MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2008

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	38-2062816
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
130 SOUTH CEDAR STREET, MANISTIQUE, MI	49854
(Address of principal executive offices)	(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 þ 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 the 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 þ
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes o No þ

As of October 31, 2008, there were outstanding 3,419,736 shares of the registrant s common stock, no par value.

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MACKINAC FINANCIAL CORPORATION
PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands)

(Dollars in thousands)	September 30, 2008 (unaudited)	December 31, 2007	September 30, 2007 (unaudited)
ASSETS			
Cash and due from banks	**$ 8,217**	$ 6,196	$ 7,364
Federal funds sold	**4,422**	166	947
Cash and cash equivalents	**12,639**	6,362	8,311
Interest-bearing deposits in other financial institutions	**382**	1,810	6,995
Securities available for sale	**42,781**	21,597	17,973
Federal Home Loan Bank stock	**3,794**	3,794	3,794
Loans:			
Commercial	**290,406**	288,839	279,670
Mortgage	**67,576**	62,703	60,972
Installment	**3,539**	3,537	3,507
Total Loans	**361,521**	355,079	344,149
Allowance for loan losses	**(3,385)**	(4,146)	(5,022)
Net loans	**358,136**	350,933	339,127
Premises and equipment	**11,360**	11,609	12,733
Other real estate held for sale	**1,751**	1,226	451
Other assets	**10,110**	11,549	11,829
TOTAL ASSETS	**$ 440,953**	$ 408,880	$ 401,213
LIABILITIES AND SHAREHOLDERS EQUITY			
Liabilities:			
Non-interest-bearing deposits	**$ 34,858**	$ 25,557	$ 28,325
Interest-bearing deposits:			
NOW, Money Market, Checking	**80,185**	81,160	87,262
Savings	**18,957**	12,485	12,831
CDs<$100,000	**74,940**	80,607	90,220
CDs>$100,000	**30,220**	22,355	24,432
Brokered	**121,534**	98,663	78,301
Total deposits	**360,694**	320,827	321,371

Borrowings:						
Federal funds purchased				7,710		
Short-term				1,959		
Long-term		**36,210**		36,280		38,239
Total borrowings		**36,210**		45,949		38,239
Other liabilities		**2,622**		2,783		2,906
Total liabilities		**399,526**		369,559		362,516
Shareholders equity:						
Preferred stock No par value:						
Authorized 500,000 shares, no shares outstanding						
Common stock and additional paid in capital No par value						
Authorized - 18,000,000 shares						
Issued and outstanding **3,419,736**; 3,428,695; and 3,428,695 shares, respectively		**42,794**		42,843		42,810
Accumulated deficit		**(1,456)**		(3,582)		(4,107)
Accumulated other comprehensive income (loss)		**89**		60		(6)
Total shareholders equity		**41,427**		39,321		38,697
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$**	**440,953**	$	408,880	$	401,213

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in Thousands, Except per Share Data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	**2008**	2007
	(unaudited)		(unaudited)	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	**$ 5,537**	$ 6,929	**$ 17,241**	$ 19,610
Tax-exempt	**100**	118	**310**	432
Interest on securities:				
Taxable	**303**	263	**840**	857
Tax-exempt	**1**		**4**	
Other interest income	**87**	209	**257**	575
Total interest income	**6,028**	7,519	**18,652**	21,474
INTEREST EXPENSE:				
Deposits	**2,308**	3,443	**7,924**	9,932
Borrowings	**349**	516	**1,194**	1,535
Total interest expense	**2,657**	3,959	**9,118**	11,467
Net interest income	**3,371**	3,560	**9,534**	10,007
Provision for loan losses	**450**	400	**1,200**	400
Net interest income after provision for loan losses	**2,921**	3,160	**8,334**	9,607
OTHER INCOME:				
Service fees	**229**	169	**597**	515
Net security gains	**(1)**		**64**	
Net gains on sale of secondary market loans	**16**	165	**113**	364
Proceeds from settlement of lawsuit			**3,475**	470
Other	**44**	62	**96**	302
Total other income	**288**	396	**4,345**	1,651
OTHER EXPENSE:				
Salaries and employee benefits	**1,534**	1,695	**5,416**	5,106
Occupancy	**336**	322	**1,039**	983
Furniture and equipment	**202**	178	**570**	501

Data processing	**212**	196	**649**	577
Professional service fees	**120**	78	**352**	403
Loan and deposit	**176**	63	**430**	214
Telephone	**41**	68	**125**	185
Advertising	**93**	97	**213**	280
Other	**221**	304	**803**	873
Total other expenses	**2,935**	3,001	**9,597**	9,122
Income before income taxes	**274**	555	**3,082**	2,136
Provision for (benefit of) income taxes	**58**	(7,500)	**958**	(7,500)
NET INCOME	**$ 216**	$ 8,055	**$ 2,124**	$ 9,636
INCOME PER COMMON SHARE:				
Basic	**$ .06**	$ 2.35	**$ .62**	$ 2.81
Diluted	**$ .06**	$ 2.35	**$ .62**	$ 2.81

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY
(Dollars in Thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	**2008**	2007
Balance, beginning of period	**$ 40,975**	$ 30,485	**$ 39,321**	$ 28,790
Net income for period	**216**	8,055	**2,124**	9,636
Stock option compensation	**21**	30	**63**	90
Net unrealized gain on securities available for sale	**215**	127	**29**	181
Total comprehensive income	**452**	8,212	**2,216**	9,907
Repurchase of common stock - 8,959 oddlot shares			**(110)**	
Balance, end of period	**$ 41,427**	$ 38,697	**$ 41,427**	$ 38,697

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2008	2007
Cash Flows From Operating Activities:		
Net income	**$ 2,124**	$ 9,636
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	**917**	547
Provision for loan losses	**1,200**	400
Provision for deferred income taxes		(7,500)
(Gain) on sales/calls of securities available for sale	**(64)**	
(Gain) on sales of premises, equipment, and other real estate	**(35)**	(12)
Writedown of other real estate	**936**	40
Stock option compensation	**63**	90
Change in other assets	**396**	221
Change in other liabilities	**797**	(368)
Net cash provided by operating activities	**6,334**	3,054
Cash Flows From Investing Activities:		
Net (increase) in loans	**(11,144)**	(22,435)
Net (increase) decrease in interest-bearing deposits in other financial institutions	**1,428**	(6,139)
Purchase of securities available for sale	**(45,699)**	(18,558)
Proceeds from maturities, calls or paydowns of securities available for sale	**24,542**	33,715
Capital expenditures	**(519)**	(1,231)
Proceeds from sale of premises, equipment, and other real estate	**1,317**	317
Net cash (used in) investing activities	**(30,075)**	(14,331)
Cash Flows From Financing Activities:		
Net increase in deposits	**39,867**	8,950
Net increase (decrease) in federal funds purchased	**(7,710)**	
Net increase (decrease) in lines of credit	**(1,959)**	
Principal payments on borrowings	**(70)**	(68)
Net (decrease) in repurchase of common stock oddlot shares	**(110)**	
Net cash provided by financing activities	**30,018**	8,882
Net increase (decrease) in cash and cash equivalents	**6,277**	(2,395)
Cash and cash equivalents at beginning of period	**6,362**	10,706

Cash and cash equivalents at end of period	**$ 12,639**	$ 8,311
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	**$ 7,872**	$ 9,735
Income taxes	**44**	
Noncash Investing and Financing Activities:		
Transfers of foreclosures from loans to other real estate held for sale (net of adjustments made through the allowance for loan losses)	**1,804**	443

See accompanying notes to condensed consolidated financial statements.

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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, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. 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, 2007.

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 were not changed due to these classifications.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to commercial loans, which 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.

Stock Option Plans

The Corporation sponsors three stock option plans. One plan was approved in 2000 and applies 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 reverse stock split), were

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

made available for grant under these plans. These two 1997 plans expired early in 2007. Options under all of the plans are granted at the discretion of a committee of the Corporation s Board of Directors. Options to purchase shares of the Corporation s stock are granted at a price equal to the market price of the stock at the date of grant. The committee determines the vesting of the options when they are granted as established under the plan.

The Corporation adopted SFAS No. 123 (Revised) Share Based Payments in the first quarter of 2006. This statement supersedes APB Opinion No. 25 Accounting for Stock Issued to Employees and its related implementation guidance. Under Opinion No. 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This adoption resulted in the recognition of before tax compensation expense in the amount of $63,000 for the nine months ended September 30, 2008, and $90,000 for the same period in 2007. The expense recorded recognizes the current period vesting of options outstanding. The per share impact of this accounting change was $.02 and $.03 in the first nine months of 2008 and 2007, respectively.

2. **RECENT ACCOUNTING PRONOUNCEMENT**

FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes

In July 2006, the Financial Accounting Standards Board (FASB) issued this interpretation to clarify the accounting for uncertainty in tax positions. FIN 48 requires, among other matters, that the Corporation recognize in its financial statements the impact of a tax position, if that position is more likely than not of being sustained on an audit, based on the technical merits of the position. The provisions of FIN 48 were effective as of the beginning of the Corporation s 2007 fiscal year and required any cumulative effect of the change in accounting principle to be recorded as an adjustment to opening retained earnings. The Corporation did not record an adjustment to retained earnings upon adoption of FIN 48. In future periods, The Corporation will, in accordance with FIN 48, evaluate its tax positions to determine whether or not an adjustment to deferred tax balances and related valuation accounts is warranted.

SFAS No. 157, Fair Value Measurements

SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is to be applied in concert with other accounting pronouncements which require or allow fair value measurements. This statement does not require any new fair value adjustments.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159)

SFAS No. 159 permits an entity to measure certain financial assets and financial liabilities at fair value. The Statement s objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Under SFAS No. 159, entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with a few exceptions, as long as it is applied to the instrument in its entirety. The fair value option election is irrevocable, unless a new election date occurs. The new Statement establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity s election on its earnings but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet.

SFAS No. 157 and No. 159 were effective January 1, 2008. The adoption of SFAS No. 157 and No. 159 by the Corporation did not have any material impact on the consolidated financial statements.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

2. **RECENT ACCOUNTING PRONOUNCEMENTS** (Continued)

The Corporation has reviewed other recent accounting pronouncements by the Financial Accounting Standards Board (FASB), in addition to those noted above and determined that there is no current impact of these accounting pronouncements in the consolidated financial statements of the Corporation.

3. **EARNINGS PER SHARE**

Earnings per share are based upon the weighted average number of shares outstanding.

Additional shares issued as a result of option exercises would not be dilutive in either period.

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2008 and 2007 (dollars in thousands, except per share data):

	Three Months Ended September 30,	Net Income	Weighted Average Number of Shares	Income Per Share
2008				
Income per share	**Basic and diluted**	**$ 216**	**3,419,736**	**$ .06**
2007				
Income per share	Basic and diluted	$ 8,055	3,428,695	$ 2.35

	Nine Months Ended September 30,			
2008				
Income per share	**Basic and diluted**	**$ 2,124**	**3,422,777**	**$ .62**
2007				
Income per share	Basic and diluted	$ 9,636	3,428,695	$ 2.81

4. **INVESTMENT SECURITIES**

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2008, December 31, 2007 and September 30, 2007 are as follows (dollars in thousands):

	September 30, 2008		December 31, 2007		September 30, 2007	
	Amortized Cost	**Estimated Fair Value**	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
US Agencies MBS	**$ 42,147**	**$ 42,234**	$	$	$	$

US Agencies			20,982	20,969	17,494	17,428
Obligations of states and political subdivisions	**499**	**547**	556	628	485	545
Total securities available for sale	**$ 42,646**	**$ 42,781**	$ 21,538	$ 21,597	$ 17,979	$ 17,973

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $19.243 million and $19.276 million, respectively, at September 30, 2008.

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MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. LOANS

The composition of loans at September 30, 2008, December 31, 2007 and September 30, 2007 is as follows (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Commercial real estate	**$ 184,423**	$ 171,695	$ 161,032
Commercial, financial, and agricultural	**75,610**	78,192	78,822
One to four family residential real estate	**62,895**	57,613	54,962
Construction:			
Commercial	**30,373**	38,952	39,816
Consumer	**4,681**	5,090	6,010
Consumer	**3,539**	3,537	3,507
Total loans	**$ 361,521**	$ 355,079	$ 344,149

LOANS Allowance for loan losses

An analysis of the allowance for loan losses for the nine months ended September 30, 2008, the year ended December 31, 2007, and the nine months ended September 30, 2007 is as follows: (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Balance at beginning of period	**$ 4,146**	$ 5,006	$ 5,006
Recoveries on loans	**117**	50	39
Loans charged off	**(2,078)**	(1,310)	(423)
Provision	**1,200**	400	400
Balance at end of period	**$ 3,385**	$ 4,146	$ 5,022

In the first nine months of 2008, net charge off activity was $1.961 million, or .55% of average loans outstanding compared to net charge-offs of $.384 million, or .12% of average loans, in the first nine months of 2007. In the first nine months of 2008, the Corporation recorded a provision for loan loss in the amount of $1.2 million, which is discussed in more detail under Management s Discussion and Analysis.

LOANS 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 and that which would have been recorded had nonaccrual and renegotiated loans been current or not troubled was not material to the consolidated financial statements for the nine months ended September 30, 2008 and 2007.

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MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. **LOANS** (Continued)

Information regarding impaired loans as of September 30, 2008, December 31, 2007 and September 30, 2007 is as follows (dollars in thousands):

	September 30, 2008 (Unaudited)	December 31, 2007	September 30, 2007 (Unaudited)	Valuation Reserve **September 30, 2008**	December 31, 2007	September 30, 2007
Balances, at period end						
Impaired loans with specific valuation reserve	**$ 3,913**	$ 3,639	$ 2,889	**$ 951**	$ 1,320	$ 835
Impaired loans with no specific valuation reserve	**736**	369	283			
Total impaired loans	**$ 4,649**	$ 4,008	$ 3,172	**$ 951**	$ 1,320	$ 835
Impaired loans on nonaccrual basis	**$ 4,649**	$ 3,298	$ 3,136	**$ 951**	$ 1,219	$ 835
Impaired loans on accrual basis		710	36		101	
Total impaired loans	**$ 4,649**	$ 4,008	$ 3,172	**$ 951**	$ 1,320	$ 835
Average investment in impaired loans	**$ 4,732**	$ 4,135	$ 4,018			
Interest income recognized during impairment	**50**	129	71			
Interest income that would have been recognized on an accrual basis	**263**	391	288			
Cash-basis interest income recognized	**50**	84	65			

The average investment in impaired loans was approximately $4.732 million for the nine months ended September 30, 2008, $4.135 million for the year ended December 31, 2007, and $4.018 million for the nine months ended September 30, 2007, respectively. Additional discussion on impaired loans is presented in the Management s Discussion and Analysis section of this report.

LOANS Related parties

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, 2008	December 31, 2007	September 30, 2007
Loans outstanding beginning of period	**$ 1,720**	$ 1,621	$ 1,621
New loans	**115**		
Net activity on revolving lines of credit	**2,109**	556	
Repayment	**(647)**	(457)	(449)
Change in related party interest	**3,758**		
Loans outstanding end of period	**$ 7,055**	$ 1,720	$ 1,172

There were no loans to related-parties classified substandard at September 30, 2008, December 31, 2007 or September 30, 2007, respectively. In addition to the outstanding balances above, there were unused commitments of $3.6 million to related parties at September 30, 2008.

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MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

6. SHORT-TERM BORROWINGS

Short-term borrowings consist of the following at September 30, 2008, December 31, 2007, and September 30, 2007 (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Fed funds purchased	**$**	$ 7,710	$
Advance outstanding on line of credit with a correspondent bank, interest payable at the prime rate, 5.00% as of September 30, 2008, maturing November 30, 2008		1,959	
	$	$ 9,669	$

7. LONG-TERM BORROWINGS

Long-term borrowings consist of the following at September 30, 2008, December 31, 2007 and September 30, 2007 (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Federal Home Loan Bank fixed rate advances at rates ranging from 4.98% to 5.16% maturing in 2010	**$ 15,000**	$ 15,000	$ 15,000
Federal Home Loan Bank variable rate advances at rates of 2.81% maturing in 2011	**20,000**	20,000	20,000
Advance outstanding on line of credit with a correspondent bank, interest payable at the prime rate, 5.00% as of September 30, 2008, maturing November 30, 2008			1,959
Farmers Home Administration, fixed-rate note payable, maturing August 24, 2024 interest payable at 1%	**1,210**	1,280	1,280
	$ 36,210	$ 36,280	$ 38,239

The Federal Home Loan Bank borrowings are collateralized at September 30, 2008 by the following: a collateral agreement on the Corporation s one to four family residential real estate loans with a book value of approximately $25.251 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $18.693 million and $18.726 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.794 million. Prepayment of the remaining 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, 2008.

The U.S.D.A. Rural Development borrowing is collateralized by loans totaling $352,000 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 $.964 million, and guaranteed by the Corporation.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. STOCK OPTION PLANS

A summary of stock option transactions for the nine months ended September 30, 2008 and 2007, and the year ended December 31, 2007, is as follows: (Historical stock option information has been adjusted for the 1:20 reverse stock split which occurred in December 2004).

	September 30, 2008	December 31, 2007	September 30, 2007
Outstanding shares at beginning of year	**446,417**	446,417	446,417
Granted during the period			
Expired during the period	**180**		
Outstanding shares at end of period	**446,237**	446,417	446,417
Weighted average exercise price per share at end of period	**$ 12.14**	$ 12.29	$ 12.29
Shares available for grant at end of period	**18,488**	18,488	18,488

There were no options granted in the first nine months of 2008 and 2007.

Following is a summary of the options outstanding and exercisable at September 30, 2008:

Exercise Price Range	Number Outstanding	Number Exercisable	Weighted Average Remaining Contractual Life-Years	Weighted Average Exercise Price
$9.16	12,500	5,000	7.21	$ 9.16
$9.75	257,152	120,861	6.21	9.75
$10.65	72,500	14,500	8.21	10.65
$11.50	40,000	8,000	7.00	11.50
$12.00	60,000	12,000	6.71	12.00
$156.00 - $240.00	3,545	3,545	2.48	186.75
$300.00 - $406.60	540	540	1.21	333.33
	446,237	164,446	6.66	$ 12.14

9. INCOME TAXES

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. At September 30, 2008, the Corporation evaluated the valuation allowance against the net deferred tax asset which would require future taxable income in order to be utilized. The

Corporation, as of September 30, 2008 had a net operating loss and tax credit carryforwards for tax purposes of approximately $34.1 million, and $2.1 million, respectively.

The Corporation utilized NOL carryforwards to offset taxable income for the first nine months of 2007. In the third quarter of 2007, the Corporation reversed a portion of the valuation allowance, $7.500 million that pertained to the deferred tax benefit of NOL and tax credit carryforwards. This valuation adjustment was recorded as a current period income tax benefit. In 2006, the Corporation recorded a $500,000 tax benefit and utilized additional NOL carryforwards to offset current taxable income. The recognition of the deferred tax benefit in 2007 and 2006 was in accordance with generally accepted accounting principles, and considered among other things, the probability of utilizing the NOL and credit carryforwards.

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9. INCOME TAXES (Continued)

The Corporation recorded the future benefits from these carryforwards at such time as it became more likely than not that they would be utilized prior to expiration. Please refer to further discussion on income taxes contained in Management s Discussion and Analysis. 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 $22 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 $1.4 million for the NOL and the equivalent value of tax credits, which is approximately $.477 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December, 2004.

10. FAS 157 FAIR VALUE MEASUREMENTS

The following tables present information about the Corporation s assets and liabilities measured at fair value on a recurring basis at September 30, 2008, 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.

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.

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.

Disclosures concerning assets and liabilities measured at fair value are as follows (dollars in thousands):

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2008

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2008
Assets				
Investment securities - available for sale	$ 42,713	$ 68	$	$ 42,781
Liabilities				
None				

The Corporation had no Level 3 assets or liabilities on a recurring basis as of December 31, 2007 or September 30, 2008.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. FAS 157 FAIR VALUE MEASUREMENTS (Continued)

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

(dollars in thousands)	Balance at September 30, 2008	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, 2008	Total Losses for Nine Months Ended September 30, 2008
Assets						
Impaired loans accounted for under FAS 114		$	$	$ 640	$	$ 862
					$	$ 862

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

Impaired loans accounted for under FAS 114 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).

Other assets, including bank owned life insurance, goodwill, intangible assets and other assets acquired in business combinations, are also subject to periodic impairment assessments under other accounting principles generally accepted in the United States of America. These assets are not considered financial instruments. Effective February 12, 2008, the FASB issued a staff position, FSP FAS 157-2, which delayed the applicability of FAS 157 to nonfinancial instruments. Accordingly, these assets have been omitted from the above disclosures.

In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.* FSP 157-3 provides clarification of the application of FASB 157 in an inactive market. FSP 157-3 is effective for the Corporation s interim financial statements as of September 30, 2008. This change had no impact on the Corporation s disclosure on fair value measurements.

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.

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MACKINAC FINANCIAL CORPORATION
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(Unaudited)

11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK (Continued)

These commitments are as follows (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Commitments to extend credit:			
Variable rate	**$ 40,133**	$ 43,903	$ 50,728
Fixed rate	**2,752**	8,055	10,075
Standby letters of credit Variable rate	**6,308**	5,930	5,957
Credit card commitments Fixed rate	**2,457**	2,414	2,388
	$ 51,650	$ 60,302	$ 69,148

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.

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.

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, 2008 represents $41.5 million, or 14.29%, compared to $43.4 million, or 15.53%, of the commercial loan portfolio on September 30, 2007. 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.

12. RECENT DEVELOPMENTS

The Corporation has applied for capital under the Troubled Asset Relief Program (TARP) to strengthen its capital position. For further discussion regarding this, please refer to the Capital and Regulatory portion of Management s Discussion and Analysis.

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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 interest rate environment which increase or decrease interest rate margins;

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.

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.

MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

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, 2007. Throughout this discussion, the term Bank refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

Year-to-date consolidated net income was $2.124 million through September 30, 2008, or $.62 per share, compared to income of $9.636 million, $2.81 per share, for the same period in 2007. The income for the three months ended September 30, 2008 amounted to $.216 million, or $.06 per share, compared to income of $8.055 million, or $2.35 per share for the same period in 2007. The results of operations for the first nine months of 2008 include the positive effect, $3.475 million, of a lawsuit settlement, the negative effect, $.425 million, of a severance agreement and a $1.200 million loan loss provision. The results of operations for the same period in 2007 include a provision for the benefit of income taxes in the amount of $7.500 million in recognition of a deferred tax benefit, $470,000, of proceeds from the settlement of a lawsuit against the Corporation s former accountants, and a provision for loan losses of $400,000.

Total assets increased $32.073 million from December 31, 2007 to September 30, 2008. The loan portfolio increased $6.442 million in the first nine months of 2008, from December 31, 2007 balances of $355.079 million. Deposits totaled $360.694 million at September 30, 2008, an increase of $39.867 million from the $320.827 million at December 31, 2007.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $6.277 million in 2008. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $21.184 million, or 98.09%, from December 31, 2007 to September 30, 2008, with the balance on September 30, 2008, totaling $42.781 million. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2008, investment securities with an estimated fair value of $19.276 million were pledged.

In the third quarter of 2008, investment securities were increased in order to address overall market liquidity concerns. The Bank s investment portfolio increased from $23.230 million at June 30, 2008 to $42.781 million on September 30, 2008. This increase of $19.557 million provided the Bank with significant short-term liquidity, since $23.505 million of the investments are unpledged. All of the Bank s current investments are highly marketable investments guaranteed by the U.S. government.

Loans

Through the third quarter of 2008, loan balances increased by $6.442 million, or 1.81%, from December 31, 2007 balances of $355.079 million. During the first nine months of 2008, the Bank had total loan production of $46.539 million. This loan production, some of which has not yet funded, was significantly offset by normal principal runoff and amortization, $24.320 million, and large paydowns and refinancing, which totaled $18.680 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 changes to the 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.

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MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Following is a summary of the loan portfolio at September 30, 2008, December 31, 2007 and September 30, 2007 (dollars in thousands):

	September 30, 2008	**Percent of Total**	December 31, 2007	Percent of Total	September 30, 2007	Percent of Total
Commercial real estate	**$ 184,423**	**51.01%**	$ 171,695	48.35%	$ 161,032	46.79%
Commercial, financial, and agricultural	**75,610**	**20.91**	78,192	22.02	78,822	22.90
One to four family residential real estate	**62,895**	**17.40**	57,613	16.23	54,962	15.97
Consumer	**3,539**	**.98**	3,537	1.00	3,507	1.02
Construction:						
Commercial	**30,373**	**8.40**	38,952	10.97	39,816	11.57
Consumer	**4,681**	**1.30**	5,090	1.43	6,010	1.75
Total loans	**$ 361,521**	**100.00%**	$ 355,079	100.00%	$ 344,149	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2008, December 31, 2007 and September 30, 2007 (dollars in thousands):

	September 30, 2008			December 31, 2007			September 30, 2007		
	Outstanding Balance	**Percent of Commercial Loans**	**Percent of Shareholders Equity**	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders Equity	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders Equity
R/E oper of nonresidential bldgs.	**$ 41,486**	**14.29%**	**100.14%**	$ 41,597	14.40%	105.79%	$ 43,422	15.53%	112.21%
Hospitality and tourism	**35,287**	**12.15**	**85.18**	37,604	13.02	95.63	37,479	13.40	96.85
Real estate agents & managers	**29,277**	**10.08**	**70.67**	29,571	10.24	75.20	25,662	9.18	66.32
Commercial construction	**30,373**	**10.46**	**73.32**	38,952	13.49	99.06	39,816	14.24	102.89
Other	**153,983**	**53.02**	**371.70**	141,115	48.85	358.88	133,291	47.65	344.45
Total Commercial Loans	**$ 290,406**	**100.00%**		$ 288,839	100.00%		$ 279,670	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 gaming 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, 2008. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

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, 2008 amounted to $1.961 million, or .55% of average loans outstanding, compared to $.384 million, .12% of average loans outstanding, for the same period in 2007. The 2008 nine month charge-offs reflect the writedown of three commercial loans, totaling $.862 million, which were reserved for in prior periods. 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.

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MACKINAC FINANCIAL CORPORATION

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

The table below shows period end balances of non-performing assets (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Nonperforming Assets :			
Nonaccrual loans	**$ 4,649**	$ 3,298	$ 3,136
Loans past due 90 days or more		710	36
Total nonperforming loans	**4,649**	4,008	3,172
Other real estate owned	**1,751**	1,226	451
Total nonperforming assets	**$ 6,400**	$ 5,234	$ 3,623
Nonperforming loans as a % of loans	**1.29**%	1.13%	.92%
Nonperforming assets as a % of assets	**1.45**%	1.28%	.90%
Reserve for Loan Losses:			
At period end	**$ 3,385**	$ 4,146	$ 5,022
As a % of loans	**.94**%	1.24%	1.46%
As a % of nonperforming loans	**72.81**%	103.44%	158.32%
As a % of nonaccrual loans	**72.81**%	125.71%	160.14%

The following ratios assist management in the determination of the Corporation s credit quality (dollars in thousands):

	September 30, 2007	December 31, 2007	September 30, 2007
Total loans, at period end	**$ 361,521**	$ 355,079	$ 344,149
Average loans for the year	**359,729**	333,415	327,810
Allowance for loan losses	**3,385**	4,146	5,022
Allowance to total loans at period end	**.94**%	1.17%	1.46%
Net charge-offs during the period	**$ 1,961**	$ 1,260	$ 384
Net charge-offs to average loans	**.55**%	.38%	.12%
Net charge-offs to beginning allowance balance	**47.30**%	25.17%	7.67%

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 a loan review consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the independent review, early in 2008, provided findings similar to management on the overall adequacy of the reserve.

MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table will provide additional information with respect to our nonperforming assets as of September 30, 2008 (dollars in thousands):

Collateral Type	Balance (a)	Estimated Liquidation Value (b)	(Deficiency) Surplus (c) = (b) - (a)	SBA Guarantee (d)	Reserve Allocation (e)	Estimated Net Surplus/ (Exposure) (f) = (c) + (d) + (e)
Nonaccrual Loans						
Land Development	$ 2,754	$ 2,134	$ (620)	$	$ 620	$
Land Development/Condo	1,038	700	(338)		350	12
Cabins / Land	410	410				
Non-Farm/Non-Residential	229	234	5	116		121
Land	107	149	42		13	55
1-4 Family	85	84	(1)		2	1
Business Equipment	26	10	(16)		16	
Total nonaccrual loans	4,649	3,721	(928)	116	1,001	189
Other Real Estate						
Land Development	511	511				
1-4 Family	403	377	(26)		25	(1)
Motel/Hotel	337	337				
Cabins/Land	260	240	(20)			(20)
Non-Farm/Non-Residential	163	142	(21)		20	(1)
Downtown Store Frontage / 2 / 1-4 Family	77	77				
Total other real estate owned	1,751	1,684	(67)		45	(22)
Total nonperforming assets	$ 6,400	$ 5,405	$ (995)	$ 116	$ 1,046	$ 167

The schedule above shows the detail of nonperforming assets categorized by type of loan/collateral. In determining estimated liquidation value, management considered existing appraisals, the date of the appraisals, and current market conditions, along with related selling costs. Personal guarantees are also in place for various nonperforming assets, which will also help mitigate losses.

Following is the allocation of the allowance for loan losses as of September 30, 2008, December 31, 2007 and September 30, 2007 (dollars in thousands):

	September 30, 2008	December 31, 2007	September 30, 2007
Commercial, financial and agricultural loans	**$ 2,974**	$ 3,808	$ 4,803
One to four family residential real estate loans	**53**	22	31

Consumer loans		**9**		20		
Unallocated and general reserves		**349**		296		188
Totals	**$**	**3,385**	$	4,146	$	5,022

As of September 30, 2008, the allowance for loan losses represented 0.94% of total loans. 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.

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

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

	Nine Months Ended September 30, 2008	Year Ended December 31, 2007	Nine Months Ended September 30, 2007
Balance at beginning of period	**$ 1,226**	$ 26	$ 26
Other real estate transferred from loans due to foreclosure	**2,745**	1,218	443
Other real estate sold/written down	**(2,220)**	(18)	(18)
Balance at end of period	**$ 1,751**	$ 1,226	$ 451

During the first nine months of 2008, the Corporation received real estate in lieu of loan payments of $2.745 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 balance. Any additional reduction in the fair value results in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits in the first nine months of 2008. Total deposits increased by $39.867 million, or 12.43%, in the first nine months of 2008. Core deposits increased from $199.809 million at 2007 year end to $208.940 million, an increase of $9.131 million. Noncore deposits increased by $30.736 million during the first nine months of 2008, largely due to increased liquidity needs. 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 our markets to grow core deposits, with an emphasis placed on transactional accounts.

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

	September 30, 2008	**% of Total**	December 31, 2007	% of Total	September 30, 2007	% of Total
Non-interest-bearing	**$ 34,858**	**9.66%**	$ 25,557	7.97%	$ 28,325	8.81%
NOW, money market, checking	**80,185**	**22.23**	81,160	25.30	87,262	27.15
Savings	**18,957**	**5.26**	12,485	3.89	12,831	3.99
Certificates of Deposit <$100,000	**74,940**	**20.78**	80,607	25.12	90,220	28.07
Total core deposits	**208,940**	**57.93**	199,809	62.28	218,638	68.02
Certificates of Deposit >$100,000	**30,220**	**8.38**	22,355	6.97	24,432	7.61
Brokered CDs	**121,534**	**33.69**	98,663	30.75	78,301	24.37
Total non-core deposits	**151,754**	**42.07**	121,018	37.72	102,733	31.98

Total deposits	**$**	**360,694**	**100.00%**	$	320,827	100.00%	$	321,371	100.00%

Borrowings

The Corporation historically used alternative funding sources to provide long-term, stable sources of funds. Current borrowings total $35.000 million with stated maturities ranging through 2011. Borrowings at quarter end include $20.000 million with adjustable rates that reprice quarterly based upon the three month LIBOR. The FHLB has the option to convert the remaining $15.000 million fixed-rate advances to adjustable rate advances on the original call date and quarterly thereafter.

Shareholders Equity

Total shareholders equity increased $2.106 million from December 31, 2007 to September 30, 2008. The increase is comprised of net income of $2.124 million, contributed capital of $63,000 in recognition of stock option expense, a $29,000 increase in the market value of securities and the cost of a one-time odd lot share buyback in the amount of $110,000. The Board of Directors does not anticipate declaring any dividends in the near future.

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MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

RESULTS OF OPERATIONS

Summary

The Corporation reported income of $2.124 million for the first nine months of 2008, $.62 per share, compared to net income of $9.636 million, $2.81 per share, in the first nine months of 2007. In the third quarter of 2008, net income was $.216 million, $.06 per share, compared to $8.055 million, $2.35 per share, in the third quarter of 2007.

The Corporation is experiencing net interest margin pressure due to an asset sensitive position, since 65% of its commercial loan portfolio, approximately $188.764 million, reprices with interest rate changes. The Corporation is also reliant on brokered deposits, and rates have not declined in line with asset repricing.

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 income before provision for loan losses for the nine months ended September 30, 2008 decreased by $.473 million, or 4.73%, compared to the same period one year ago.

Net interest income declined to $3.371 million in the third quarter of 2008, compared to $3.560 million in the third quarter of 2007. The decrease in net interest income for 2008 was primarily the result of prime rate reductions that have translated into lower yields on the Corporation s earning assets, specifically variable rate commercial loans and short-term investments which reprice immediately. Offering rates on brokered certificates of deposit are influenced by other factors, such as overall market liquidity. Reliance upon wholesale funding and further rate reductions in the near term will unfavorably impact the net interest margin of the Corporation.

While a majority of the Corporation s loan portfolio is repriced with each prime rate change due to floating rate loans, interest paid on similar rate changes does not impact the pricing of interest bearing liabilities to nearly the same degree. The mix of time deposits reflects the Corporation s need to utilize the brokered certificate of deposit markets for loan funding when core deposits did not provide adequate sources.

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MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following tables present 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							**2008-2007**			
	Average Balances			**Average Rates**		**Interest**		Income/			Rate/
	September 30,		Increase/	September 30,		September 30,		Expense	Volume	Rate	Volume
(dollars in thousands)	**2008**	2007	(Decrease)	**2008**	2007	**2008**	2007	Variance	Variance	Variance	Variance
Loans (1,2,3)	**$ 358,844**	$ 340,391	$ 18,453	**6.31%**	8.28%	**$ 5,689**	$ 7,107	$ (1,418)	$ 384	$ (1,691)	(111)
Taxable securities	**24,647**	22,979	1,668	**4.89**	4.54	**303**	263	40	19	20	1
Nontaxable securities	**68**		68	**11.70**		**2**		2			2
Federal funds sold	**7,944**	9,339	(1,395)	**2.00**	5.14	**40**	121	(81)	(18)	(74)	11
Other interest-earning assets	**4,178**	7,838	(3,660)	**4.48**	4.45	**47**	88	(41)	(41)		
Total earning assets	**395,681**	380,547	15,134	**6.11**	7.90	**6,081**	7,579	(1,498)	344	(1,745)	(97)
Reserve for loan losses	**(3,500)**	(4,839)	1,339								
Cash and due from banks	**7,443**	7,110	333								
Intangible assets	**74**	152	(78)								
Other assets	**24,004**	17,135	6,869								
Total assets	**$ 423,702**	$ 400,105	$ 23,597								
NOW and money market deposits	**$ 78,645**	$ 83,186	$ (4,541)	**1.55**	3.60	**307**	755	(448)	(41)	(428)	21
Interest checking	**2,087**		2,087	**3.05**		**16**		16			16
Savings deposits	**17,453**	12,900	4,553	**1.41**	1.54	**62**	50	12	18	(4)	(2)
CDs <$100,000	**76,621**	93,223	(16,602)	**3.75**	4.92	**723**	1,155	(432)	(205)	(272)	45
CDs >$100,000	**29,905**	24,590	5,315	**3.61**	5.15	**271**	319	(48)	69	(95)	(22)
Brokered deposits	**103,012**	85,203	17,809	**3.59**	5.42	**930**	1,164	(234)	243	(392)	(85)
Borrowings	**37,245**	38,325	(1,080)	**3.73**	5.34	**349**	516	(167)	(15)	(155)	3
Total interest-bearing liabilities	**344,968**	337,427	7,541	**3.07**	4.65	**2,658**	3,959	(1,301)	69	(1,346)	(24)
Demand deposits	**33,654**	28,191	5,463								
Other liabilities	**3,983**	2,303	1,680								
Shareholders equity	**41,097**	32,184	8,913								
Total liabilities and shareholders equity	**$ 423,702**	$ 400,105	$ 23,597								

Rate spread				**3.04**%	3.25%						
Net interest margin/revenue				**3.44**%	3.77%	**$ 3,423**	$ 3,620	$ (197)	$ 275	$ (399)	$ (73)

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

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

(3) Interest income on loans includes loan fees.

	Nine Months Ended							**2008-2007**			
	Average Balances			**Average Rates**		**Interest**		Income/			Rate/
	September 30,		Increase/	September 30,		September 30,		Expense	Volume	Rate	Volume
(dollars in thousands)	**2008**	2007	(Decrease)	**2008**	2007	**2008**	2007	Variance	Variance	Variance	Variance
Loans (1,2)	**$ 359,729**	$ 327,810	$ 31,919	**6.58**	8.26%	**$ 17,712**	$ 20,264	$ (2,552)	$ 1,975	$ (4,142)	(385)
Taxable securities	**24,171**	26,111	(1,940)	**4.63**	4.39	**838**	857	(19)	(64)	47	(2)
Nontaxable securities	**69**		69	**11.62**		**6**		6			6
Federal funds sold	**5,086**	9,183	(4,097)	**2.44**	5.26	**93**	361	(268)	(161)	(193)	86
Other interest-earning assets	**4,349**	6,254	(1,905)	**5.07**	4.57	**165**	214	(49)	(65)	23	(7)
Total earning assets	**393,404**	369,358	24,046	**6.39**	7.85	**18,814**	21,696	(2,882)	1,685	(4,265)	(302)
Reserve for loan losses	**(3,820)**	(4,936)	1,116								
	6,569	6,315	254								

Cash and due from banks											
Intangible assets	**94**	173	(79)								
Other assets	**23,644**	16,687	6,957								
Total assets	**$ 419,891**	$ 387,597	$ 32,294								
NOW and money market deposits	**$ 80,274**	$ 75,957	$ 4,317	**1.75**	3.53	**1,054**	2,005	(951)	114	(1,010)	(55)
Interest checking	**707**		707	**3.02**		**16**		16			16
Savings deposits	**14,275**	13,155	1,120	**1.10**	1.61	**118**	158	(40)	13	(49)	(4)
CDs <$100,000	**80,291**	93,898	(13,607)	**4.22**	4.94	**2,537**	3,467	(930)	(503)	(503)	76
CDs >$100,000	**26,622**	24,276	2,346	**4.00**	5.04	**798**	915	(117)	89	(188)	(18)
Brokered deposits	**105,730**	83,094	22,636	**4.30**	5.45	**3,401**	3,387	14	924	(717)	(193)
Borrowings	**39,677**	38,637	1,040	**4.02**	5.31	**1,194**	1,535	(341)	41	(374)	(8)
Total interest-bearing liabilities	**347,576**	329,017	18,559	**3.50**	4.66	**9,118**	11,467	(2,349)	678	(2,841)	(186)
Demand deposits	**28,824**	25,144	3,680								
Other liabilities	**3,159**	2,809	350								
Shareholders equity	**40,332**	30,627	9,705								
Total liabilities and shareholders equity	**$ 419,891**	$ 387,597	$ 32,294								
Rate spread				**2.89**	3.19%						
Net interest margin/revenue				**3.29**	3.70%	**$ 9,696**	$ 10,229	$ (533)	$ 1,007	$ (1,424)	$ (116)

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

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

(3) Interest income on loans includes loan fees.

The rate reductions on approximately 65% of the Corporation s loan portfolio repriced with prime rate reductions from 8.25% in September of 2007 to 5.00% in September 2008. The reduced rates of the Corporation s loan portfolio are reflected in the overall decrease in rates on earning assets from 7.90% in the third quarter of 2007 to 6.11% in the third quarter of 2008. During this period of prime rate reductions, the Corporation reduced bank deposit rates in order to mitigate the impact on earnings. The Corporation is somewhat reliant on wholesale funding sources, specifically brokered deposits. The Corporation had average balances of $103.012 million in the third quarter of 2008 with an average cost of 3.59% compared to $85.203 million at 5.42% in the third quarter of 2007.

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In the nine months ended September 30, 2008, the Corporation had average balances of brokered deposits totaling $105.730 million at a weighted average cost of 4.30% compared to $83.094 million at 5.45% for the same nine month period in 2007.

These deposits have not repriced in line with rate reductions on earning assets, which significantly contributed to the Corporation s reduced net interest income. The Corporation expects to see less pressure on its interest margin as these wholesale deposits reprice.

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 third quarter of 2008, the Corporation recorded a $450,000 provision for loan loss. For the nine months ended September 30, 2008, the provision for loan loss totaled $1.200 million. In future periods, loan loss provisions will be required if there is further market deterioration that impacts the credit quality on the existing portfolio.

Other Income

Other income increased by $2.694 million for the nine months ended September 30, 2008, compared to the nine months ended September 30, 2007. The Corporation recognized a benefit from the settlement of a lawsuit totaling $3.475 million in the first nine months of 2008. Service fees increased $82,000 in the first nine months of 2008, while other noninterest income decreased $.206 million. Revenue due to loans produced and sold in the secondary market amounted to $.113 million compared to $.364 million a year ago. Poor overall market conditions, caused by a declining economy and a housing slump, have limited any ability to expand our revenues from fee income during the first nine months of 2008. We do not expect to generate increased fee income during the later part of 2008 but do anticipate increased fee income in future periods as the housing market improves and home buyers look to more traditional lenders for their borrowing needs. The Corporation recognized a benefit from the settlement of a lawsuit against its former accountants in the first half of 2007, which amounted to $.470 million.

During the third quarter of 2008, the Corporation recognized $.288 million in other income, compared to $.396 million for the third quarter of 2007. Service fees increased for the third quarter of 2008 by $.060 million to $.229 million when compared to $.169 million in the third quarter of 2007.

The following table details noninterest income for the three and nine months ended September 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	% Increase (Decrease) 2008-2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	% Increase (Decrease) 2008-2007
Service fees	**$ 229**	$ 169	35.5	**$ 597**	$ 515	15.9
Net gains on sale of loans	**16**	165	(90.3)	**113**	364	(69.0)
Proceeds from settlement of lawsuit			N/A	**3,475**	470	639.4
Other	**44**	62	(29.0)	**96**	302	(68.2)
Subtotal	**289**	396	(27.0)	**4,281**	1,651	159.3
Net securities gains	**(1)**		N/A	**64**		N/A
Total other income	**$ 288**	$ 396	(27.3)	**$ 4,345**	$ 1,651	163.2

Other Expenses

Other expenses increased $.475 million for the nine months ended September 30, 2008, compared to the same period in 2007. Salaries and employee benefits increased $.310 million during the first nine months of 2008, compared to the first nine months of 2007. The Corporation recorded a $.425 million expense related to a severance

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payment in the first nine months of 2008. The $72,000 increase in data processing costs is the result of increased deposit balances and activity, along with added data processing services. The $.216 million increase in loan and deposit expense is due in large part to carrying costs associated with nonperforming assets. During the second quarter of 2008, the Corporation settled a long standing derivative shareholder lawsuit. As a part of this settlement, the Corporation received funds amounting to $3.475 million, recorded as other income, and a dismissal of unpaid legal fees, totaling $95,000, related to the defense of prior directors of the Corporation. The reversal of the accrual for these fees contributed to the reduction in professional service fees for the first nine months of 2008, compared to the same period in 2008. Management continually reviews all areas of noninterest expense for cost reduction opportunities that will not impact service quality and employee morale.

Telephone expenses for the three and nine month periods in 2008 are lower than the same periods in 2007, as a result of the installation of a new phone system which reduced long distance service costs. Advertising expenses have decreased in 2008, as the Corporation has initiated cost controls.

The Corporation recognized other expense in the third quarter of 2008 totaling $2.935 million, compared to $3.001 million in the third quarter of 2007. The decrease in noninterest expense between periods was composed primarily of decreases in salary and employee benefits. Early in 2008, the Corporation implemented several cost reduction initiatives in order to mitigate the impact of reduced interest income. Specific initiatives included nonessential staff reductions, decreases in incentive and bonus plan programs and advertising expense. The Corporation expects to realize an annualized benefit from these reductions of approximately $.750 million.

The following table details noninterest expense for the three and nine months ended September 30, 2008 and September 30, 2007 (dollars in thousands):

	Three Months Ended September 30,		% Increase (Decrease)	**Nine Months Ended September 30,**		% Increase (Decrease)
	2008	2007	2007-2006%	**2008**	2007	2007-2006%
Salaries and employee benefits	**$ 1,534**	$ 1,695	(9.5)	**$ 5,416**	$ 5,106	6.1
Occupancy	**336**	322	4.3	**1,039**	983	5.7
Furniture and equipment	**202**	178	13.5	**570**	501	13.8
Data processing	**212**	196	8.2	**649**	577	12.5
Professional service fees	**120**	78	53.8	**352**	403	(12.7)
Loan and deposit	**176**	63	179.4	**430**	214	100.9
Telephone	**41**	68	(39.7)	**125**	185	(32.4)
Advertising	**93**	97	(4.1)	**213**	280	(23.9)
Other	**221**	304	(27.3)	**803**	873	(8.0)
Total other expense	**$ 2,935**	$ 3,001	(2.2)	**$ 9,597**	$ 9,122	5.2

Federal Income Taxes

Current Federal Tax Provision

The Corporation recorded a current period federal tax provision of $958,000 in the first nine months of 2008, compared to a $7.500 million negative provision in the same period a year earlier, in recognition of a federal deferred tax benefit, which is discussed further below.

Deferred Tax Benefit

The Corporation recognized a federal deferred tax benefit of $7.500 million in the third quarter of 2007. The recognition of this deferred tax benefit relates to the generally accepted accounting principles applicable to the probability of utilizing the NOL and tax credit carryforwards of the Corporation. The Corporation, based upon current profitability trends largely supported by expansion of the net interest margin and controlled expenses, determined that the utilization of the NOL carryforward was probable. This tax benefit was recorded by reducing the valuation allowance that was recorded against the deferred tax assets of the Corporation. In 2006, the

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Corporation recognized a portion of this benefit, $500,000, based upon the then current probabilities. The $7.500 million recognition is based upon assumptions of a sustained level of taxable income within the NOL carryforward period and takes into account Section 382, establishing annual limitations. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized. As of September 30, 2008, the Corporation had an NOL carryforward of approximately $34.1 million along with various credit carryforwards of $2.1 million. This NOL and credit carryforward benefit is dependent upon the future profitability of the Corporation. A portion of the NOL, approximately $22 million, and all of the tax credit carryforwards are also subject to the use limitations of Section 382 of the Internal Revenue Code since they originated prior to the December 2004 recapitalization of the Corporation. The Corporation intends to further evaluate the utilization of the NOL and credit carryforwards in subsequent periods to determine if any further adjustment to the valuation allowance is necessary. The determination criteria for recognition of deferred tax benefits will include the assumption of future period taxable income based upon the projected profitability of the Corporation.

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.

During the first nine months of 2008, the Corporation increased cash and cash equivalents by $6.277 million. As shown on the Corporation s condensed consolidated statement of cash flows, liquidity was primarily impacted by cash provided by investing activities, a net increase in loans of $11.144 million and a net increase in securities available for sale of $21.157 million. The net increases in assets were offset by a similar increase in deposit liabilities of $39.867 million. This increase in deposits was composed of an increase in brokered deposits of $30.736 million combined with an increase in bank deposits of $9.131 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.

During the third quarter of 2008, management increased the Bank s investment portfolio by approximately $20 million. The Bank s investment portfolio, most of which are guaranteed by the U.S. government, provide added liquidity during periods of market turmoil and overall liquidity concerns in the financial markets. As of September 30, 2008, $23.505 million of the Bank s investment portfolio is unpledged, which makes them readily available for sale to address any short term liquidity needs.

It is anticipated that during the remainder of 2008, the Corporation will fund anticipated loan production with a combination of core deposit growth and noncore funding, primarily brokered CDs.

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 restate its capital accounts, which requires the approval of the Office of Financial and Insurance Services of the State of Michigan. The Corporation has a $6 million correspondent bank line of credit available for short-term liquidity. This line of credit has no outstanding balance as of September 30, 2008. The Corporation is currently exploring alternative opportunities for longer term sources of liquidity and permanent equity to support projected asset growth.

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 non-core funding dependence ratio, which explains the degree of reliance on non-core 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. Non-core funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At September 30, 2008, the Bank s core deposits in relation to total funding were 52.64% compared to 61.13% at September 30, 2007. These ratios indicated at September 30, 2008, that the Bank has decreased its reliance on non-core deposits and

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borrowings to fund the Bank s long-term assets, namely loans and investments. Management 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, 2008, the Bank had $13.375 million of unsecured lines available and another $10.250 million available if secured. Management 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 liquidity plan for 2008 includes strategies to increase core deposits in the Corporation s local markets. The new deposit products and strategic advertising is expected to aid in efforts of management in growing core deposits to reduce the dependency on non-core deposits, while also reducing interest costs. The Corporation s liquidity plan for 2008 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, 2008, the Corporation and Bank were well capitalized. The Corporation is currently exploring its alternatives for the possible issuance of equity or debt in order to provide a broader base to support future asset growth. During the first nine months of 2008, total capitalization increased by $2.106 million primarily from an increase in retained earnings from net income earned in the period.

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA), which provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. One of the provisions resulting from the EESA is the Treasury Capital Purchase Program (CPP), which provides direct equity investment of perpetual preferred stock by the Treasury in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions including limits on executive compensation, stock redemptions and declaration of dividends. Applications must be submitted by November 14, 2008, and are subject to approval by the Treasury. The CPP provides for a minimum of 1% of risk weighted assets, with a maximum investment equal to the lesser of 3% of total risk weighted assets or $25 billion. The perpetual preferred stock investment will have a dividend rate of 5% per year, until the fifth anniversary of the Treasury investments, and a dividend of 9% thereafter. The CPP also requires the Treasury to receive warrants for common stock equal to 15% of the capital invested by the Treasury.

The Corporation has applied for $11.0 million in capital under this program. This application is subject to approval by the U.S. Department of the Treasury.

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

	September 30, 2008	December 31, 2007	September 30, 2007
Capital Structure			
Shareholders equity	**$ 41,427**	$ 39,321	$ 38,697
Total capitalization	**$ 41,427**	$ 39,321	$ 38,697
Tangible capital	**$ 41,362**	$ 39,197	$ 38,554
Intangible Assets			
Core deposit premium	**$ 65**	$ 124	$ 143
Other identifiable intangibles			
Total intangibles	**$ 65**	$ 124	$ 143
Regulatory capital			
Tier 1 capital:			
Shareholders equity	**$ 41,427**	$ 39,321	$ 38,697
Net unrealized (gains) losses on available for sale securities	**(89)**	(60)	6
Less: intangibles	**(65)**	(124)	(143)
Less: disallowed deferred tax asset	**(6,600)**	(6,990)	(7,000)
Total Tier 1 capital	**$ 34,673**	$ 32,147	$ 31,560
Tier 2 Capital:			
Allowable reserve for loan losses	**$ 3,385**	$ 4,146	$ 4,379
Qualifying long-term debt			
Total Tier 2 capital	**3,385**	4,146	4,379
Total capital	**$ 38,058**	$ 36,293	$ 35,939
Risk-adjusted assets	**$ 369,011**	$ 358,410	$ 349,678
Capital ratios:			
Tier 1 Capital to average assets	**8.31%**	8.05%	8.03
Tier 1 Capital to risk weighted assets	**9.40%**	8.97%	9.03
Total Capital to risk weighted assets	**10.31%**	10.13%	10.28

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.

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
Regulatory minumum for capital adequacy purposes	N/A	N/A	4.00%	4.00%	8.00%
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
The Corporation:					
September 30, 2008	**9.40%**	**9.38%**	**8.31%**	**9.40%**	**10.31%**
September 30, 2007	9.65%	9.61%	8.03%	9.03%	10.28%
The Bank:					
September 30, 2008	**9.31%**	**9.30%**	**8.26%**	**9.32%**	**10.22%**
September 30, 2007	10.05%	10.02%	8.46%	9.51%	10.76%

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 also has $42.781 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 offers deposit products with 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.

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.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

The following are the Corporation s repricing opportunities at September 30, 2008 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 253,043	$ 9,431	$ 28,639	$ 70,408	$ 361,521
Securities		5	30,809	11,967	42,781
Other (1)	4,804			3,794	8,598
Total interest-earning assets	257,847	9,436	59,448	86,169	412,900
Interest-bearing obligations:					
NOW, money markets, savings and interest checking	99,142				99,142
Time deposits	31,939	59,150	13,218	853	105,160
Brokered deposits	66,823	54,711			121,534
Borrowings	20,000		15,000	1,210	36,210
Total interest-bearing obligations	217,904	113,861	28,218	2,063	362,046
Gap	$ 39,943	$ (104,425)	$ 31,230	$ 84,106	$ 50,854
Cumulative gap	$ 39,943	$ (64,482)	$ (33,252)	$ 50,854	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at September 30, 2008, the Corporation had a cumulative liability sensitivity gap position of $64.482 million within the one-year time frame. The Corporation s cumulative liability sensitive gap suggests that if market interest rates increase in the next twelve months, the Corporation has the potential to earn less net interest income. Conversely, if market interest rates decrease in the next twelve months, the above GAP position suggests the Corporation s net interest income would increase. 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, 2007, the Corporation had a cumulative liability sensitivity gap position of $43.774 million within the one-year time frame.

The borrowings in the gap analysis include $15 million of the FHLB advances as fixed-rate advances. These advances give the FHLB the option to convert from a fixed-rate advance to an adjustable rate advance with quarterly repricing at three-month LIBOR Flat. The exercise of this conversion feature by the FHLB would impact the repricing dates currently assumed in the analysis.

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.

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.

MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

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. As of September 30, 2008, the Corporation had excess Canadian assets of $.161 million (or $.154 million in U.S. dollars). 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.

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MACKINAC FINANCIAL CORPORATION

ITEM 4 CONTROLS AND PROCEDURES

An evaluation was performed under the supervision of and with the participation of the Corporation s management, including the Chairman and Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Corporation s disclosure controls and procedures (as such term is defined in Rules 13-a 15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Corporation s management, including the Chairman and Chief Executive Officer, have concluded that, as of the end of such period, the Corporation s disclosure controls and procedures were effective in timely alerting them to material information relating to the Corporation (including its consolidated subsidiaries) required to be disclosed by the Corporation in the reports that it files or submits under the Exchange Act.

There was no change in the Corporation s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the Corporation s fiscal quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Corporation s internal control over financial reporting.

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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. The litigation that is not routine and incidental to the business of banking is described below.

Shareholder s Derivative Litigation

Damon Trust v. Bittner, et al.

This matter has been resolved and concluded with the Corporation receiving $3.475 million in settlement proceeds during the second quarter of 2008.

Damon Trust v. Wipfli

This matter has been resolved and concluded with the Corporation receiving $470,000 in settlement proceeds during the first quarter of 2007. Please refer to the Annual Report for a more detailed description and explanation of this litigation.

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MACKINAC FINANCIAL CORPORATION
PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 3.1	Articles of Incorporation, as amended, incorporated herein by reference to exhibit 3.1 of the Corporation s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999.
Exhibit 3.2	Amended and Restated Bylaws, incorporated herein by reference to exhibit 3.1 of the Corporation s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.
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.

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MACKINAC FINANCIAL CORPORATION
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, 2008

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 accounting officer)