (Continued)

Level 3: Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

The fair value of all investment securities at September 30, 2012 and September 30, 2011 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 3 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of September 30, 2012, December 31, 2011 or September 30, 2011.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation s assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include 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

(dollars in thousands)	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)	Total Losses for Three Months Ended September 30, 2012	Total Losses for Nine Months Ended September 30, 2012
Assets						
Impaired loans	$ 5,290	$	$	$ 5,290	$ 53	$ 1,065
Other real estate owned	3,511			3,511	265	450
					$ 318	$ 1,515

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

(dollars in thousands)	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)	Total Losses for Year Ended December 31, 2011
Assets					
Impaired loans	$ 7,993	$	$	$ 7,993	$ 3,200
Other real estate owned	3,162			3,162	1,137
					$ 4,337

Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2011

(dollars in thousands)	Balance at September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended September 30, 2011	Total Losses for Nine Months Ended September 30, 2011
Assets						
Impaired loans	$ 9,673	$	$	$ 9,673	$ 712	$ 1,587
Other real estate owned	5,212			5,212	296	728
					$ 1,008	$ 2,315

The Corporation had no investments subject to fair value measurement on a nonrecurring basis.

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management s best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. SHAREHOLDER S EQUITY

In August 2012 the corporation consummated the previously announced $7.000 million rights offering and the investment by Steinhardt Capital Investors, LLLP (SCI) by issuing 2,140,178 shares of common stock for net proceeds of $11.500 million. Also, in August 2012, the Corporation exited the TARP Capital Purchase Program (CPP) when the Corporations 11,000 Series A Preferred Shares, issued in April, 2009 to the U.S. Treasury, were publically offered and sold. The Corporation still has outstanding, 379,310 of Common Stock Warrants issued to the U.S. Treasury under the CPP.

11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK

Financial Instruments With Off-Balance-Sheet Risk

The Corporation is a party to 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 and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Corporation s exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

	September 30, 2012	**December 31, 2011**	**September 30, 2011**
Commitments to extend credit:			
Variable rate	**$ 38,068**	$ 28,495	$ 16,443
Fixed rate	**21,247**	15,453	29,632
Standby letters of credit - Variable rate	**3,816**	3,523	4,307
Credit card commitments - Fixed rate	**3,161**	3,019	3,119
	$ 66,292	$ 50,490	$ 53,501

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management s credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit.

Credit card commitments are commitments on credit cards issued by the Corporation s subsidiary and serviced by other companies. These commitments are unsecured.

Legal Proceedings and Contingencies

In the normal course of business, the Corporation is involved in various legal proceedings. For expanded discussion on the Corporation s legal proceedings, see Part II, Item 1, Legal Proceedings in this report.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK (Continued)

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank s most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at September 30, 2012 represents $88.505 million, or 22.53%, compared to $62.567 million, or 20.92%, of the commercial loan portfolio on September 30, 2011. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank s locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

Table of Contents

MACKINAC FINANCIAL CORPORATION

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Corporation intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words believe , expect , intend , anticipate , estimate project , or similar expressions. The Corporation s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

- The highly regulated environment in which the Corporation operates could adversely affect its ability to carry out its strategic plan due to restrictions on new products, funding opportunities or new market entrances;
- General economic conditions, either nationally or in the state(s) in which the Corporation does business;
- Legislation or regulatory changes which affect the business in which the Corporation is engaged;
- Changes in the level and volatility of interest rates which may negatively affect the Corporation s interest margin;
- Changes in securities markets with respect to the market value of financial assets and the level of volatility in certain markets such as foreign exchange;
- Significant increases in competition in the banking and financial services industry resulting from industry consolidation, regulatory changes and other factors, as well as action taken by particular competitors;
- The ability of borrowers to repay loans;
- The effects on liquidity of unusual decreases in deposits;
- Changes in consumer spending, borrowing, and saving habits;
- Technological changes;
- Acquisitions and unanticipated occurrences which delay or reduce the expected benefits of acquisitions;
- Difficulties in hiring and retaining qualified management and banking personnel;
- The Corporation s ability to increase market share and control expenses;

- The effect of compliance with legislation or regulatory changes;
- The effect of changes in accounting policies and practices;
- The costs and effects of existing and future litigation and of adverse outcomes in such litigation; and
- An increase in the Corporation s FDIC insurance premiums, or the collection of special assessments by the FDIC.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation s financial results, is included in the Corporation s filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation s Annual Report and Form 10-K for the year-ended December 31, 2011. Throughout this discussion, the term Bank refers to mBank, the principal banking subsidiary of the Corporation.

Table of Contents

FINANCIAL OVERVIEW

The Corporation recorded third quarter 2012 net income available to common shareholders of $.897 million or $.19 per share compared to net income of $.707 million, or $.21 per share for the third quarter of 2011. Income for the nine months ended September 30, 2012 totaled $5.536 million, or $1.44 per share, compared to $1.566 million and $.46 per share in the 2010 nine month period. Operating results for the nine month period in 2012 included a valuation adjustment to the deferred tax asset of $3.000 million.

Weighted average shares outstanding totaled 4,722,029 for the third quarter and 3,857,002 for the nine months ended September 30, 2012. Weighted average shares were constant in 2011 at 3,419,736. The common stock warrants outstanding, of 379,310 shares, were dilutive, at approximately $.01 per share, for the 2012 third quarter and $.05 per share for the nine month period, as the market value of our stock remained above the $4.35 strike price. Dilution of the warrant shares in 2011 was approximately $.01 per share for both reported periods.

The net interest margin for the third quarter of 2012 increased to $4.930 million, or 4.10%, compared to $4.709 million, of 4.14% in the third quarter of 2011. The nine month margin in 2012 was $14.712 million, or 4.19% compared to $13.028 million, or 3.95%.

Total assets of the Corporation at September 30, 2012 were $551.117 million, up by $52.519 million, or 10.53% from the $498.598 million in total assets reported at September 30, 2011 and up by $52.806 million, or 10.60%, from total assets of $498.311 million at year-end 2011. The loan portfolio increased $32.712 million, or 8.15%, from December 31, 2011 balances of $401.246 million. Deposits totaled $439.363 million at September 30, 2012, an increase of $34.574 million from the $404.789 million at December 31, 2011.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $13.335 million during the first nine months of 2012. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $3.749 million from December 31, 2011 to September 30, 2012, with the balance on September 30, 2012, totaling $42.476 million. The Corporation purchased $11.031 million of investments during the 2012 first nine months mainly to replace maturities and paydowns of investments. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2012, investment securities with an estimated fair value of $7.786 million were pledged.

Loans

Through the first nine months of 2012, loan balances increased by $32.712 million, or 8.15%, from December 31, 2011 balances of $401.246 million. During the first nine months of 2012, the Bank had total loan production of $145 million, which included $46 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization, and also SBA/USDA loan sales of $11.540 million, and nonperforming loans transferred to other real estate owned (OREO) amounting to $1.013 million.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Table of Contents

Following is a summary of the loan portfolio at September 30, 2012, December 31, 2011 and September 30, 2011 (dollars in thousands):

	September 30, 2012	Percent of Total	December 31, 2011	Percent of Total	September 30, 2011	Percent of Total
Commercial real estate	**$ 224,061**	**51.63%**	$ 199,201	49.64%	$ 195,079	49.78%
Commercial, financial, and agricultural	**84,073**	**19.37**	92,269	23.00	84,285	21.51
One to four family residential real estate	**86,643**	**19.97**	77,332	19.27	78,759	20.10
Construction:						
Consumer	**6,803**	**1.57**	5,774	1.44	6,268	1.60
Commercial	**21,757**	**5.01**	19,745	4.92	19,771	5.04
Consumer	**10,621**	**2.45**	6,925	1.73	7,741	1.97
Total loans	**$ 433,958**	**100.00%**	$ 401,246	100.00%	$ 391,903	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2012, December 31, 2011 and September 30, 2011 (dollars in thousands):

	September 30, 2012			December 31, 2011			September 30, 2011		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonres bldgs	**$ 88,505**	**26.82%**	**121.33%**	$ 75,391	24.22%	135.53%	$ 62,567	20.92%	112.78%
Hospitality and tourism	**36,950**	**11.20**	**50.65**	33,306	10.70	59.87	33,867	11.32	61.04
Commercial construction	**21,757**	**6.60**	**29.83**	19,745	6.34	35.50	19,771	6.61	35.64
Real estate agents and managers	**12,336**	**3.74**	**16.91**	10,617	3.41	19.09	12,781	4.27	23.04
Lessors of nonresidential buildings	**12,326**	**3.74**	**16.90**	16,499	5.30	29.66	16,433	5.49	29.62
Other	**158,017**	**47.90**	**326.30**	155,657	50.02	279.83	153,716	51.39	277.07
Total Commercial Loans	**$ 329,891**	**100.00%**		$ 311,215	100.00%		$ 299,135	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation s highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of September 30, 2012. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of September 30, 2012, our residential loan portfolio totaled $86.643 million, or 19.97% of our total outstanding loans. Management has been conservative in its consumer lending policies and has not engaged in lending activities such as subprime loans or making loans in excess of appraised value. The majority of its residential real estate portfolio is composed of credit extended based upon appraised values not to exceed 80% to 90%.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from $1.991 million at the end of December 31, 2011 to $1.689 million at September 30, 2012. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

Due to the seasonal nature of many of the Corporation s commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer s business cycle. The lending staff evaluates the collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Table of Contents

Credit Quality

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the nine months ended September 30, 2012 amounted to $.860 million, or .28% annualized, of average loans outstanding, compared to $1.775 million, or .62% annualized, of average loans outstanding, for the same period in 2011. The current reserve balance is representative of the relevant risk inherent within the Corporation s loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

The table below shows period end balances of nonperforming assets (dollars in thousands):

	September 30, 2012	December 31, 2011	September 30, 2011
Nonperforming Assets:			
Nonaccrual Loans	**$ 3,122**	$ 5,490	$ 5,954
Loans past due 90 days or more			
Restructured loans	**2,168**	2,503	3,719
Total nonperforming loans	**5,290**	7,993	9,673
Other real estate owned	**3,511**	3,162	5,212
Total nonperforming assets	**$ 8,801**	$ 11,155	$ 14,885
Nonperforming loans as a % of loans	**1.22**%	1.99%	2.47%
Nonperforming assets as a % of assets	**1.60**%	2.24%	2.99%
Reserve for Loan Losses:			
At period end	**$ 5,186**	$ 5,251	$ 5,838
As a % of loans	**1.20**%	1.35%	1.49%
As a % of nonperforming loans	**98.03**%	65.69%	60.35%
As a % of nonaccrual loans	**166.11**%	95.65%	98.05%
Texas ratio*	**11.26**%	18.43%	24.28%

calculated by taking total nonperforming assets divided by total equity plus reserve for loan losses

Nonperforming assets at $8.801 million have been reduced in 2012 by $2.354 million from the $11.155 million at 2011 year end. This reduction in nonperforming assets reflects management s efforts in the aggressive remediation of problem credits and disposition of OREO properties.

The following ratios provide additional information relative to the Corporation s credit quality:

		At Period End	
	September 30, 2012	December 31, 2011	September30, 2011
Total loans, at period end	**$ 433,958**	$ 401,246	$ 391,903

Average loans for the year	**$ 417,159**	$ 388,115	$ 385,391

	Nine Months Ended September 30, 2012	For the Period Ended Twelve Months Ended December 31, 2011	Nine Months Ended September 30, 2011
Net charge-offs during the period	**$ 860**	$ 3,662	$ 1,775
Net charge-offs to average loans, annualized	**.28%**	.94%	.62%
Net charge-offs to beginning allowance balance	**16.38%**	55.38%	26.84%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation s senior lending staff and the bank regulatory examinations, management reviews the Corporation s loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation s loan rating system. In 2012, the Corporation has engaged a consultant for loan review in 2012, which is currently in process.

Table of Contents

As of September 30, 2012, the allowance for loan losses represented 1.20% of total loans. At September 30, 2012, the allowance included specific reserves in the amount of $1.631 million, as compared to $1.200 million at December 31, 2011 and $1.992 million at September 30, 2011. In management s opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate for the periods indicated (dollars in thousands):

	Nine Months Ended September 30 2012	Year Ended December 31, 2011	Nine Months Ended September 30, 2011
Balance at beginning of period	**$ 3,162**	$ 5,562	$ 5,562
Other real estate transferred from loans due to foreclosure	**1,013**	4,194	4,129
Other real estate sold	**(178)**	(5,457)	(3,751)
Writedowns on other real estate held for sale	**(474)**	(855)	(550)
Loss on sale of other real estate held for sale	**(12)**	(282)	(178)
Balance at end of period	**$ 3,511**	$ 3,162	$ 5,212

During the first nine months of 2012, the Corporation received real estate in lieu of loan payments of $1.013 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits in the first nine months of 2012. Total deposits increased by $34.574 million, or 8.54%, in the first nine months of 2012. The increase in deposits for the first nine months of 2012 is composed of an increase in noncore deposits of $10.798 million and an increase in core deposits of $23.776 million. In 2012, the rate of growth on core deposits slowed from that experienced in recent years. The Corporation, as part of an overall strategy to increase interest margins, reduced rates on some of its deposits to be more in line with competitors. This has resulted in slower core deposit growth and some migration of deposit dollars to short-term certificates of deposit. Management will continue to monitor deposit flows and adjust rates when it is deemed necessary to maintain or increase core deposits.

Management continues to monitor existing deposit products in order to stay competitive as to both terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional deposits.

The following table represents detail of deposits at the end of the periods indicated (dollars in thousands):

	September 30, 2012	% of Total	December 31, 2011	% of Total	September 30, 2011	% of Total
Noninterest bearing	**$ 62,306**	**14.18%**	$ 51,273	12.67%	$ 53,736	13.27%
NOW, money market, checking	**152,286**	**34.66**	152,563	37.69	157,596	38.92
Savings	**15,783**	**3.59**	14,203	3.51	15,618	3.86
Certificates of Deposit <$100,000	**142,125**	**32.35**	130,685	32.28	119,893	29.60
Total core deposits	**372,500**	**84.78**	348,724	86.15	346,843	85.63
Certificates of Deposit >$100,000	**25,390**	**5.78**	23,229	5.74	24,138	5.96
Brokered CDs	**41,473**	**9.44**	32,836	8.11	34,077	8.41
Total non-core deposits	**66,863**	**15.22**	56,065	13.85	58,215	14.37
Total deposits	**$ 439,363**	**100.00%**	$ 404,789	100.00%	$ 405,058	100.00%

Table of Contents

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At September 30, 2012, this source of funding totaled $35 million and the Corporation secured this funding by pledging loans and investments. The $35 million of FHLB borrowings has a weighted average maturity of 2.28 years and a weighted average rate of 1.82% at September 30, 2012. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has a fixed interest rate of 1% and matures in August 2024.

Shareholders   Equity

Total shareholders   equity increased $17.682 million from December 31, 2011 to September 30, 2012. The major reason for the increase in shareholders   equity was the common stock rights offering and a private placement, in which the Corporation issued 2,140,178 shares of its common stock and received net proceeds of $11.506 million. Also contributing to the increase was net income of $5.536 million, an increase in the market value of securities of $.545 million, the accretion of the discount on preferred stock of $.079 million, and stock option compensation of $.016 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of $5.536 million, or $1.44 per share, in the first nine months of 2012, compared to $1.566 million or $.46 per share for the first nine months of 2011. Fully diluted earnings per share amounted to $1.39 per share for the 2012 nine-month period and $.45per share in 2011. The warrants outstanding were more dilutive in 2012 due to the increased market value of our common stock. The first nine month results include a valuation adjustment to the deferred tax asset of $3 million, a provision for loan losses of $.795 million and OREO writedowns and losses of $.450 million. Operating results for the same period in 2011 include a $1.000 million provision for loan losses, and $.728 million of OREO writedowns and losses.

Net Interest Income

Net interest income is the Corporation   s primary source of core earnings. Net interest income represents the difference between the average yield earned on interest earning assets and the average rate paid on interest bearing obligations. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest margin on a fully taxable equivalent basis amounted to $4.934 million, 4.10% of average earning assets, in the third quarter of 2012, compared to $4.732 million, and 4.18% of average earning assets, in the third quarter of 2011. In the first nine months of 2012, net interest margin increased to $14.722 million, 4.19% of average earning assets, compared to $13.103 million, 3.78 % of average earning assets, for the same period in 2011. Margin improvement in 2012 was primarily due to a reduction in funding costs between periods.

Table of Contents

The following table presents the amount of interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

Three Months Ended

(dollars in thousands)	Average Balances September 30, 2012	Average Balances September 30, 2011	Increase/ (Decrease)	Average Rates September 30, 2012	Average Rates September 30, 2011	Interest September 30, 2012	Interest September 30, 2011	2012-2011 Income/ Expense Variance	2012-2011 Volume Variance	2012-2011 Rate Variance	2012-2011 Rate/ Volume Variance
Loans (1),(2),(3)	**$ 424,461**	$ 397,665	$ 26,796	**5.47%**	5.62%	**$ 5,831**	$ 5,637	$ 194	$ 379	$ (159)	$ (26)
Taxable securities	**37,900**	38,102	(202)	**2.36**	3.17	**225**	304	(79)	(2)	(77)	
Nontaxable securities (2)	**847**	858	(11)	**5.17**	5.09	**11**	11				
Federal funds sold	**12,131**	12,054	77	**.13**	.16	**4**	5	(1)		(1)	
Other interest-earning assets	**3,070**	3,070		**4.92**	2.71	**38**	21	17		17	
Total earning assets	**478,409**	451,749	26,660	**5.08**	5.25	**6,109**	5,978	131	377	(220)	(26)
Reserve for loan losses	**(5,212)**	(6,070)	858								
Cash and due from banks	**43,388**	24,525	18,863								
Fixed Assets	**10,523**	9,588	935								
Other Real Estate	**3,484**	3,945	(461)								
Other assets	**15,196**	13,596	1,600								
Total assets	**$ 545,788**	$ 497,333	$ 48,455								
NOW and money market deposits	**$ 118,627**	$ 127,630	$ (9,003)	**.34%**	.55%	**$ 101**	$ 177	$ (76)	$ (12)	$ (68)	$ 4
Interest checking	**31,938**	28,820	3,118	**.45**	.81	**36**	59	(23)	6	(26)	(3)
Savings deposits	**14,665**	15,734	(1,069)	**.11**	.20	**4**	8	(4)	(1)	(4)	1
CDs <$100,000	**139,779**	117,182	22,597	**1.75**	1.81	**614**	536	78	102	(20)	(4)
CDs >$100,000	**27,860**	23,773	4,087	**1.71**	1.60	**120**	96	24	16	7	1
Brokered deposits	**41,473**	37,890	3,583	**1.31**	2.24	**137**	214	(77)	20	(89)	(8)
Borrowings	**35,973**	36,045	(72)	**1.80**	1.72	**163**	156	7		8	(1)
Total interest-bearing liabilities	**410,315**	387,074	23,241	**1.14**	1.28	**1,175**	1,246	(71)	131	(192)	(10)
Demand deposits	**64,985**	52,928	12,057								
Other liabilities	**3,161**	2,333	828								
Shareholders equity	**67,327**	54,998	12,329								
Total liabilities and shareholders equity	**$ 545,788**	$ 497,333	$ 48,455								
Rate spread				**3.94%**	3.97%						
Net interest margin/revenue				**4.10%**	4.18%	**$ 4,934**	$ 4,732	$ 202	$ 246	$ (28)	$ (16)

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax euivalent basis, using a 34% tax rate.

(3) Interest income on loans includes fees.

Nine Months Ended

	Average Balances			Average Rates		Interest		2012-2011			
	September 30,		Increase/	September 30,		September 30,		Income/ Expense	Volume	Rate	Rate/ Volume
(dollars in thousands)	2012	2011	(Decrease)	2012	2011	2012	2011	Variance	Variance	Variance	Variance
Loans (1),(2),(3)	**$ 417,159**	$ 385,391	$ 31,768	**5.55%**	5.58%	**$ 17,346**	$ 16,097	$ 1,249	$ 1,328	$ (87)	$ 8
Taxable securities	**37,398**	35,897	1,501	**2.59**	3.27	**726**	878	(152)	37	(182)	(7)
Nontaxable securities (2)	**851**	852	(1)	**5.18**	5.02	**33**	32	1		1	
Federal funds sold	**10,745**	15,319	(4,574)	**.15**	.17	**12**	19	(7)	(6)	(2)	1
Other interest-earning assets	**3,070**	3,651	(581)	**3.65**	2.56	**84**	70	14	(11)	30	(5)
Total earning assets	**469,223**	441,110	28,113	**5.18**	5.18	**18,201**	17,096	1,105	1,348	(240)	(3)
Reserve for loan losses	**(5,213)**	(6,295)	1,082								
Cash and due from banks	**28,834**	27,119	1,715								
Fixed Assets	**10,095**	9,655	440								
Other Real Estate	**3,388**	4,525	(1,137)								
Other assets	**14,060**	14,179	(119)								
Total assets	**$ 520,387**	$ 490,293	$ 30,094								
NOW and money market deposits	**$ 118,841**	$ 123,856	$ (5,015)	**.36%**	.68%	**$ 319**	$ 627	$ (308)	$ (25)	$ (295)	$ 12
Interest checking	**31,086**	26,233	4,853	**.49**	.99	**114**	195	(81)	36	(99)	(18)
Savings deposits	**13,631**	16,859	(3,228)	**.12**	.24	**12**	30	(18)	(6)	(15)	3
CDs <$100,000	**137,810**	108,105	29,705	**1.77**	1.85	**1,831**	1,497	334	412	(62)	(16)
CDs >$100,000	**25,596**	22,827	2,769	**1.72**	1.68	**330**	287	43	35	7	1
Brokered deposits	**36,037**	54,606	(18,569)	**1.41**	2.22	**381**	905	(524)	(308)	(329)	113
Borrowings	**35,989**	36,061	(72)	**1.83**	1.68	**492**	452	40	(1)	41	
Total interest-bearing liabilities	**398,990**	388,547	10,443	**1.16**	1.37	**3,479**	3,993	(514)	143	(752)	95
Demand deposits	**58,808**	44,994	13,814								
Other liabilities	**3,007**	2,412	595								
Shareholders equity	**59,582**	54,340	5,242								
Total liabilities and shareholders equity	**$ 520,387**	$ 490,293	$ 30,094								
Rate spread				**4.02%**	3.81%						
Net interest margin/revenue				**4.19%**	3.78%	**$ 14,722**	$ 13,103	$ 1,619	$ 1,205	$ 512	$ (98)

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax euivalent basis, using a 34% tax rate.

(3) Interest income on loans includes fees.

We are now into the third year of a low interest rate environment. The Corporation, during this period, repriced all of its brokered deposits along with the majority of its bank time deposits. This repricing of liabilities is the primary reason for the increased interest margin, on a fully taxable equivalent basis, from 3.78% in the first nine months of 2011 to 4.19% in the first nine months of 2012.

During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread.

Table of Contents

Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first nine months of 2012, the Corporation determined through this analysis that a $.795 million provision for loan loss was required, compared to $1.000 million in the same period of 2011. For the three months ended September 30, 2012, the Corporation recorded a provision for loan loss of $.150 million compared to $.400 million for the same period in 2011. Impacting the loan loss provision for the nine month period in 2012 were net charge-offs of $.860 million.

Other Income

Other income increased by $.143 million for the three months ended September 30, 2012. Included in the 2012 three month period was income from secondary market loans of $.320 million and income from SBA/USDA loan sales of $.506 million, compared to $.195 million and $.283 million for the same period in 2011. In 2011, the Corporation recorded the initial recognition of mortgage servicing rights in the amount of $.300 million, and in 2012, recorded ongoing income from this source of $.092 million.

Other income increased by $.129 million for the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011. In the first nine months of 2012, revenue due to 1-4 family loans produced and sold in the secondary market, amounted to $.844 million compared to $.394 million a year ago. We expect to continue to benefit from secondary market activity in future periods. SBA/USDA loan sale gains amounted to $1.126 million in the first nine months of 2012, compared to $1.469 million for the same period in 2011. Service fees and other noninterest income decreased slightly between periods largely because of lower NSF fees, which we believe will continue due to customers being more diligent in managing their accounts.

Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

The following table details other income for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
			Increase/(Decrease)				Increase/(Decrease)	
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent
Deposit service fees	**$ 155**	$ 180	$ (25)	(13.89)%	**$ 538**	$ 616	$ (78)	(12.66)%
Income from secondary market loans sold	**320**	195	125	64.10	**844**	394	450	114.21
SBA/USDA loan sale gains	**506**	283	223	78.80	**1,126**	1,469	(343)	(23.35)
Mortgage servicing income	**92**	300	(208)	100.00	**292**	300	(8)	100.00
Other noninterest income	**76**	48	28	58.33	**260**	152	108	71.05

Total other income	**$**	**1,149**	$	1,006	$	143	14.21%	**$**	**3,060**	$	2,931	$	129	4.40%

Other Expense

For the three month period ended September 30, 2012, the Corporation recorded other expense of $4.367 million, compared to $.3960 million for the same period in 2011, an increase of $.407 million. Included in other expense for the quarter is an increase salaries and employee benefits of $.252 million compared to 2011.

Other expenses increased $.659 million for the nine months ended September 30, 2012, compared to the same period in 2011. The most significant increases in other expense were in salaries and benefits and professional services. During the first nine months of 2012, the Corporation recorded write-downs and net losses on OREO properties of $.450, compared to $.728 million for the same period in 2011. In 2012, the Corporation has experienced a significant decline in FDIC insurance premiums at $.354 million, compared to $.728 million for 2011.

Table of Contents

Management continually reviews all areas of other expense for cost reduction opportunities that will not impact service quality and employee morale.

The following table details other expense for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
			Increase/(Decrease)				Increase/(Decrease)	
	2012	**2011**	**Dollars**	**Percentage**	**2012**	**2011**	**Dollars**	**Percentage**
Salaries and employee benefits	**$ 2,063**	$ 1,811	$ 252	13.91%	**$ 6,041**	$ 5,441	$ 600	11.03%
Occupancy	**370**	334	36	10.78	**1,050**	1,048	2	0.19
Furniture and equipment	**213**	197	16	8.12	**660**	612	48	7.84
Data processing	**253**	177	76	42.94	**739**	532	207	38.91
Professional service fees	**210**	165	45	27.27	**700**	550	150	27.27
Loan and deposit	**195**	288	(93)	(32.29)	**674**	719	(45)	(6.26)
Writedowns and losses on other real estate held for sale	**265**	296	(31)	(10.47)	**450**	728	(278)	(38.19)
FDIC insurance premiums	**36**	215	(179)	(83.26)	**354**	755	(401)	(53.11)
Telephone	**56**	51	5	9.80	**168**	160	8	5.00
Advertising	**96**	93	3	3.23	**292**	292		
Other	**610**	333	277	83.18	**1,280**	912	368	40.35
Total other expense	**$ 4,367**	$ 3,960	$ 407	10.28%	**$ 12,408**	$ 11,749	$ 659	5.61%

Federal 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. The Corporation, as of September 30, 2012 had a net operating loss and tax credit carryforwards for tax purposes of approximately $23.8 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $15.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation recognized a deferred tax benefit of approximately $1.458 million for the September 30, 2012 nine month period and a deferred tax liability of $1.071 million for the nine months ended September 30, 2011. The valuation allowance at September 30, 2012 was approximately $3.3 million. Management evaluated the deferred tax valuation allowance as of September 30, 2012 and determined that no adjustment to the valuation was warranted. The Corporation reduced the valuation allowance by $3.0 million in June 2012 since it was determined that it was more likely than not that these benefits would be realized. The Corporation made this determination after a thorough review of projected earnings and the composition and sustainability of those earnings over the projected tax carryover period. This analysis substantiated the ability to utilize these deferred tax assets. The Corporation 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 will recognize the additional benefits as an adjustment to the valuation allowance.

LIQUIDITY

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank s principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of $31.403 million in cash and due from balances $16.002 of federal funds sold and, $34.690 million of unpledged investment securities. The Corporation experienced deposit inflows during the nine months of 2012 that exceeded loan funding needs. Management anticipates reducing liquidity levels in future periods through payments of maturing brokered deposits and funding loan growth.

Table of Contents

During the first nine months of 2012, the Corporation increased cash and cash equivalents by $13.335 million. As shown on the Corporation s condensed consolidated statement of cash flows, liquidity was impacted by cash used by investing activities, with a net increase in loans of $34.652 million. Offsetting the net decrease used by investing activities was cash provided by financing activities, primarily a net increase in deposits of $34.574 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30 to 90 day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

It is anticipated that during the remainder of 2012, the Corporation will fund anticipated loan production by reducing current balances of liquidity.

The Corporation s primary source of liquidity on a stand-alone basis is dividends from the Bank. The Bank is currently prohibited from paying dividends because of a deficit in retained earnings. The Bank, in order to pay dividends in future periods, will need to completely eliminate the negative balance of retained earnings through future profits.

Liquidity is managed by the Corporation through its Asset and Liability Committee (ALCO). The ALCO Committee meets monthly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank s liquidity is best illustrated by the mix in the Bank s core and noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $100,000. Noncore funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At September 30, 2012, the Bank s core deposits in relation to total funding were 78.37% compared to 78.64% at September 30, 2011. These ratios indicated at June 30, 2012, that the Bank has decreased its reliance on noncore deposits and borrowings to fund the Bank s long-term assets, namely loans and investments. The bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of September 30, 2012, the Bank had $28.375 million of unsecured lines available and additional funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank s liquidity.

From a long-term perspective, the Corporation s operating plan for 2012 includes strategies to increase core deposits in the Corporation s local markets. New deposit products and strategic advertising is expected to aid in efforts of management in growing core deposits which will then reduce the dependency on noncore deposits. The Corporation s operating plan for 2012 calls for augmenting local deposit growth efforts with wholesale CD funding, to the extent necessary.

CAPITAL AND REGULATORY

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of September 30, 2012, the Corporation and Bank were well capitalized. During the first nine months of 2012, total capitalization increased by $17.682 million.

Table of Contents

The following table details sources of capital for the periods indicated (dollars in thousands):

	September 30, 2012	December 31, 2011	September 30, 2011
Capital Structure			
Shareholders equity	**$ 61,945**	$ 44,342	$ 44,613
Preferred stock	**11,000**	10,921	10,866
Total shareholders equity	**$ 72,945**	$ 55,263	$ 55,479
Total capitalization	**$ 72,945**	$ 55,263	$ 55,479
Tangible capital	**$ 72,945**	$ 55,263	$ 55,479
Intangible Assets			
Core deposit premium	**$**	$	$
Other identifiable intangibles	**571**	400	
Total intangibles	**$ 571**	$ 400	$
Regulatory capital			
Tier 1 capital:			
Shareholders equity	**$ 72,945**	$ 55,263	$ 55,477
Net unrealized (gains) losses on available for sale securities	**(870)**	(325)	(481)
Less: disallowed deferred tax asset	**(8,000)**	(6,500)	(7,400)
Less: intangibles	**(57)**	(40)	
Total Tier 1 capital	**$ 64,018**	$ 48,398	$ 47,596
Tier 2 Capital:			
Allowable reserve for loan losses	**$ 5,186**	$ 5,206	$ 5,114
Qualifying long-term debt			
Total Tier 2 capital	**5,186**	5,206	5,114
Total capital	**$ 69,204**	$ 53,604	$ 52,710
Risk-adjusted assets	**$ 456,754**	$ 416,423	$ 408,400
Capital ratios:			
Tier 1 Capital to average assets	**11.93**%	10.08%	9.73%
Tier 1 Capital to risk weighted assets	**14.02**%	11.62%	11.65%
Total Capital to risk weighted assets	**15.15**%	12.87%	12.97%

Regulatory capital is not the same as shareholders equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes, such as acquisition intangibles and noncurrent deferred tax benefits.

Presented below is a summary of the capital position in comparison to generally applicable regulatory requirements:

	Shareholders Equity to Quarter-end Assets	Tangible Equity to Quarter-end Assets	Tier 1 Capital to Average Assets	Tier 1 Capital to Risk-Weighted Assets	Total Capital to Risk-Weighted Assets
	N/A	N/A	4.00%	4.00%	8.00%

Regulatory minumum for capital adequacy purposes					
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
The Corporation:					
September 30, 2012	**13.24%**	**13.23%**	**11.93%**	**14.02%**	**15.15%**
September 30, 2011	11.17%	11.17%	9.73%	11.65%	12.97%
The Bank:					
September 30, 2012	**10.61%**	**10.60%**	**9.26%**	**10.89%**	**12.02%**
September 30, 2011	10.46%	10.46%	8.79%	10.56%	11.81%

Table of Contents

MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation s earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation s safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices such as the prime rate or rates paid on various government issued securities. In addition, the Corporation prices the majority of fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

The Corporation has established interest rate floors on approximately $184 million, or 84% of its variable rate commercial loans. These interest rate floors will result in a lag on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $100 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with another $84 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $42.476 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has $230.375 million of transactional accounts, of which $62.306 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation s focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

Other deposit products have a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income. Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

Table of Contents

The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following time frames. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1- to 90-day time frame. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following is the Corporation s opportunities at September 30, 2012 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	**$ 295,464**	**$ 10,642**	**$ 43,181**	**$ 84,671**	**$ 433,958**
Securities	**2,507**	**5,047**	**25,076**	**9,846**	**42,476**
Other (1)				**3,060**	**3,060**
Total interest-earning assets	**297,971**	**15,689**	**68,257**	**97,577**	**479,494**
Interest-bearing obligations:					
NOW, money market, savings, interest checking	**168,069**				**168,069**
Time deposits	**25,463**	**50,297**	**91,532**	**223**	**167,515**
Brokered CDs	**3,629**		**37,844**		**41,473**
Borrowings			**35,000**	**925**	**35,925**
Total interest-bearing obligations	**197,161**	**50,297**	**164,376**	**1,148**	**412,982**
Gap	**$ 100,810**	**$ (34,608)**	**$ (96,119)**	**$ 96,429**	**$ 66,512**
Cumulative gap	**$ 100,810**	**$ 66,202**	**$ (29,917)**	**$ 66,512**	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at September 30, 2012, the Corporation had a cumulative asset sensitivity gap position of $34.608 million within the one-year time frame. The Corporation s cumulative asset sensitive gap suggests that if market interest rates continue to decline in the next twelve months, the Corporation may experience a decrease in net interest income. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2011, the Corporation had a cumulative liability sensitivity gap position of $69.219 million within the one-year time frame.

The borrowings in the gap analysis include $35.000 million of FHLB advances that were refinanced in late 2011. These borrowings now have a weighted average maturity of 2.28 years and a weighted average rate of 1.82%.

The Corporation s primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets and therefore has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

Table of Contents

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation s interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking offices in Sault Ste. Marie, Michigan. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation.

OFF-BALANCE-SHEET RISK

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps, or options. However, the Corporation is party to 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 and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the condensed consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised.

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation s operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation s performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation s ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation s performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

Table of Contents

MACKINAC FINANCIAL CORPORATION

ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2012, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of September 30, 2012.

Changes in Internal Control Over Financial Reporting

There were no changes in the Corporation s internal control over financial reporting that occurred during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Corporation s internal control over financial reporting.

Table of Contents

MACKINAC FINANCIAL CORPORATION

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
Exhibit 31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
Exhibit 32.1	Section 1350 Certification of Chief Executive Officer.
Exhibit 32.2	Section 1350 Certification of Chief Financial Officer.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

Table of Contents

SIGNATURES

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.

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date: November 14, 2012		By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
		By:	/s/ Ernie R. Krueger ERNIE R. KRUEGER EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)