

First Federal of Northern Michigan Bancorp, Inc.  
Form 10-K  
March 29, 2012

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Fiscal Year Ended December 31, 2011

**OR**

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission File Number: 000-31957**

**FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.**

(Exact name of registrant as specified in its charter)

Maryland 32-0135202  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification Number)

100 S. Second Avenue, Alpena, Michigan 49707  
(Address of Principal Executive Offices) Zip Code

(989) 356-9041  
(Registrant's telephone number)

Securities Registered Pursuant to Section 12(b) of the Act:

Common Stock, par value \$.01 per share The Nasdaq Stock Market LLC  
(Title of Class) (Name of Exchange of Which Registered)

**Securities Registered Pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past twelve months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

YES . NO .

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES . NO .

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. .

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

Large accelerated filer

Accelerated filer

Non-Accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

YES . NO .

Indicate by check mark if the registrant is a well-know seasoned issuer, as defined in Rule 405 of the Securities Act.

YES . NO .

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The aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the last sale price on June 30, 2011 (\$3.75 per share) was \$9.5 million.

As of March 26, 2012, there were issued and outstanding 2,884,049 shares of the registrant's common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

1. Proxy Statement for the 2012 Annual Meeting of Stockholders (Parts I and III).
2. Annual Report to Shareholders for the Year Ended December 31, 2011 (Part II).

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PART I

ITEM 1. BUSINESS

**Private Securities Litigation Reform Act Safe Harbor Statement**

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which can be identified by the use of words such as “estimate,” “project,” “believe,” “intend,” “anticipate,” “plan,” “seek,” “expect,” “will,” “may,” and words of similar meaning. These forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;
- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. We are under no duty to and do not take any obligation to update any forward-looking statements after the date of this Form 10-K.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market areas, that are worse than expected;
- competition among depository and other financial institutions;

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inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;

· adverse changes in the securities markets;

· changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;

· our ability to enter new markets successfully and capitalize on growth opportunities;

· our ability to successfully integrate acquired entities;

· changes in consumer spending, borrowing and savings habits;

· changes in accounting policies and practices, as may be adopted by the regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commissions and the Public Company Accounting Oversight Board;

· changes in our organization, compensation and benefit plans;

· changes in our financial condition or results or operations that reduce capital available to pay dividends;

· regulatory changes or actions; and

· changes in the financial condition or future prospects of issuers of securities that we own.

Because of these and a wide variety of other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements.

### **First Federal of Northern Michigan Bancorp, Inc.**

First Federal of Northern Michigan Bancorp, Inc. is a Maryland corporation that owns all of the outstanding shares of common stock of First Federal of Northern Michigan. At December 31, 2011, First Federal of Northern Michigan Bancorp, Inc. had consolidated assets of \$217.0 million, deposits of \$150.6 million and stockholders' equity of \$24.6 million. As of December 31, 2011, First Federal of Northern Michigan Bancorp, Inc. had 2,884,049 shares of common stock issued and outstanding. First Federal of Northern Michigan Bancorp, Inc.'s executive offices are located at 100 South Second Avenue, Alpena, Michigan 49707. Its phone number at that address is (800) 498-0013.

The Company also maintains a website at [www.first-federal.com](http://www.first-federal.com) that includes important information on our Company, including a list of our products and services, branch locations and current financial information. In addition, we make available, without charge, through our website, a link to our filings with the SEC, including copies of annual reports on Form 10-K, quarterly reports in Form 10-Q, current reports in Form 8-K, and amendments to these filings, if any. Information on our website should not be considered a part of this Annual Report.

### **First Federal of Northern Michigan**

First Federal of Northern Michigan is a full-service, community-oriented savings bank that provides financial services to individuals, families and businesses from eight full-service facilities located in Alpena, Cheboygan, Emmet, Iosco, Otsego, Montmorency and Oscoda Counties, Michigan. First Federal of Northern Michigan was chartered in 1957, and reorganized into the mutual holding company structure in 1994. In 2000, First Federal of Northern Michigan became the wholly owned subsidiary of Alpena Bancshares, Inc., our predecessor company, and in April 2005 we completed our "second step" mutual-to-stock conversion and formed our current ownership structure.



First Federal of Northern Michigan's business consists primarily of accepting deposits from the general public and investing those deposits, together with funds generated from operations and borrowings, in one- to four-family residential mortgage loans, commercial real estate loans, commercial business loans, consumer loans and in investment securities and mortgage-backed securities.

First Federal of Northern Michigan's executive offices are located at 100 South Second Avenue, Alpena, Michigan 49707. Its phone number at that address is (800) 498-0013.

### **Market Area and Competition**

First Federal of Northern Michigan conducts operations through its main office in Alpena, Michigan, which is located in the northeastern lower peninsula of Michigan, and through its seven other branch offices in Michigan. The population of Alpena County, from which the majority of our deposits are drawn, has decreased approximately 5.4% since 2000, and currently is approximately 30,000. The population of our primary market area, which includes Alpena County and seven surrounding counties, was approximately 180,000 according to the 2010 census, a decrease of just over 1% from the estimated 2008 population of approximately 182,000. Median household income for the counties which comprised our market area in 2010 ranged from approximately \$31,000 - \$46,000. Median household income for our entire market area was below the national level of \$49,445 and below the Michigan level of \$45,354 in all but two counties in our market area, reflecting the largely rural nature of our market area and the absence of more densely populated urban and suburban areas. Household income levels are not expected to increase in our market area in the near future. The unemployment rate in our primary market, Alpena County, was 9.8% for December 2011, but ranged from 12.2% - 17.9% across the rest of our primary market area, as compared to 8.3% nationally and 9.0% for Michigan.

Alpena is the largest city located in the northeastern lower peninsula of Michigan. This area has long been associated with agricultural, wood and concrete industries. Tourism has also been a major industry in our primary market area. All of these industries tend to be seasonal and are strongly affected by state and national economic conditions.

Major employers in our primary market area include various public schools and governmental agencies, Alpena Regional Medical Center, Besser Company (a manufacturer of concrete products equipment), Lafarge Corporation (a limestone mining and cement producer), Panel Processing (a peg board manufacturer), Treetops Sylvan Resort (an operator of resort properties), Garland Resort (an operator of resort properties and golf courses), Otsego Memorial Hospital, Cheboygan Memorial Hospital, Decorative Panels International (a hardboard manufacturer), OMNI Metalcraft Corp. (a diversified manufacturer), and various other small companies.

As of December 31, 2011, First Federal of Northern Michigan was the only thrift institution headquartered in our market area. We encounter strong competition both in attracting deposits and in originating real estate and other loans. Our most direct competition for deposits has historically come from commercial banks, other savings institutions, and credit unions in our market area. Competition for loans comes from such financial institutions. We expect continued strong competition in the foreseeable future, including the “super-regional” banks currently in our markets, from internet banks, and from credit unions in many of our markets. We compete for savings deposits by offering depositors a high level of personal service and a wide range of competitively priced financial products. We compete for real estate loans primarily on the basis of the interest rates and fees we charge and through advertising. Strong competition for deposits and loans may limit our ability to grow and may adversely affect our profitability in the future.

## **Lending Activities**

**General.** The largest part of our loan portfolio is mortgage loans secured by one- to four-family residential real estate. In recent years, we have sold into the secondary mortgage market most of the fixed-rate conventional one- to four-family mortgage loans that we originate that have terms of 15 years or more. We retain the servicing on a majority of the mortgage loans that we sell. To a lesser extent, we also originate commercial loans, commercial real estate loans and consumer loans. At December 31, 2011, we had total loans of \$142.7 million, of which \$66.6 million, or 46.7% were one- to four-family residential real estate mortgage loans, \$54.2 million, or 38.0% were commercial real estate loans, and \$7.0 million, or 4.9%, were commercial loans. Other loans consisted primarily of home equity loans, which totaled \$13.4 million, or 9.4% of total loans, and other consumer loans which totaled \$1.5 million, or 1.0% of total loans.

**One- to Four-Family Residential Real Estate Lending.** Our primary lending activity consists of originating one- to four-family owner-occupied residential mortgage loans, virtually all of which are collateralized by properties located in our market area. We also originate one- to four-family loans that pay interest only during the initial construction period (which generally does not exceed twelve months) and then pay interest and principal for the remainder of the loan term. We generally sell into the secondary mortgage market most of our one- to four-family fixed-rate mortgage

loans with terms of 15 years or more and retain the loan servicing on a majority of these mortgage loans. One- to four-family residential mortgage loans are underwritten and originated according to policies and guidelines established by the secondary mortgage market agencies and approved by our Board of Directors. We utilize existing liquidity, deposits, loan repayments, and Federal Home Loan Bank advances to fund new loan originations.

We currently offer fixed rate one- to four-family residential mortgage loans with terms ranging from 15 to 30 years. One- to four-family residential mortgage loans often remain outstanding for significantly shorter periods than their contractual terms because borrowers may refinance or prepay loans at their option. The average length of time that our one- to four-family residential mortgage loans remain outstanding varies significantly depending upon trends in market interest rates and other factors. In recent years, the average maturity of our mortgage loans has decreased significantly because of the declining trend in market interest rates and the unprecedented volume of refinancing activity resulting from such interest rate decreases. Accordingly, estimates of the average length of one- to four-family loans that remain outstanding cannot be made with any degree of certainty.

Originations of fixed rate mortgage loans are regularly monitored and are affected significantly by the level of market interest rates, our interest rate gap position, and loan products offered by our competitors. Our fixed rate mortgage loans amortize on a monthly basis with principal and interest due each month. To make our loan portfolio less interest rate sensitive, fixed-rate loans originated with terms of 15 years or greater are generally underwritten to secondary mortgage market standards and sold. Adjustable rate mortgage loans are generally underwritten to secondary mortgage market standards, but are retained in our loan portfolio.

We have in the past originated some fixed-rate loans that are generally amortized over 15 years but that have “balloon payments” that are due upon the maturity of the loan in five years. As a general rule, we no longer originate this type of mortgage loan. Upon maturity, existing balloon mortgage loans are either underwritten as fixed-rate loans and sold in the secondary mortgage market or rewritten as adjustable rate mortgages at current market rates. While the majority of our balloon mortgage loans amortize over 15 years, some amortize over 10 or 30 years, and a limited number amortize over five years.

Our one- to four-family residential mortgage loans customarily include due-on-sale clauses, which are provisions giving us the right to declare a loan immediately due and payable in the event, among other things, that the borrower sells or otherwise disposes of the underlying real property serving as security for the loan. Due-on-sale clauses are an important means of adjusting the rates on our fixed-rate mortgage loan portfolio, and we have generally exercised our rights under these clauses.

Regulations limit the amount that a savings institution may lend relative to the appraised value of the real estate securing the loan, as determined by an appraisal at the time of loan origination. Such regulations permit a maximum loan-to-value ratio of 100% for residential property and 90% for all other real estate loans. Our lending policies limit the maximum loan-to-value ratio on fixed-rate loans without private mortgage insurance to 80% of the lesser of the appraised value or the purchase price of the property serving as collateral for the loan.

We make one- to four-family real estate loans with typical loan-to-value ratios of up to 90%. However, for one- to four-family real estate loans with loan-to-value ratios of between 80% and 90%, we may require the borrower to purchase private mortgage insurance. In 2005 we began making 80/20 loans and interest-only loans subject to Board-approved dollar limits to limit risk exposure. In late 2007 these products were eliminated; however, at December 31, 2011 approximately \$465,000 of these products remained in our portfolio. We require fire and casualty insurance, flood insurance when applicable, as well as title insurance, on all properties securing real estate loans made by us.

***Commercial Real Estate Lending.*** We also originate commercial real estate loans. At December 31, 2011, we had a total of 180 loans secured primarily by commercial real estate properties, unimproved vacant land and, to a limited extent, multifamily properties. Our commercial real estate loans are secured by income-producing properties such as office buildings, retail buildings, restaurants and motels. A majority of our commercial real estate loans are secured by properties located in our primary market area, although at December 31, 2011 we did have \$7.8 million in commercial real estate loans located outside of Michigan. We have originated commercial construction loans that are originated as permanent loans but are interest-only during the initial construction period, which generally does not exceed nine months. At December 31, 2011, our commercial real estate loans, totaled \$54.2 million, or 38.0% of our total loans, and had an average principal balance of approximately \$327,000. The terms of each loan are negotiated on a case-by-case basis, although such loans typically amortize over 15 years and have a three- or five-year balloon feature. An origination fee of 0.5% to 1.0% is generally charged on commercial real estate loans. We generally make commercial real estate loans up to 75% of the appraised value of the property securing the loan.

At December 31, 2011, our largest commercial real estate relationship consisted of seven loans having a total principal balance of \$2.3 million, which were all performing according to their repayment terms as of December 31, 2011. This loan relationship is secured by five pieces of commercial real estate. Our largest single commercial real estate loan was a loan of \$3.4 million, of which \$1.4 million has been participated to other banks, leaving a net exposure on our books of \$2.0 million. This loan is secured by a non-residential real estate property, furniture, fixtures and all other assets. At December 31, 2011, this loan was performing according to its repayment terms.

Commercial real estate loans generally carry higher interest rates and have shorter terms than those on one- to four-family residential mortgage loans. However, loans secured by commercial real estate generally involve a greater degree of credit risk than one- to four-family residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the business or the related real estate property. If the cash flow from the business operation is reduced, the borrower's ability to repay the loan may be impaired. This may be particularly true in the early years of the business operation when the risk of failure is greatest. Many of our commercial real estate loans have been made to borrowers whose business operations are untested, which increases our risk.

**Consumer and Other Loans.** We originate a variety of consumer and other loans, including loans secured by savings accounts, new and used automobiles, mobile homes, boats, recreational vehicles, and other personal property. As of December 31, 2011, consumer and other loans totaled \$14.9 million, or 10.4% of our total loan portfolio. At such date, \$412,000, or 0.3% of our consumer loans, were unsecured. As of December 31, 2011, home equity loans totaled \$13.4 million, or 9.4% of our total loan portfolio, and automobile loans totaled \$774,000, or 0.5% of our total loan portfolio. We originate automobile loans directly to our customers and have no outstanding agreements with automobile dealerships to generate indirect loans.

Our procedures for underwriting consumer loans include an assessment of an applicant's credit history and the ability to meet existing obligations and payments on the proposed loan. Although an applicant's creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral security, if any, to the proposed loan amount.

Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that tend to depreciate rapidly, such as automobiles, mobile homes, boats and recreational vehicles. In addition, the repayment of consumer loans depends on the borrower's continued financial stability, as repayment is more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy than a single family mortgage loan.

**Commercial Loans.** At December 31, 2011, we had \$7.0 million in commercial loans which amounted to 4.9% of total loans. We make commercial loans primarily in our market area to a variety of professionals, sole proprietorships and small businesses. Commercial lending products include term loans and revolving lines of credit. The maximum amount of a commercial loan is our loans-to-one-borrower limit, which was \$3.6 million at December 31, 2011. Such loans are generally used for longer-term working capital purposes such as purchasing equipment or furniture. Commercial loans are made with either adjustable or fixed rates of interest. Variable rates are generally based on the prime rate, as published in *The Wall Street Journal*, plus a margin. Fixed rate commercial loans are set at a margin above the Federal Home Loan Bank comparable advance rate.

When making commercial loans, we consider the financial statements of the borrower, our lending history with the borrower, the debt service capabilities of the borrower, the projected cash flows of the business and the value of the collateral. Commercial loans are generally secured by a variety of collateral, primarily accounts receivable, inventory and equipment, and are supported by personal guarantees. Depending on the collateral used to secure the loans, commercial loans are typically made in amounts of up to 75% of the value of the collateral securing the loan.

Commercial loans generally have greater credit risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income, and which are secured by real property whose value tends to be more easily ascertainable, commercial loans generally are made on the basis of the borrower's ability to repay the loan from the cash flow of the

borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. If the cash flow from the business operation is reduced, the borrower's ability to repay the loan may be impaired. This may be particularly true in the early years of the business operation when the risk of failure is greatest. Moreover, any collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. We seek to minimize these risks through our underwriting standards. At December 31, 2011, our largest commercial loan was a \$2.4 million commercial participation loan collateralized by manufacturing equipment and a related plant facility. At December 31, 2011, the outstanding balance was \$2.3 million and the loan was performing according to its repayment terms.

**Construction Loans.** We originate construction loans to local home builders in our market area, generally with whom we have an established relationship, and to individuals engaged in the construction of their residences. We also originate loans for the construction of commercial buildings and, to an extent, participate in construction loan projects originated by other lenders. Our construction loans totaled \$762,000, or 0.6% of our total loan portfolio, at December 31, 2011.

Our construction loans to home builders are repaid on an interest-only basis for the term of the loan (which is generally six to 12 months), with interest calculated on the amount disbursed to the builders based upon a percentage of completion of construction. These loans typically have a maximum loan-to-value ratio of 80%, based on the appraised value. Interest rates are fixed during the construction phase of the loan. Loans to builders are made on either a pre-sold or speculative (unsold) basis. Most of our construction loans to individuals who intend to occupy the completed dwelling are originated via a "one-step closing" process, whereby the construction phase and end-financing are handled with one loan closing. Prior to funding a construction loan, we require an appraisal of the property from a qualified appraiser approved by us, and all appraisals are reviewed by us.

Construction lending exposes us to greater credit risk than permanent mortgage financing because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction costs is inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion is inaccurate, the value of the property may be insufficient to assure full repayment. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the repayment of the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. We have attempted to minimize these risks by, among other things, limiting our residential construction lending primarily to residential properties in our market area and generally requiring personal guarantees from the principals of corporate borrowers.

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

	At December 31, 2011		2010		2009		2008		2007		Percent
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount		
	(Dollars in thousands)										
Real estate loans:											
Residential Mortgages:											
1-4 Family Mortgages	\$64,177	45.0	% \$68,298	42.7	% \$77,851	44.4	% \$87,179	44.1	% \$91,433	44.5	
Purchased Mortgage	1,924	1.3	% 3,243	2.0	% 3,342	1.9	% 3,802	1.9	% 4,531	2.2	
In-State Purchased Mortgage	-	0.0	% -	0.0	% -	0.0	% 358	0.2	% 1,302	0.6	
Out-of-State 1-4 Family Construction Home Equity/Junior Liens	498	0.3	% 156	0.1	% 427	0.2	% 1,025	0.5	% 2,108	1.0	
Nonresidential Mortgages:											
Nonresidential Purchased	44,020	30.9	% 43,580	27.3	% 43,446	24.8	% 42,526	21.5	% 44,634	21.7	
Nonresidential In-State	2,130	1.5	% 4,232	2.6	% 3,894	2.2	% 257	0.1	% -	0.0	
	7,788	5.5	% 9,928	6.2	% 8,428	4.8	% 3,141	1.6	% 1,295	0.6	



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Purchased Nonresidential Out-of-State Nonresidential Construction	91	0.1	%	1,498	0.9	%	2,816	1.6	%	6,635	3.3	%	6,184	3.0
Purchased Construction Out-of-State	173	0.1	%	1,772	1.1	%	3,792	2.2	%	9,781	4.9	%	4,920	2.4
Non real estate loans:														
Commercial Loans	6,621	4.6	%	7,382	4.6	%	7,035	4.0	%	15,816	8.0	%	19,181	9.3
Purchased Commerical Loans In-State	381	0.3	%	1,466	0.9	%	2,838	1.6	%	1,804	0.9	%	1,387	0.7
Consumer and other loans	1,477	1.0	%	2,118	1.3	%	2,553	1.6	%	3,564	1.7	%	4,555	2.3
Total Loans	\$142,675	100.00%		\$160,220	100.00%		\$175,154	100.00%		\$198,191	100.00%		\$205,625	100.00%
Other items:														
Deferred loan origination costs	14			31			12			13			13	
Deferred loan origination fees	(287 )			(276 )			(287 )			(287 )			(292 )	
Allowance for loan losses	(1,518 )			(2,831 )			(3,660 )			(5,647 )			(4,013 )	
Total loans, net	\$140,884			\$157,144			\$171,219			\$192,270			\$201,333	

***Loan Portfolio Maturities and Yield.*** The following table summarizes the scheduled repayments of our loan portfolio at December 31, 2011. Demand loans, loans having no stated repayment or maturity, and overdraft loans are reported as being due in one year or less.

Due During the Years Ending December 31,	1-4 Family Mortgage		Purchased Mortgage In-State		Purchased Mortgage Out-of State		1-4 Family Construction	
	Amount	Weighted	Amount	Weighted	Amount	Weighted	Amount	Weighted
		Average Rate		Average Rate		Average Rate		Average Rate
2012	\$ 182	7.11 %	\$ -	0.00 %	\$ -	0.00 %	\$ 498	3.54 %
2013	915	6.31 %	-	0.00 %	-	0.00 %	-	0.00 %
2014	610	6.89 %	-	0.00 %	-	0.00 %	-	0.00 %
2015 to 2016	377	6.82 %	-	0.00 %	-	0.00 %	-	0.00 %
2017 to 2021	8,068	5.87 %	-	0.00 %	-	0.00 %	-	0.00 %
2022 to 2026	15,777	5.59 %	34	5.83 %	-	0.00 %	-	0.00 %
2027 and beyond	38,248	6.18 %	1,890	3.23 %	-	0.00 %	-	0.00 %
<b>Total</b>	<b>\$64,177</b>	<b>6.04 %</b>	<b>\$1,924</b>	<b>4.10 %</b>	<b>\$ -</b>	<b>0.00 %</b>	<b>\$ 498</b>	<b>3.54 %</b>

Due During the Years Ending December 31,	Home Equity/Junior Liens		Nonresidential		Purchased Nonresidential In-State		Purchased Nonresidential Out-of-State	
	Amount	Weighted	Amount	Weighted	Amount	Weighted	Amount	Weighted
		Average Rate		Average Rate		Average Rate		Average Rate
2012	\$ 46	7.42 %	\$ 18,322	6.61 %	\$ -	0.00 %	\$ 2,057	5.58 %
2013	104	7.08 %	7,946	6.66 %	222	6.34 %	-	0.00 %
2014	209	6.75 %	4,296	6.16 %	1,835	5.12 %	2,264	7.25 %
2015 to 2016	1,168	7.63 %	10,723	6.00 %	73	7.58 %	1,643	4.56 %
2017 to 2021	5,479	5.85 %	748	5.74 %	-	0.00 %	-	0.00 %
2022 to 2026	6,389	4.80 %	922	7.43 %	-	0.00 %	-	0.00 %
2027 and beyond	-	0.00 %	1,063	6.28 %	-	0.00 %	1,824	5.16 %
<b>Total</b>	<b>\$ 13,395</b>	<b>5.89 %</b>	<b>\$ 44,020</b>	<b>6.47 %</b>	<b>\$ 2,130</b>	<b>6.35 %</b>	<b>\$ 7,788</b>	<b>5.54 %</b>

Nonresidential Construction	Purchased Construction In-State	Purchased Construction Out-of-State	Commercial Loans
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	Weighted Average		Weighted Average		Weighted Average		Weighted Average	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
Due During the Years Ending December 31,								
2012	\$ 91	7.10 %	\$ -	0.00 %	\$ -	0.00 %	\$ 1,710	6.36 %
2013	-	0.00 %	-	0.00 %	-	0.00 %	907	5.27 %
2014	-	0.00 %	-	0.00 %	173	9.38 %	401	6.37 %
2015 to 2016	-	0.00 %	-	0.00 %	-	0.00 %	3,525	6.33 %
2017 to 2021	-	0.00 %	-	0.00 %	-	0.00 %	78	3.19 %
2022 to 2026	-	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
2027 and beyond	-	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Total	\$ 91	7.10 %	\$ -	0.00 %	\$ 173	9.38 %	\$ 6,621	5.82 %

	Purchased Commercial Loans In-State		Purchased Commercial Loans Out-of State		Consumer & Other Loans		Total	Weighted Average	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	
Due During the Years Ending December 31,									
2012	\$ -	0.00 %	\$ -	0.00 %	\$ 53	8.02 %	\$ 22,959	6.72 %	
2013	381	6.34 %	-	0.00 %	92	7.68 %	10,567	6.20 %	
2014	-	0.00 %	-	0.00 %	87	8.43 %	9,875	6.87 %	
2015 to 2016	-	0.00 %	-	0.00 %	392	7.05 %	17,901	7.22 %	
2017 to 2021	-	0.00 %	-	0.00 %	752	9.37 %	15,125	6.06 %	
2022 to 2026	-	0.00 %	-	0.00 %	101	8.00 %	23,223	5.16 %	
2027 and beyond	-	0.00 %	-	0.00 %	-	0.00 %	43,025	6.17 %	
Total	\$ 381	6.34 %	\$ -	0.00 %	\$ 1,477	8.65 %	\$ 142,675	6.09 %	

**Fixed- and Adjustable-Rate Loans.** The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2011 that are contractually due after December 31, 2012.

	Due After December 31, 2012		
	Fixed	Adjustable	Total
	(In thousands)		
Residential Mortgages:			
1-4 Family Mortgages	\$35,759	\$ 28,236	\$63,995
Purchased Mortgage In-State	-	1,924	1,924
Home Equity/Junior Liens	5,775	7,574	13,349
Nonresidential Mortgages:			
Nonresidential	16,065	9,633	25,698
Purchased Nonresidential In-State	2,130	-	2,130
Purchased Nonresidential Out-of-State	2,264	3,467	5,731
Purchased Construction Out-of-State	-	173	173
Non real estate loans:			
Commercial Loans	2,948	1,963	4,911
Purchased Commerical Loans In-State	381	-	381
Consumer and other loans	1,048	376	1,424
Total Loans	\$66,370	\$ 53,346	\$ 119,716

**Loan Originations, Purchases, Sales and Servicing.** While we originate both fixed-rate and adjustable-rate loans, our ability to generate each type of loan depends upon borrower demand, market interest rates, borrower preference for fixed- versus adjustable-rate loans, and the interest rates offered on each type of loan by other lenders in our market area. These lenders include competing banks, savings banks, credit unions, internet lenders, mortgage banking companies and life insurance companies that may also actively compete for local commercial real estate loans. Loan originations are derived from a number of sources, including real estate agent referrals, existing customers, borrowers, builders, attorneys, our directors, walk-in customers and our own sales force. Upon receiving a loan application, we obtain a credit report and employment verification to verify specific information relating to the applicant's employment, income, and credit standing. In the case of a real estate loan, we obtain a determination of value of the real estate intended to collateralize the proposed loan. Our residential mortgage lending limits vary by residential mortgage officer but range from \$150,000 to \$250,000. While certain Senior Bank Officers have residential lending limits up to \$400,000, the Officer Loan Committee generally approves residential loans from \$250,000 to \$400,000 while requests from \$400,000 to \$500,000 will receive approval from Senior Loan Committee. Residential loan requests over \$500,000 must be approved by the Board of Directors. Secured consumer lending limits by officer range from \$25,000 to \$150,000. For secured commercial loans, the limits range from \$250,000 to \$400,000.

A commercial commitment letter specifies the terms and conditions of the proposed loan including the amount of the loan, interest rate, amortization term, a brief description of the required collateral, and required insurance coverage. Commitments are typically issued for 15-day periods. The borrower must provide proof of fire and casualty insurance on the property serving as collateral, which must be maintained during the full term of the loan. A title insurance

policy is required on all real estate loans. At December 31, 2011, we had outstanding loan commitments of \$24.4 million, including unfunded commitments under lines of credit and commercial and standby letters of credit.

Our loan origination and sales activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand, while declining interest rates may stimulate increased loan demand. Accordingly, the volume of loan originations, the mix of fixed- and adjustable-rate loans, and the profitability of this activity can vary from period to period. One- to four-family residential mortgage loans are generally underwritten to investor guidelines, and closed on standard investor documents. We currently sell loans to Freddie Mac. If such loans are sold, the sales are conducted using standard investor purchase contracts and master commitments as applicable. The majority of one- to four-family mortgage loans that we have sold to investors have been sold on a non-recourse basis, whereby foreclosure losses are generally the responsibility of the purchaser and not First Federal of Northern Michigan.

We are a qualified loan servicer for Freddie Mac. Our policy has historically been to retain the servicing rights for all conforming loans sold, and to continue to collect payments on the loans, maintain tax escrows and applicable fire and flood insurance coverage, and supervise foreclosure proceedings if necessary. We retain a portion of the interest paid by the borrower on the loans as consideration for our servicing activities.

We require appraisals of real property securing loans. Appraisals are performed by independent appraisers, who are approved by our Board of Directors annually. We require fire and extended coverage insurance in amounts adequate to protect our principal balance. Where appropriate, flood insurance is also required. Private mortgage insurance is required for most residential mortgage loans with loan-to-value ratios greater than 80%.

**Loan Origination Fees and Costs.** In addition to interest earned on loans, we generally receive fees in connection with loan originations. Such loan origination fees, net of costs to originate, are deferred and amortized using an interest method over the contractual life of the loan. Fees deferred are recognized into income immediately upon prepayment or subsequent sale of the related loan. At December 31, 2011, we had \$273,000 of net deferred loan origination fees. Such fees vary with the volume and type of loans and commitments made and purchased, principal repayments, and competitive conditions in the mortgage markets, which in turn respond to the demand and availability of money. In addition to loan origination fees, we also generate other income through the sales and servicing of mortgage loans, late charges on loans, and fees and charges related to deposit accounts. We recognized fees and service charges of \$730,000, \$804,000 and \$869,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

To the extent that originated loans are sold with servicing retained, we capitalize a mortgage servicing asset at the time of the sale in accordance with applicable accounting standards (FASB ASC 860, "Transfers and Servicing"). The capitalized amount is amortized thereafter (over the period of estimated net servicing income) as a reduction of servicing fee income. The unamortized amount is fully charged to income when loans are prepaid. Originated mortgage servicing rights with an amortized cost of \$993,000 were included in other assets at December 31, 2011.

**Origination, Purchase and Sale of Loans.** The table below shows our loan originations, purchases, sales, and repayments of loans for the periods indicated.

	Years Ended December 31,		
	2011	2010	2009
	(In Thousands)		
Loans receivable at beginning of period	\$160,220	\$175,154	\$198,191
Originations:			
Real estate:			

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Residential 1-4 family	38,150	47,838	58,909
Commercial and Multi-family	12,941	14,841	17,254
Consumer	2,113	3,660	3,894
Total originations	53,204	66,339	80,057
Loan purchases:			
Residential 1-4 family	-	-	-
Commercial	1,000	-	4,914
Total loan purchases	1,000	-	4,914
Loan sales	(28,353 )	(42,151 )	(49,545 )
Transfer of loans to foreclosed assets	(3,459 )	(2,080 )	(6,382 )
Repayments	(39,937 )	(37,042 )	(52,081 )
Total loans receivable at end of period	\$142,675	\$160,220	\$175,154



## **Delinquent Loans, Other Real Estate Owned and Classified Assets**

**Collection Procedures.** Our general collection procedures provide that when a commercial loan becomes 10 days past due and when a mortgage or consumer loan become 15 days past due, a computer-generated late charge notice is sent to the borrower requesting payment. If delinquency continues, a second delinquent notice is mailed when the loan continues past due for 30 days. If a loan becomes 60 days past due, the loan becomes subject to possible legal action. We will generally send a “due and payable” letter upon a loan becoming 60 days delinquent. This letter grants the borrower 30 days to bring the account paid to date prior to the start of any legal action. If not paid, foreclosure proceedings are initiated after this 30-day period. To the extent required by regulations of the Department of Housing and Urban Development (“HUD”), generally within 30 days of delinquency, a Section 160 HUD notice is given to the borrower which provides access to consumer counseling services. General collection procedures may vary with particular circumstances on a loan by loan basis. Also, collection procedures for Freddie Mac serviced loans follow the Freddie Mac guidelines which are different from our general procedures.

**Loans Past Due and Non-Performing Assets.** Loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collection of additional interest is doubtful or when extraordinary efforts are required to collect the debt. Interest accrued and unpaid at the time a loan is placed on non-accrual status is charged against interest income.

Real estate acquired by us as a result of foreclosure or by deed in lieu of foreclosure is deemed real estate owned (“REO”) until such time as it is sold. In general, we consider collateral for a loan to be “in-substance” foreclosed if: (i) the borrower has little or no equity in the collateral; (ii) proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; and (iii) the borrower has either formally or effectively abandoned control of the collateral, or retained control of the collateral but is unlikely to be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future. Cash flow attributable to in-substance foreclosures is used to reduce the carrying value of the collateral.

When collateral, other than real estate, securing commercial and consumer loans is acquired as a result of delinquency or other reasons, it is classified as Other Repossessed Assets (“ORA”) and recorded at the lower of cost or fair market value until it is disposed of.

When collateral is acquired or otherwise deemed REO/ORA, it is recorded at the lower of the unpaid principal balance of the related loan or its estimated net realizable value. This write down is recorded against the allowance for loan losses. Periodic future valuations are performed by management, and any subsequent decline in fair value is charged to operations. At December 31, 2011, we held \$2.1 million in properties that were classified REO and \$1.3 million in assets classified as ORA.



**Delinquent Loans.** The following table sets forth certain information with respect to our loan portfolio delinquencies at the dates indicated.

	At December 31,				
	2011	2010	2009	2008	2007
	(Dollars in thousands)				
<b>Non-Accrual Loans:</b>					
Residential Mortgage	\$2,420	\$3,114	\$2,944	\$1,876	\$697
Commercial Mortgage	356	1,148	2,204	4,002	3,825
Construction	-	-	1,433	3,469	3,475
Purchased Out-of-State	173	1,772	2,113	1,980	-
Commercial	-	-	96	535	433
Consumer and other	152	206	157	90	29
<b>Total non-accrual loans</b>	<b>\$3,101</b>	<b>\$6,240</b>	<b>\$8,947</b>	<b>\$11,952</b>	<b>\$8,459</b>
<b>Accrual loans delinquent 90 days or more:</b>					
Residential Mortgage	238	282	89	128	532
Commercial Mortgage	-	82	2,696	72	-
Construction	-	-	-	-	-
Purchased Out-of-State	-	-	-	-	-
Commercial	-	-	-	-	100
Consumer and other	-	2	54	17	45
<b>Total accrual loans delinquent 90 days or more</b>	<b>\$238</b>	<b>\$366</b>	<b>\$2,839</b>	<b>\$217</b>	<b>\$677</b>
<b>Total nonperforming loans (1)</b>	<b>\$3,339</b>	<b>\$6,606</b>	<b>\$11,786</b>	<b>\$12,169</b>	<b>\$9,136</b>
<b>Real Estate Owned and Other Repossessed Assets:</b>					
Residential Mortgage	1,087	494	584	686	872
Commercial Mortgage	1,015	2,304	2,985	882	406
Construction	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer and other	1,306	20	11	70	2
<b>Total real estate owned and other repossessed assets (2)</b>	<b>\$3,408</b>	<b>\$2,818</b>	<b>\$3,580</b>	<b>\$1,638</b>	<b>\$1,280</b>
<b>Total nonperforming assets</b>	<b>\$6,747</b>	<b>\$9,424</b>	<b>\$15,366</b>	<b>\$13,807</b>	<b>\$10,416</b>
<b>Total nonperforming loans to total loans receivable</b>	<b>2.34 %</b>	<b>4.12 %</b>	<b>6.73 %</b>	<b>6.14 %</b>	<b>4.54 %</b>
<b>Total nonperforming assets to total assets</b>	<b>3.11 %</b>	<b>4.37 %</b>	<b>6.58 %</b>	<b>5.57 %</b>	<b>4.15 %</b>

(1) All of our loans delinquent 90 days or more are classified as nonperforming.

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

related loan.

**Nonperforming Assets.** The following table sets forth the amounts and categories of our non-performing assets at the dates indicated.

	Loan Delinquent For		90 Days and		Total	
	60-89 Days	90 Days and Over	Number	Amount	Number	Amount
(Dollars In Thousands)						
<u>At December 31, 2011</u>						
Residential Mortgages	16	\$ 1,501	23	\$ 1,969	39	\$ 3,470
Commercial Mortgages	3	339	1	245	4	584
Construction	-	-	1	173	1	173
Commercial	1	29	-	-	1	29
Consumer	6	59	5	128	11	187
Total	26	\$ 1,928	30	\$ 2,515	56	4,443
<u>At December 31, 2010</u>						
Residential Mortgages	23	\$ 2,056	34	\$ 2,434	57	\$ 4,490
Commercial Mortgages	3	488	8	784	11	1,272
Construction	-	-	2	1,772	2	1,772
Commercial	1	6	-	-	1	6
Consumer	10	122	9	207	19	329
Total	37	\$ 2,672	53	\$ 5,197	90	7,869
<u>At December 31, 2009</u>						
Residential Mortgages	22	\$ 1,819	23	\$ 1,719	45	\$ 3,538
Commercial Mortgages	7	1,125	12	3,705	19	4,830
Construction	2	1,255	1	290	3	1,545
Commercial	3	402	1	80	4	482
Consumer	14	226	14	135	28	361
Total	48	\$ 4,827	51	\$ 5,929	99	10,756
<u>At December 31, 2008</u>						
Residential Mortgages	26	\$ 2,513	13	\$ 766	39	\$ 3,279
Commercial Mortgages	8	1,359	6	5,879	14	7,238
Construction	-	-	2	1,980	2	1,980
Commercial	1	95	1	72	2	167
Consumer	26	155	10	66	36	221
Total	61	\$ 4,122	32	\$ 8,763	93	12,885
<u>At December 31, 2007</u>						
Residential Mortgages	24	\$ 1,315	6	\$ 532	30	\$ 1,847
Commercial Mortgages	1	797	-	-	1	797
Construction	-	-	-	-	-	-
Commercial	-	-	1	100	1	100
Consumer	19	181	10	45	29	226

Total	44	\$ 2,293	17	\$ 677	61	2,970
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Interest income that would have been recorded for the year ended December 31, 2011, had non-accruing loans been current according to their original terms amounted to \$678,000. Interest of \$59,000 was recognized on these impaired loans prior to placing them on non-accrual status, and is included in net income for the year ended December 31, 2011.

**Classification of Assets.** Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets such as debt and equity securities and real estate held for sale considered by the Office of the Comptroller of the Currency (OCC) to be of lesser quality as “substandard,” “doubtful,” or “loss” assets. An asset is considered “substandard” if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. “Substandard” assets include those characterized by the “distinct possibility” that the savings institution will sustain “some loss” if the deficiencies are not corrected. Assets classified as “doubtful” have all of the weaknesses inherent in those classified “substandard,” with the added characteristic that the weaknesses present make “collection or liquidation in full,” on the basis of currently existing facts, conditions, and values, “highly questionable and improbable.” Assets classified as “loss” are those considered “uncollectible” and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not expose the savings institution to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses, are required to be designated “special mention” by management. Loans designated as special mention are generally loans that, while current in required payments, have exhibited some potential weaknesses that, if not corrected, could increase the level of risk in the future.

The allowance for loan losses represents amounts that have been established to recognize losses inherent in the loan portfolio that are both probable and reasonably estimable at the date of the financial statements. When we classify problem assets as loss, we charge-off such amount. Our determination as to the classification of our assets and the amount of our loss allowances are subject to review by our regulatory agencies, which can order the establishment of additional loss allowances. Management regularly reviews our asset portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of management’s review of our assets at December 31, 2011, classified assets consisted of substandard assets of \$16.4 million. There were no assets classified as doubtful or loss at December 31, 2011.

We classify our assets pursuant to criteria similar to the classification structure provided in the OCC regulations. The following table sets forth the aggregate amount of our internally classified assets at the dates indicated.

	At December 31,				
	2011	2010	2009	2008	2007
	(In Thousands)				
Substandard assets	\$16,435	\$15,974	\$18,141	\$19,409	\$14,362
Doubtful assets	-	-	-	-	-
Loss assets	-	-	-	-	-
Total classified assets	\$16,435	\$15,974	\$18,141	\$19,409	\$14,362

**Allowance for Loan Losses.** We provide for loan losses based on the allowance method. Accordingly, all loan losses are charged to the related allowance and all recoveries are credited to it. Additions to the allowance for loan losses are provided by charges to income based on various factors which, in management’s judgment, deserve current recognition in estimating probable losses. Management regularly reviews the loan portfolio and makes provisions for loan losses in order to maintain the allowance for loan losses in accordance with accounting principles generally accepted in the

United States of America. The allowance for loan losses consists of amounts specifically allocated to non-performing loans and other criticized or classified loans (if any) as well as general allowances determined for each major loan category. Commercial loans and loans secured by commercial real estate are evaluated individually for impairment. Other smaller-balance, homogeneous loan types, including loans secured by one- to four-family residential real estate and consumer installment loans, are evaluated for impairment on a collective basis. After we establish a provision for loans that are known to be non-performing, criticized or classified, we calculate percentage loss factors to apply to the remaining categories within the loan portfolio to estimate probable losses inherent in these categories of the portfolio. When the loan portfolio increases, therefore, the percentage calculation results in a higher dollar amount of estimated probable losses than would be the case without the increase, and when the loan portfolio decreases, the percentage calculation results in a lower dollar amount of estimated probable losses than would be the case without the decrease. These percentage loss factors are determined by management based on our historical loss experience and credit concentrations for the applicable loan category, which may be adjusted to reflect our evaluation of levels of, and trends in, delinquent and non-accrual loans, trends in volume and terms of loans, and local economic trends and conditions.



We consider commercial and commercial real estate loans and construction loans to be riskier than one- to four-family residential mortgage loans. Commercial and commercial real estate loans have greater credit risks compared to one- to four-family residential mortgage loans, as they typically involve large loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment experience on loans secured by income-producing properties typically depends on the successful operation of the related real estate project and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy. Construction loans have greater credit risk than permanent mortgage financing because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction costs is inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion is inaccurate, the value of the property may be insufficient to assure full repayment. Projects also may be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the repayment of the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The increased risk characteristics associated with commercial real estate and land loans and construction loans are considered by management in the evaluation of the allowance for loan losses and generally result in a larger loss factor applied to these segments of the loan portfolio in developing an estimate of the required allowance for loan losses. We intend to increase our originations of commercial and commercial real estate loans, and we intend to retain these loans in our portfolio. Because these loans entail significant additional credit risks compared to one- to four-family residential mortgage loans, an increase in our origination (and retention in our portfolio) of these types of loans would, in the absence of other offsetting factors, require us to make additional provisions for loan losses.

The carrying value of loans is periodically evaluated and the allowance is adjusted accordingly. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, our regulatory agencies periodically review the allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

***Analysis of the Allowance for Loan Losses.*** The following table sets forth the activity on our allowance for loan losses for the periods indicated.

For the Years Ended December 31,  
2011 2010 2009 2008 2007  
(Dollars in thousands)

Allowance at beginning of period	\$2,831	\$3,660	\$5,647	\$4,013	\$2,079
(Charge-offs):					
Real Estate:					
Residential Mortgages	(1,119)	(258 )	(362 )	(342 )	(225 )
Nonresidential Real Estate:					
Commercial Mortgages	(334 )	(198 )	(4,903)	(2,023)	(59 )
Purchased In-State	-	-	(2,482)	-	-
Purchased Out-of-State	(93 )	(314 )	-	-	-
Construction	-	(751 )	-	-	-
Purchased In-State	-	-	-	-	-
Purchased Out-of-State	-	(262 )	-	-	-
Non Real Estate Loans:					
Commercial	(6 )	-	(246 )	(331 )	(4 )
Consumer and other	(192 )	(319 )	(254 )	(141 )	(190 )
Total charge offs	(1,744)	(2,102)	(8,247)	(2,837)	(478 )
Recoveries:					
Real Estate:					
Residential Mortgages	25	2	-	-	1
Purchased In-State	-	-	-	-	-
Purchased Out-of-State	-	-	-	-	-
Nonresidential Real Estate:					
Commercial Mortgages	79	85	-	-	-
Purchased In-State	-	-	-	-	-
Purchased Out-of-State	-	-	-	-	-
Construction	-	60	-	-	-
Purchased In-State	-	-	-	-	-
Purchased Out-of-State	-	-	-	-	-
Non Real Estate Loans:					
Commercial	1	-	-	-	-
Consumer and other	42	25	64	50	34
Total recoveries	147	172	64	50	35
Net (charge offs) recoveries	(1,597)	(1,930)	(8,183)	(2,787)	(443 )
Provision for loan losses	284	1,101	6,196	4,421	2,377
Balance at end of year	\$1,518	\$2,831	\$3,660	\$5,647	\$4,013
Ratios:					
Net Charge-offs to average loans outstanding (annualized)	1.02 %	1.14 %	4.58 %	1.40 %	0.21 %
Allowance for loan loss to non-performing loans at end of period	45.46 %	87.70 %	31.05 %	46.41 %	43.93 %

Allowance for loan losses to total loans at end of period            1.06 %   1.98 %   2.09 %   2.85 %   1.95 %

***Allocation of Allowance for Loan Losses.*** The following table sets forth the allowance for loan losses allocated by loan category, the total loan balances by category, and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	At December 31 2011		2010		2009			
	Allowance for Loan Losses	Percent of Each Category to Total Loans	Allowance for Loan Losses	Percent of Each Category to Total Loans	Allowance for Loan Losses	Percent of Each Category to Total Loans		
Residential Mortgages:								
1 - 4 family residential	\$858	45.0	% \$519	42.7	% \$634	44.4	%	
Purchased Mortgages In-State	12	1.3	% 17	2.0	% 12	1.9	%	
Purchased Mortgages Out-of-State	-	0.0	% -	0.0	% -	0.0	%	
1 - 4 family construction	-	0.3	% -	0.1	% 3	0.2	%	
Home Equity & Junior Liens	146	9.4	% 228	10.3	% 214	10.7	%	
Nonresidential Mortgages:								
Nonresidential	320	30.9	% 967	27.3	% 1,055	24.9	%	
Purchased Nonresidential In-State	16	1.5	% 94	2.6	% 140	2.2	%	
Purchased Nonresidential Out-of-State	57	5.5	% 220	6.2	% 175	4.8	%	
Construction	3	0.1	% 245	0.9	% 647	1.6	%	
Purchased Construction In-State	-	0.0	% -	0.0	% -	0.0	%	
Purchased Construction Out-of-State	7	0.1	% 290	1.1	% 350	2.2	%	
Non Real Estate Loans:								
Commercial	50	4.6	% 192	4.6	% 316	4.0	%	
Purchased Commercial In-State	3	0.3	% -	0.9	% 73	1.6	%	
Purchased Commercial Out-of-State	-	0.0	% -	0.0	% -	0.0	%	
Consumer	46	1.0	% 59	1.3	% 41	1.5	%	
Total	\$1,518	100.0	% \$2,831	100.0	% \$3,660	100.0	%	

	At December 31 2008		2007			
	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans		
Residential Mortgages:						
One to four family residential	\$967	44.0	% \$787	44.5	%	
Purchased Mortgages In-State	11	1.9	% 5	2.2	%	
Purchased Mortgages Out-of-State	1	0.2	% 1	0.6	%	
1 - 4 family construction	5	0.5	% 14	1.0	%	
Home Equity & Junior Liens	231	11.3	% 171	11.7	%	
Nonresidential Mortgages:						
Nonresidential	1,768	21.5	% 1,374	21.7	%	

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Purchased Nonresidential In-State	3	0.1	%	-	0.0	%
Purchased Nonresidential Out-of-State	14	1.6	%	5	0.6	%
Construction	7	3.3	%	18	3.0	%
Purchased Construction In-State	-	0.0	%	-	0.0	%
Purchased Construction Out-of-State	740	4.9	%	22	2.4	%
Non Real Estate Loans:						
Commercial	1,795	8.0	%	1,529	9.3	%
Purchased Commercial In-State	18	0.9	%	9	0.7	%
Purchased Commercial Out-of-State	32	0.0	%	14	0.0	%
Consumer	55	1.8	%	64	2.3	%
Total	\$5,647	100.0	%	\$4,013	100.0	%

## **Mortgage Banking Activities**

Our mortgage banking activities involve the origination and subsequent sale into the secondary mortgage market of one- to four-family residential mortgage loans. When loans are sold into the secondary market, we generally retain the rights to service those loans thereby maintaining our customer relationships. We intend to use these customer relationships to cross-sell additional products and services. Loans that we sell are originated using the same personnel and the same underwriting policies as loans that we maintain in our portfolio. The decision whether to sell a loan is dependent upon the type of loan product and the term of the loan. In recent years, we have sold most of our fixed-rate one- to four-family residential loans with maturities of 15 years or greater, and have retained servicing on most of these loans. For a brief period we sold some mortgage loans servicing-released to be able to offer additional products to our customers, however, we currently do not sell loans servicing-released.

Mortgage servicing involves the administration and collection of home loan payments. When we acquire mortgage servicing rights through the origination of mortgage loans and the subsequent sale of those loans with servicing rights retained, we allocate a portion of the total cost of the mortgage loans to the mortgage servicing rights based on their relative fair value. As of December 31, 2011, we were servicing loans sold to third parties totaling \$143.1 million, and the mortgage servicing rights associated with such loans had a book value, at such date, of \$993,000. Generally, the value of mortgage servicing rights increases as interest rates rise and decreases as interest rates fall, because the estimated life and estimated income from the underlying loans increase with rising interest rates and decrease with falling interest rates.

## **Insurance Brokerage Activities**

In March 2003, we acquired InsuranCenter of Alpena (“ICA”), a licensed insurance agency, to increase and diversify our sources of non-interest income. In April 2008, ICA sold to a non-related third party the rights to service certain health insurance contracts and collect commissions on the contracts written through the local Chambers of Commerce. This sale resulted in a nominal gain to us, but reduced health insurance revenues. The sale also reduced non-interest expenses and amortization of intangibles.

On February 27, 2009, we sold the majority of the assets of ICA. We retained the residual income stream associated with the April 2008 sale of its wholesale Blue Cross/Blue Shield override business to the third party. The financial position and results of operations of ICA are presented separately in our consolidated financial statements as “discontinued operations” through the date of sale. We continue to collect the residual revenue stream associated with this sale through FFNM Agency, the successor company to ICA.

See “-Subsidiary Activity” for a further discussion of ICA and FFNM Agency.

### **Real Estate Development Activities**

On a limited basis, we have purchased real estate for development through our subsidiary Financial Services & Mortgage Corporation. See "—Subsidiary Activity" for a discussion of our real estate development subsidiary, Financial Services & Mortgage Corporation. The last such purchase was a 37 acre lot which we purchased in 1994 for \$130,000. As of December 31, 2011, we had sold the 43 lots comprising this property. Our investment in land and real estate is "held for sale" and separately stated in the statement of financial condition, net of any allowance for impairment. Management actively marketed the property by using local real estate agents to facilitate the sale of these properties. For reporting purposes, this investment was considered "impaired" under the definition in FASB ASC 360-10, Accounting for Impairment or Disposal of Long-Lived Assets. Accordingly, the investment was recorded at the lower of its cost or fair value less cost to sell, which include realtor commissions, legal and title transfer fees, and closing costs that must be incurred before legal title could be transferred.

Annually, management used recent sales of comparable property to determine estimated future cash flows. The estimated future cash flows were used as the "fair value." The fair value, less cost to sell, was compared to the net carrying amount. If the fair value, less cost to sell, exceeded the recorded amount, a loss was recognized. Losses recognized for the initial and subsequent write-down to fair value, less cost to sell, are recognized in the "gain (loss) on the sale of real estate" line in the statement of income. A gain is recognized for any subsequent increase in fair value, less cost to sell, but not in excess of the cumulative loss previously recognized. A gain or loss not previously recognized that results from the sale of the property are recognized at the date of sale.

The last four lots were sold in January 2011 at a loss of less than \$1,000.

## Investment Activities

Our investment securities portfolio comprises U.S. Government, state agency and municipal obligations, mortgage-backed securities, Federal Home Loan Bank stock, and other investments of which \$53.0 million, or 95.6%, was available-for-sale and \$2.4 million, or 4.4%, of the total portfolio was classified as held-to-maturity. At December 31, 2011, we had no investments in unrated securities. At December 31, 2011, \$18.6 million, or 33.5% of our investment portfolio was scheduled to mature in less than five years, and \$37.0 million, or 66.7%, was scheduled to mature in over five years. At December 31, 2011, \$1.6 million, or 2.9% of our investment portfolio was scheduled to mature in less than one year.

At December 31, 2011, we held U.S. Government and state agency obligations and municipal obligations classified as available-for-sale, with a fair market value of \$22.1 million. While these securities generally provide lower yields than other investments such as mortgage-backed securities, our current investment strategy is to maintain investments in such instruments to the extent appropriate for liquidity purposes, as collateral for borrowings, and for prepayment protection.

We invest in mortgage-backed securities in order to: generate positive interest rate spreads with minimal administrative expense; lower credit risk as a result of the guarantees provided by Ginnie Mae and, to a lesser extent, Fannie Mae and Freddie Mac; supplement local loan originations; reduce interest rate risk exposure; and increase liquidity. Our mortgage-backed securities portfolio consists of pass-through certificates. At December 31, 2011, mortgage-backed securities totaled \$30.9 million, or 55.8% of total investments. At December 31, 2011, 0.01% of our mortgage-backed securities were secured by balloon loans. All of our pass-through certificates are insured or guaranteed by Freddie Mac, Ginnie Mae or Fannie Mae. Our policy is to hold mortgage-backed securities as available for sale.

We have interests in pools of single-family mortgages in which the principal and interest payments are passed from the mortgage originators, through intermediaries (generally government-sponsored agencies) that pool and repackage loans and sell the participation interest in the form of securities, to investors. These government-sponsored agencies include Freddie Mac, Ginnie Mae, or Fannie Mae. The underlying pool of mortgages can be comprised of either fixed-rate mortgage loans or adjustable-rate mortgage loans. The interest rate risk characteristics of the underlying pool of mortgages, *i.e.*, fixed-rate or adjustable rate, are shared by the investors in that pool.

During 2010 the Company restructured its investment portfolio by selling 16 bonds, mostly issued by Freddie Mac (FHLMC) and Fannie Mae (FNMA). Although these bonds have government guarantees, they are only implied guarantees, hence the bonds are not truly backed by the full faith and credit of the United States. The bonds sold were replaced with Ginnie Mae (GNMA) bonds, which are supported by the full faith and credit of the United States government. By selling the FNMA and FHLMC bonds the Company was able to accomplish two things:



Reduce its overall credit risk in the investment portfolio.

Improve its risk-based capital position as bonds sold were 20% risk-weighted while the replacement bonds are 0% risk-weighted.

The Company concluded this move was prudent and necessary due to the following reasons:

- Because of the timing of the restructuring, the Company was able to capture some previously unrealized gains.

The Company did forego a higher yield (approximately 10bps), but was able to minimize the yield loss by buying longer-term GNMA's, which was possible because of the minimal level of interest-rate risk inherent in the Company's balance sheet.

Our investment policy also permits investment in corporate debt obligations. Although corporate bonds may offer higher yields than U.S. Treasury or agency securities of comparable duration, corporate bonds also have a higher risk of default due to possible adverse changes in the creditworthiness of the issuer.

We are required under federal regulations to maintain a minimum amount of liquid assets that may be invested in specified short term securities and certain other investments. We generally have maintained a portfolio of liquid assets that exceeds regulatory requirements. Liquidity levels may be increased or decreased depending upon the yields on investment alternatives and upon management's judgment as to the attractiveness of the yields then available in relation to other opportunities and its expectation of the level of yield that will be available in the future, as well as management's projections as to the short term demand for funds to be used in our loan origination and other activities.

FASB ASC 320-10 requires that, at the time of purchase, we designate a security as held to maturity, available for sale, or trading, depending on our ability and intent. Securities available for sale are reported at fair value. As of December 31, 2011, all of our investment securities were designated as available for sale except for \$2.4 million in municipal bond investments designated as held to maturity.

**Investment Securities Portfolio.** The following table sets forth the composition of our investment securities portfolio at the dates indicated.

	At December 31, 2011		2010		2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Debt Securities:</b>						
U.S. Government and agency obligations	\$14,756	\$14,863	\$4,518	\$4,562	\$8,220	\$8,257
State agency and municipal obligations	9,362	9,941	7,395	7,641	11,798	12,143
Corporate bonds and other obligations	-	-	-	-	1,000	1,002
<b>Mortgage-backed securities:</b>						
<b>Pass-through securities:</b>						
Fannie Mae	4,984	4,990	296	306	8,579	8,887
Freddie Mac	3,981	3,974	1,078	1,095	4,823	4,922
Ginnie Mae	21,385	21,945	24,310	24,291	2,577	2,588
Total debt securities	54,468	55,713	37,597	37,895	36,997	37,799
Marketable equity securities Common stock	3	1	3	1	3	4
Total equity securities	3	1	3	1	3	4
Total investment securities	\$54,471	\$55,714	\$37,600	\$37,896	\$37,000	\$37,803

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*Portfolio Maturities and Yields.* The composition and maturities of the investment securities portfolio at December 31, 2011 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. State and municipal securities yields have not been adjusted to a tax-equivalent basis.

At December 31, 2011											
	One Year or Less		More than One Year Through Five years		More than Five Years Through Ten Years		More than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield
(Dollars in Thousands)											
<b>Debt Securities:</b>											
U.S. Government and agency securities	\$1,000	1.30%	\$12,256	2.12%	\$1,500	3.52%	\$-	0.00%	\$14,756	\$14,863	2.20%
State agency and municipal obligations	580	3.45%	4,459	4.28%	2,680	4.71%	1,643	4.75%	9,362	9,941	4.44%
Corporate bonds and other obligations	-	0.00%	-	0.00%	-	0.00%	-	0.00%	-	-	0.00%
<b>Mortgage-backed securities</b>											
Fannie Mae	-	0.00%	-	0.00%	4,984	3.06%	-	0.00%	4,984	4,990	3.06%
Freddie Mac	292	4.50%	147	3.97%	2,028	3.00%	1,514	0.00%	3,981	3,974	3.14%
Ginnie Mae	-	0.00%	25	3.99%	60	3.22%	21,300	4.12%	21,385	21,945	4.11%
<b>Total debt securities</b>	<b>1,872</b>		<b>16,887</b>		<b>11,252</b>		<b>24,457</b>		<b>54,468</b>	<b>55,713</b>	
<b>Marketable equity securities:</b>											
Common Stock	-	0.00%	-	0.00%	-	0.00%	3	0.00%	3	1	0.00%
<b>Total investment securities</b>	<b>\$1,872</b>		<b>\$16,887</b>		<b>\$11,252</b>		<b>\$24,460</b>		<b>\$54,471</b>	<b>\$55,714</b>	

## Sources of Funds

**General.** Deposits are the major source of our funds for lending and other investment purposes. We generate deposits from our eight full-service offices in Alpena, Mio, Cheboygan, Oscoda, Lewiston, Alanson and Gaylord. In addition to deposits, we derive funds from borrowings, proceeds from the settlement of loan sales, the amortization and prepayment of loans and mortgage-backed securities, the maturity of investment securities, and operations. Scheduled loan principal repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and market conditions. Borrowings are used on a short-term basis to compensate for reductions in the availability of funds from other sources or on a longer term basis for general business purposes. We currently are managing liquidity levels and loan funding primarily through secondary mortgage market sales and Federal Home Loan Bank advances.

**Deposits.** We generate deposits primarily from our market area by offering a broad selection of deposit instruments including NOW accounts, regular savings, money market deposits, term certificate accounts and individual retirement accounts. Deposit account terms vary according to the minimum balance required, the period of time during which the funds must remain on deposit, and the interest rate, among other factors. The rate of interest which we must pay is not established by regulatory authority. The asset/liability committee regularly evaluates our internal cost of funds, surveys rates offered by competing institutions, reviews the cash flow requirements for lending and liquidity, and executes rate changes when deemed appropriate. We have sought to decrease the risk associated with changes in interest rates by offering competitive rates on some deposit accounts and by pricing certificates of deposit to provide customers with incentives to choose certificates of deposit with longer maturities. We also attract non-interest bearing commercial deposit accounts from our commercial borrowers and offer a competitive non-deposit sweep product that is not insured by the FDIC. In recent periods, we generally have not obtained funds through brokers or through a solicitation of funds outside our market area. At December 31, 2011 we had no brokered deposits. We offer a limited amount of certificates of deposit in excess of \$100,000 which may have negotiated rates. Future liquidity needs are expected to be satisfied through the both the use of Federal Home Loan Bank borrowings, as necessary, and through growth in deposits. Management does not generally plan on paying above-market rates on deposit products, although from time-to-time we may do so as liquidity needs dictate.

The following table sets forth the distribution of total deposit accounts, by account type, at the dates indicated.

	At December 31, 2011			2010			2009		
	Amount	Percent of Total	Weighted Average Interest Rate	Amount	Percent of Total	Weighted Average Interest Rate	Amount	Percent of Total	Weighted Average Interest Rate
Non-interest-bearing	\$12,609	8.36 %	NA	\$10,349	6.65 %	NA	\$11,074	7.00 %	NA
NOW accounts	18,602	12.35 %	0.21 %	16,935	10.89 %	0.39 %	16,298	10.31 %	0.39 %

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Passbook	17,873	11.86 %	0.05 %	16,785	10.80 %	0.05 %	15,722	9.95 %	0.05 %
Money market accounts	23,193	15.40 %	0.22 %	27,172	17.48 %	1.21 %	20,794	13.15 %	1.21 %
Time deposits that mature:									
Less than 12 months	38,503	25.56 %	1.08 %	52,059	33.49 %	2.47 %	60,552	38.30 %	2.47 %
Within 12-36 months	32,580	21.63 %	1.60 %	24,371	15.68 %	2.79 %	29,739	18.81 %	2.79 %
Beyond 36 months	7,290	4.84 %	2.21 %	7,795	5.00 %	3.30 %	3,921	2.48 %	3.30 %
Jumbo	-	0.00 %	0.00 %	-	0.00 %	0.00 %	-	0.00 %	0.00 %
Total deposits	\$ 150,650	100.00 %	0.87 %	\$ 155,466	100.00 %	1.89 %	\$ 158,100	100.00 %	1.89 %

**Time Deposit Rates.** The following table sets forth time deposits classified by rates as of the dates indicated (see Note 7 to our consolidated financial statements contained within Exhibit 13 for a more detailed breakdown by rate range):

Rate	At December 31,		
	2011	2010	2009
	(In Thousands)		
0.50 percent to 0.99 percent	\$38,802	\$9,852	\$5,926
1.00 percent to 1.99 percent	18,343	35,119	32,658
2.00 percent to 2.99 percent	16,057	26,573	24,116
3.00 percent to 3.99 percent	4,078	8,718	15,629
4.00 percent to 4.99 percent	1,092	3,488	11,912
5.00 percent to 8.99 percent	-	475	3,971
	\$78,372	\$84,225	\$94,212

**Time Deposit Maturities.** The following table sets forth the amount and maturities of time deposits at December 31, 2011.

Rate	Less Than One Year	1 - Less	2 - Less	3 - Less	5 years	Total
		than 2 Years	than 3 Years	than 5 Years	and Greater	
0.50 percent to 0.99 percent	\$ 26,396	\$12,388	\$ 18	\$-	\$-	\$38,802
1.00 percent to 1.99 percent	6,068	3,640	3,623	4,936	76	18,343
2.00 percent to 2.99 percent	4,899	3,371	1,627	4,415	1,745	16,057
3.00 percent to 3.99 percent	437	1,883	582	599	577	4,078
4.00 percent to 4.99 percent	703	257	-	79	53	1,092
5.00 percent to 8.99 percent	-	-	-	-	-	-
	\$ 38,503	\$21,539	\$ 5,850	\$10,029	\$2,451	\$78,372

As of December 31, 2011, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to \$100,000 was \$25.5 million. The following table sets forth the maturity of those certificates as of December 31, 2011.

Maturity Period	Certificates of Deposit in excess of \$100,000 (In thousands)
Three months or less	\$ 4,752
Three through six months	2,115
Six through twelve months	6,148
Over twelve months	12,484
Total	\$ 25,499



**Borrowings.** Our borrowings consist primarily of advances from the Federal Home Loan Bank of Indianapolis. At December 31, 2011, we had access to additional Federal Home Loan Bank advances of up to \$15.0 million, based upon pledged collateral. The following table sets forth information concerning balances and interest rates on our Federal Home Loan Bank advances and other borrowings at the dates and for the periods indicated.

	Years Ended December 31,		
	2011	2010	2009
	(Dollars in Thousands)		
Balance at end of period	\$34,500	\$29,000	\$45,031
Average balance during period	31,217	38,187	41,782
Maximum outstanding at any month end	36,200	45,825	46,750
Weighted average interest rate at end of period	2.30 %	2.23 %	3.13 %
Average interest rate during period	2.16 %	2.86 %	3.69 %

### Subsidiary Activity

First Federal of Northern Michigan Bancorp, Inc.'s only direct subsidiary is First Federal of Northern Michigan (the Bank).

First Federal of Northern Michigan has two wholly owned and these subsidiaries have been consolidated in the financial statements and all inter-company balances and transactions have been eliminated in consolidation.

One subsidiary, Financial Services & Mortgage Corporation, leases, sells, develops and maintains real estate properties. For reporting purposes, Financial Services & Mortgage Corporation is included in our banking segment. As of December 31, 2011, First Federal of Northern Michigan's investment in Financial Services & Mortgage Corporation was \$140,000. The primary asset of the subsidiary is an investment in land and real estate. See "Real Estate Development Activities." At December 31, 2010, Financial Services & Mortgage Corporation owned four developed building sites which were being offered for sale. These lots were sold in January 2011. Financial Services & Mortgage Corporation is not currently a party to any agreement that is material to First Federal of Northern Michigan Bancorp, Inc. on a consolidated basis.

First Federal of Northern Michigan's second subsidiary, FFNM Agency, Inc., collects the residual income stream associated with the April 2008 sale of the Company's wholesale health insurance override business to a third party. FFNM Agency is the successor company to the InsuranCenter of Alpena ("ICA"). On February 27, 2009, we sold the



majority of the assets of ICA. The financial position and results of operations of ICA are presented separately in our consolidated financial statements as “discontinued operations.”

## **Personnel**

As of December 31, 2011, First Federal of Northern Michigan had 73 full-time and 20 part-time employees. None of the Bank's employees is represented by a collective bargaining group. The Bank believes its relationship with its employees to be good. First Federal of Northern Michigan Bancorp, Inc., FFNM Agency, Inc. and FSMC have no separate employees.

## **SUPERVISION AND REGULATION**

### **General**

First Federal of Northern Michigan is a federally chartered savings bank, and as such is regulated and supervised by the Office of Comptroller of the Currency and the Federal Deposit Insurance Corporation. This regulation and supervision establishes a comprehensive framework of activities in which a financial institution may engage and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance funds and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. After completing an examination, the federal agency critiques the financial institution's operations and assigns its rating (known as an institution's CAMELS). Under federal law, an institution may not disclose its CAMELS rating to the public. First Federal of Northern Michigan also is a member of, and owns stock in, the Federal Home Loan Bank of Indianapolis, which is one of the twelve regional banks in the Federal Home Loan Bank System. First Federal of Northern Michigan also is regulated to a lesser extent by the Board of Governors of the Federal Reserve System, governing reserves to be maintained against deposits and other matters. The Comptroller of the Currency examines First Federal of Northern Michigan and prepares reports for the consideration of its board of directors on any operating deficiencies.

Any change in these laws or regulations, whether by the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or Congress, could have a material adverse impact on us and our operations.

As a savings and loan holding company, First Federal of Northern Michigan Bancorp, Inc. is required to comply with the rules and regulations of the Board of Governors of the Federal Reserve System ("Federal Reserve Board") and to file certain reports with and is subject to examination by the Federal Reserve Board. First Federal of Northern Michigan Bancorp, Inc. is also subject to the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

### **New Federal Legislation**

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act eliminated our former primary federal regulator, the Office of Thrift Supervision, and requires First Federal of Northern Michigan to be regulated by the Office of the Comptroller of the Currency (the primary federal regulator for national banks). The Dodd-Frank Act also authorizes the Federal Reserve Board to supervise and regulate all savings and loan holding companies like First

Federal of Northern Michigan Bancorp, Inc., in addition to bank holding companies which it regulates. As a result, the Federal Reserve Board's regulations applicable to bank holding companies, including holding company capital requirements, apply to savings and loan holding companies like First Federal of Northern Michigan Bancorp, Inc., unless an exemption exists. These capital requirements are substantially similar to the capital requirements currently applicable to First Federal of Northern Michigan, as described in "–Federal Banking Regulation–Capital Requirements." The Dodd-Frank Act also requires the Federal Reserve Board to set minimum capital levels for bank holding companies that are as stringent as those required for the insured depository subsidiaries, and the components of Tier 1 capital are restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. Bank holding companies with assets of less than \$500 million are exempt from these capital requirements. Under the Dodd-Frank Act, the proceeds of trust preferred securities are excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by bank or savings and loan holding companies with less than \$15 billion of assets.

The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements within 18 months that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. The Dodd-Frank Act also authorizes the payment of interest on commercial checking accounts, effective July 21, 2011.

The Dodd-Frank Act also creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions such as First Federal of Northern Michigan, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Banks and savings institutions with \$10 billion or less in assets will be examined by their applicable bank regulators. The new legislation also weakens the federal preemption available for national banks and federal savings associations, and gives state attorneys general the ability to enforce applicable federal consumer protection laws.

The legislation also broadens the base for Federal Deposit Insurance Corporation insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2012. Lastly, the Dodd-Frank Act increases stockholder influence over boards of directors by requiring companies to give stockholders a non-binding vote on executive compensation and so-called “golden parachute” payments. The legislation also directs the Federal Reserve Board to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded or not.

## **Federal Banking Regulation**

**Business Activities.** A federal savings bank derives its lending and investment powers from the Home Owners’ Loan Act, and the regulations of the Office of the Comptroller of the Currency (“OCC”). Under these laws and regulations, First Federal of Northern Michigan may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of debt securities and certain other loans and assets. First Federal of Northern Michigan also may establish subsidiaries that may engage in activities not otherwise permissible for First Federal of Northern Michigan directly, including real estate investment, securities brokerage and insurance agency services.

**Capital Requirements.** OCC regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for institutions receiving the highest CAMELS rating) and an 8% risk-based capital ratio. The prompt corrective action standards discussed below, in effect, establish a minimum 2% tangible capital standard.

The risk-based capital standard for savings banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, assigned by the OCC capital regulation based on the risks inherent in the type of asset. Core capital is defined as common stockholders’ equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, allowance for loan and lease losses up to a maximum of 1.25% of risk-weighted assets, and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

Additionally, a savings association that retains credit risk in connection with an asset sale may be required to maintain regulatory capital because of the recourse back to the savings association. In assessing an institution's capital adequacy, the OCC takes into consideration not only three numeric factors but also qualitative factors as well, and has the authority to establish higher capital requirements for individual associations where necessary.

At December 31, 2011, First Federal of Northern Michigan's capital exceeded all applicable requirements. The following table sets forth the Bank's capital position at December 31, 2011 and 2010, as compared to the minimum capital requirements.

	At December 31, 2011		2010		
	Amount	Percent of Assets	Amount	Percent of Assets	
	(Dollars in Thousands)				
Equity capital	\$23,735	11.0 %	\$22,272	10.4 %	
Tangible Capital Requirement:					
Tangible capital level	22,334	10.4 %	20,931	9.8 %	
Requirement	3,232	1.5 %	3,214	1.5 %	
Excess	19,102	8.9 %	17,717	8.3 %	
Core Capital Requirement:					
Core capital level	22,334	10.4 %	20,931	9.8 %	
Requirement	8,618	4.0 %	8,570	4.0 %	
Excess	13,716	6.4 %	12,361	5.8 %	
Risk-based Capital Requirement:					
Risk-based capital level	23,568	17.2 %	22,763	15.6 %	
Requirement	10,961	8.0 %	11,693	8.0 %	
Excess	12,607	9.2 %	11,070	7.6 %	

**Loans to One Borrower.** A federal savings bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus on an unsecured basis. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2011, First Federal of Northern Michigan was in compliance with the loans-to-one-borrower limitations.

**Qualified Thrift Lender Test.** As a federal savings bank, First Federal of Northern Michigan is subject to a qualified thrift lender, or “QTL,” test. Under the QTL test, First Federal of Northern Michigan must maintain at least 65% of its “portfolio assets” in “qualified thrift investments” in at least nine months of the most recent 12-month period.

A savings bank that fails the QTL test must operate under specified restrictions. The Dodd-Frank Act made noncompliance with the QTL test potentially subject to agency enforcement action for a violation of law. At December 31, 2011, First Federal of Northern Michigan maintained approximately 83.4% of its portfolio assets in qualified thrift investments, and therefore satisfied the QTL test.

**Capital Distributions.** Office of the Comptroller of the Currency regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the institution’s

capital account. A savings bank must file an application for approval of a capital distribution if:

· the total capital distributions for the applicable calendar year exceed the sum of the savings bank's net income for that year to date plus the savings bank's retained net income for the preceding two years;

· the savings bank would not be at least adequately capitalized following the distribution;

· the distribution would violate any applicable statute, regulation, agreement or Office of the Comptroller of the Currency-imposed condition; or

· the savings bank is not eligible for expedited treatment of its filings.

**Liquidity.** A federal savings bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

***Community Reinvestment Act and Fair Lending Laws.*** All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the Office of the Comptroller of the Currency to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In connection with its examination of a federal savings bank, the Office of the Comptroller of the Currency is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the Office of the Comptroller of the Currency, as well as other federal regulatory agencies and the Department of Justice. First Federal of Northern Michigan received an "Outstanding" Community Reinvestment Act rating in its two most recent federal examination.

***Transactions with Related Parties.*** A federal savings bank's authority to engage in transactions with its "affiliates" is limited by Office of the Comptroller of the Currency regulations and Regulation W of the Federal Reserve Board, which implements Sections 23A and 23B of the Federal Reserve Act. The term "affiliates" for these purposes generally means any company that controls or is under common control with an institution. First Federal of Northern Michigan Bancorp, Inc. and its non-savings institution subsidiaries will be affiliates of First Federal of Northern Michigan. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the savings bank. In addition, Office of the Comptroller of the Currency regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary.

First Federal of Northern Michigan's authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and (ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of First Federal of Northern Michigan's capital. In addition, extensions of credit in excess of certain limits must be approved by First Federal of Northern Michigan's board of directors.

***Enforcement.*** The Office of the Comptroller of the Currency has primary enforcement responsibility over federal savings banks and has the authority to bring enforcement action against all "institution-affiliated parties," including stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors of the savings bank, receivership, conservatorship or the termination of deposit insurance. Civil penalties cover a wide range of violations and actions, and range up to \$25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as



high as \$1 million per day. The Federal Deposit Insurance Corporation also has the authority to recommend to the Director of the Office of the Comptroller of the Currency that enforcement action be taken with respect to a particular savings bank. If action is not taken by the Director, the Federal Deposit Insurance Corporation has authority to take action under specified circumstances.

***Standards for Safety and Soundness.*** Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. The federal banking agencies adopted Interagency Guidelines Prescribing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The guidelines address internal controls and information systems, internal audit systems, credit underwriting, loan documentation, interest rate risk exposure, asset growth, compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan.

***Insurance of Deposit Accounts.*** The Dodd-Frank Act permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor, retroactive to January 1, 2008. Also, under the Dodd-Frank Act, noninterest-bearing checking accounts have unlimited deposit insurance through December 31, 2012.

On November 12, 2009, the FDIC approved a final rule requiring insured depository institutions to prepay, on December 31, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. Estimated assessments for the fourth quarter of 2009 and for all of 2010 were based upon the assessment rate in effect on September 30, 2009, with three basis points added for the 2011 and 2012 assessment rates. In addition, a 5% annual growth in the assessment base was assumed. Prepaid assessments are to be applied against the actual quarterly assessments until exhausted, and may not be applied to any special assessments that may occur in the future. Any unused prepayments will be returned to the institution on June 30, 2013. We recorded the pre-payment as a prepaid expense, which will be amortized to expense over three years. Based on our deposit and assessment rate as of September 30, 2009, our prepayment amount was \$1.4 million.

Effective April 1, 2011, the FDIC implemented a requirement of the Dodd-Frank Act to revise its assessment system to base it on each institution's total assets less tangible capital of each institution instead of deposits. The FDIC also revised its assessment schedule so that it ranges from 2.5 basis points for the least risky institutions to 45 basis points for the riskiest.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. The Bank does not believe that it is taking or is subject to any action, condition or violation that could lead to termination of its deposit insurance.

All FDIC-insured institutions are required to pay a pro rata portion of the interest due on obligations issued by the Financing Corporation ("FICO") for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2011, the annualized FICO assessment was equal to 1.00 cents for each \$100 in domestic deposits maintained at an institution. Assessments related to the FICO bond obligations were not subject to the December 31, 2009 prepayment.

For the year ended December 31, 2011, the Bank paid \$224,000 related to the FICO bonds and deposit insurance assessments. Deposit insurance assessments were prepaid in December 2009, for calendar years 2010 through 2012.

**Prompt Corrective Action.** The “prompt corrective action” provisions of the FDIA create a statutory framework that applies a system of both discretionary and mandatory supervisory actions indexed to the capital level of FDIC-insured depository institutions. These provisions impose progressively more restrictive constraints on operations, management, and capital distributions of the institution as its regulatory capital decreases, or in some cases, based on supervisory information other than the institution’s capital level. This framework and the authority it confers on the federal banking agencies supplement other existing authority vested in such agencies to initiate supervisory actions to address capital deficiencies. Moreover, other provisions of law and regulation employ regulatory capital level designations the same as or similar to those established by the prompt corrective action provisions both in imposing certain restrictions and limitations and in conferring certain economic and other benefits upon institutions. These include restrictions on brokered deposits, limits on exposure to interbank liabilities, determination of risk-based FDIC deposit insurance premium assessments, and action upon regulatory applications.

**Temporary Liquidity Guarantee Program.** On October 14, 2008, the FDIC announced a new program – the Temporary Liquidity Guarantee Program. This program has two components. One guarantees newly issued senior unsecured debt of a participating organization, up to certain limits established for each institution, issued between October 14, 2008 and June 30, 2009. The FDIC will pay the unpaid principal and interest on an FDIC -guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. The guarantee will remain in effect until June 30, 2012. In return for the FDIC’s guarantee, participating institutions will pay the FDIC a fee based on the amount and maturity of the debt. First Federal of Northern Michigan opted to participate in this component of the Temporary Liquidity Guarantee Program, but had no such unsecured debt during this time period.

***Prohibitions Against Tying Arrangements.*** Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the savings bank or its affiliates or not obtain services of a competitor of the savings bank.

***Federal Home Loan Bank System.*** First Federal of Northern Michigan is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the Federal Home Loan Bank of Indianapolis, First Federal of Northern Michigan is required to acquire and hold shares of capital stock in the Federal Home Loan Bank in an amount equal to at least 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its borrowings from the Federal Home Loan Bank, whichever is greater. As of December 31, 2011, First Federal of Northern Michigan was in compliance with this requirement.

## **Other Regulations**

Interest and other charges collected or contracted for by First Federal of Northern Michigan are subject to state usury laws and federal laws concerning interest rates. First Federal of Northern Michigan's operations are also subject to federal laws applicable to credit transactions, such as the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;

- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;

- Truth in Savings Act; and

rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of First Federal of Northern Michigan also are subject to the:

Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;

Check Clearing for the 21<sup>st</sup> Century Act (also known as "Check 21"), which gives "substitute checks," such as digital check images and copies made from that image, the same legal standing as the original paper check;

Title III of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (referred to as the "USA PATRIOT Act"), which significantly expanded the responsibilities of financial institutions, including savings and loan associations, in preventing the use of the American financial system to fund terrorist activities. Among other provisions, the USA PATRIOT Act and the related regulations of the OCC require savings associations operating in the United States to develop new anti-money laundering compliance programs, due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements, also applicable to financial institutions, under the Bank Secrecy Act and the Office of Foreign Assets Control regulations; and

The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to "opt out" of the sharing of certain personal financial information with unaffiliated third parties.

### **Federal Reserve System**

Federal Reserve Board regulations require savings banks to maintain non-interest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At December 31, 2011, First Federal of Northern Michigan was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the Office of the Comptroller of the Currency.

### **The USA PATRIOT Act**

The USA PATRIOT Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. Certain provisions of the Act impose affirmative obligations on a broad range of financial institutions, including federal savings banks, like First Federal of Northern Michigan. These obligations include enhanced anti-money laundering programs, customer identification programs and regulations relating to private banking accounts or correspondence accounts in the United States for non-United States persons or their representatives (including foreign individuals visiting the United States).

First Federal of Northern Michigan has established policies and procedures to ensure compliance with the USA PATRIOT Act's provisions, and the impact of the USA PATRIOT Act on our operations has not been material.

### **Holding Company Regulation**

Pursuant to the Dodd-Frank Act, as of July 21, 2011, the Federal Reserve Board succeeded the Office of Thrift Supervision as the regulator for savings and loan holding companies, such as First Federal of Northern Michigan Bancorp, Inc.

**General.** First Federal of Northern Michigan Bancorp, Inc. is a non-diversified unitary savings and loan holding company within the meaning of the Home Owners' Loan Act. As such, First Federal of Northern Michigan Bancorp, Inc. is registered with the Federal Reserve Board and subject to examination and supervision by the Federal Reserve Bank of Chicago. First Federal of Northern Michigan Bancorp, Inc. is subject to the Federal Reserve Board regulations (including applicable regulations of the former Office of Thrift Supervision), and reporting requirements. In addition, the Federal Reserve Board has enforcement authority over First Federal of Northern Michigan Bancorp, Inc. and its non-insured subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a serious risk to the subsidiary savings institution.

Savings and loan holding companies are not currently subject to specific regulatory capital requirements. The Dodd-Frank Act, however, requires the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Instruments such as cumulative preferred stock and trust preferred securities will no longer be includable as Tier 1 capital, as is currently the case with bank holding companies. Instruments issued prior to May 19, 2010 are grandfathered for companies with consolidated assets of \$15 billion or less. There is a five-year transition period (from the July 21, 2010 effective date of the Dodd-Frank Act) before the capital requirements will apply to savings and loan holding companies.

The Federal Reserve Board has issued a policy guidance regarding the payment of dividends by bank holding companies that it has made applicable to savings and loan holding companies as well. In general, the Federal Reserve Board's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. Federal Reserve Board guidance provides for prior regulatory review of capital distributions in certain circumstances such as where the company's net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend or the company's overall rate of earnings retention is inconsistent with the company's capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect our ability to pay dividends or otherwise engage in capital distributions.

The Dodd-Frank Act also extends the "source of strength" doctrine to savings and loan holding companies. The regulatory agencies must issue regulations requiring that all bank and savings and loan holding companies serve as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

***Permissible Activities.*** Under present law, the business activities of First Federal of Northern Michigan Bancorp, Inc. are generally limited to those activities permissible for financial holding companies under Section 4(k) of the Bank Holding Company Act of 1956, as amended, or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance as well as activities that are incidental to financial activities or complementary to a financial activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Federal Reserve Board, and certain additional activities authorized by Federal Reserve Board regulations.

Federal law prohibits a savings and loan holding company, including First Federal of Northern Michigan Bancorp, Inc., directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of another savings institution or holding company thereof, without prior written approval of the Federal Reserve Bank of Chicago. It also prohibits the acquisition or retention of, with certain exceptions, more than 5% of a non-subsidiary company engaged in activities that are not closely related to banking or financial in nature, or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Bank of Chicago must consider the financial and managerial resources, future prospects of the company and institution involved, the effect of the acquisition on the risk to the federal deposit insurance fund, the convenience and needs of the community and competitive factors.

The Federal Reserve Bank of Chicago is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions:



- (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and
- (ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisition.

The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

## **Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 was enacted in response to public concerns regarding corporate accountability. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the SEC, under the Securities Exchange Act of 1934.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and new corporate governance rules requiring the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules, and mandates further studies of certain issues by the SEC. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

## **Federal Securities Laws**

First Federal of Northern Michigan Bancorp, Inc.'s common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. First Federal of Northern Michigan Bancorp, Inc. is subject to the information, proxy solicitation, insider trader restrictions and other requirements under the Securities Exchange Act of 1934.

First Federal of Northern Michigan Bancorp, Inc. common stock held by persons who are affiliates (generally officers, directors and principal stockholders) of First Federal of Northern Michigan Bancorp, Inc. may not be resold without registration or unless sold in accordance with certain resale restrictions. If First Federal of Northern Michigan Bancorp, Inc. meets specified current public information requirements, each affiliate of First Federal of Northern Michigan Bancorp, Inc. is able to sell in the public market, without registration, a limited number of shares in any three-month period.

## **TAXATION**

### **Federal Taxation**

**General.** First Federal of Northern Michigan Bancorp, Inc. and First Federal of Northern Michigan are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize material federal income tax matters and is not a comprehensive description of the tax rules applicable to First Federal of Northern Michigan Bancorp, Inc. and First Federal of Northern Michigan.

**Method of Accounting.** For federal income tax purposes, First Federal of Northern Michigan currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31 for filing its consolidated federal income tax returns. The Small Business Protection Act of 1996 eliminated the use of the reserve method of accounting for bad debt reserves by savings institutions, effective for taxable years beginning after 1995.

**Bad Debt Reserves.** Prior to the Small Business Protection Act of 1996, First Federal of Northern Michigan was permitted to establish a reserve for bad debts for tax purposes and to make annual additions to the reserve. These additions could, within specified formula limits, be deducted in arriving at First Federal of Northern Michigan's taxable income. As a result of the Small Business Protection Act, First Federal of Northern Michigan must use the specific charge-off method in computing its bad debt deduction for tax purposes.

**Deferred Tax Asset Valuation.** The Company records a valuation allowance against its deferred tax assets if it believes, based on available evidence, that it is "more likely than not" that the future tax assets recognized will not be realized before their expiration. Realization of the Company's deferred tax assets is primarily dependent upon the generation of a sufficient level of future taxable income. At December 31, 2011 the Company had a valuation allowance against its deferred tax assets of \$3.0 million.

**Taxable Distributions and Recapture.** Prior to the Small Business Protection Act of 1996, bad debt reserves created prior to 1988 were subject to recapture into taxable income if First Federal of Northern Michigan failed to meet certain thrift asset and definitional tests. The Small Business Protection Act of 1996 eliminated these thrift-related recapture rules. However, under current law, pre-1988 reserves remain subject to tax recapture should First Federal of Northern Michigan make certain distributions from its tax bad debt reserve or cease to maintain a bank charter. At December 31, 2011, First Federal of Northern Michigan's total federal pre-1988 reserve was approximately \$60,000. This reserve reflects the cumulative effects of federal tax deductions by First Federal of Northern Michigan for which no federal income tax provision has been made.

**Minimum Tax.** The Internal Revenue Code of 1986, as amended, imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences ("alternative minimum taxable income" or "AMTI"). The alternative minimum tax is payable to the extent such AMTI is in excess of an exemption amount. Net operating losses can, in general, offset no more than 90% of AMTI. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. First Federal of Northern Michigan has not been subject to the alternative minimum tax and has no such amounts available as credits for carryover.

**Net Operating Loss Carryovers.** A financial institution may carry back net operating losses to the preceding five taxable years and forward to the succeeding 20 taxable years. At December 31, 2011, First Federal of Northern Michigan had a net operating loss of approximately \$9.5 million which it may carry forward for federal income tax purposes until 2031.

**Corporate Dividends.** We may exclude from our income 100% of dividends received from First Federal of Northern Michigan as a member of the same affiliated group of corporations.

The federal income tax returns of First Federal of Northern Michigan Bancorp, Inc. and its predecessor, Alpena Bancshares, Inc. have not been audited by the Internal Revenue Service in the last five fiscal years.

## **State and Local Taxation**

During 1999, the State of Michigan enacted legislation that resulted in elimination of the Michigan single business tax by gradually phasing it out over the next 23 years. On August 9, 2006, the Michigan Legislature approved the repeal of the Michigan SBT for tax years beginning after December 31, 2007. The Michigan SBT has been replaced with the Michigan Business Tax (MBT). Financial Institutions are subject to a component of the MBT, the Financial Institutions Tax, which is based on capital rather than taxable earnings.

Other applicable state taxes include generally applicable sales, use and real property taxes.

As a Maryland business corporation, First Federal of Northern Michigan Bancorp, Inc. is required to file annual returns with and pay annual fees to the State of Maryland.

**ITEM 1A. RISK FACTORS**

Not required for smaller reporting companies.

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**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None

**ITEM 2. PROPERTIES**

As of December 31, 2011, First Federal of Northern Michigan owned its main office and all of its branch offices. The following is a list of our locations:

Main Office	Main Office – Annex Building
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100 South Second Avenue Alpena, Michigan 49707	123 S Second Ave Alpena, MI 49707
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Branch Offices

300 South Ripley Boulevard Alpena, Michigan 49707	2885 South County Road #489 Lewiston, Michigan 49756
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6232 River Street Alanson, Michigan 49706	308 North Morenci Mio, Michigan 48647
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101 South Main Street Cheboygan, Michigan 49721	201 North State Street Oscoda, Michigan 48750
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1000 South Wisconsin  
Gaylord, Michigan 49735

**ITEM 3. LEGAL PROCEEDINGS**

The Company and the Bank are periodically involved in claims and lawsuits that are incident to their business. At December 31, 2011, neither the Company nor the Bank was involved in any claims or lawsuits material to their respective businesses.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**PART II**

**ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS**  
**5. AND ISSUER PURCHASES OF EQUITY SECURITIES**

(a) First Federal of Northern Michigan Bancorp, Inc.'s common stock is traded on the Nasdaq Capital Market under the symbol "FFNM."

As of March 23, 2012 there were 2,884,049 shares of First Federal of Northern Michigan Bancorp, Inc. common stock outstanding. At December 31, 2011, First Federal of Northern Michigan Bancorp, Inc. had approximately 575 stockholders of record. The remaining information required by this item is incorporated by reference to Exhibit 13, the Company's Annual Report to Stockholders. No equity securities were sold during the year ended December 31, 2011 that were not registered under the Securities Act.

(b)

Not Applicable

(c) First Federal of Northern Michigan Bancorp, Inc. did not repurchase any of its equity securities during the quarter ended December 31, 2011.

**ITEM 6. SELECTED FINANCIAL DATA**

Not required for smaller reporting companies.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Information contained in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" is incorporated by reference to Exhibit 13, the Company's Annual Report to Stockholders.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not required for smaller reporting companies.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Information contained in the section captioned "Financial Statements" is incorporated by reference to Exhibit 13, the Company's Annual Report to Shareholders.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**ITEM 9A. CONTROLS AND PROCEDURES**



(a) Evaluation of Disclosure Controls and Procedures

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

(b) Management's Annual Report on Internal Control over Financial Reporting

Management of First Federal of Northern Michigan Bancorp, Inc. and subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's system of internal control is designed under the supervision of management, including our Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles ("GAAP").

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are made only in accordance with the authorization of management and the Board of Directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections on any evaluation of effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in conditions or that the degree of compliance with policies and procedures may deteriorate.

As of December 31, 2011, management assessed the effectiveness of the Company's internal control over financial reporting based upon the framework established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based upon its assessment, management believes that the Company's internal control over financial reporting as of December 31, 2011 is effective using these criteria. This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission applicable to smaller reporting companies that permit the Company to provide only management's report in this annual report.

(c) Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over the financial reporting during the Company's fourth quarter of fiscal year 2011 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE**

Information concerning directors and executive officers is incorporated herein by reference from the Company's Proxy Statement, specifically the section captioned "Proposal I—Election of Directors."

**ITEM 11. EXECUTIVE COMPENSATION**

Information concerning executive compensation is incorporated herein by reference from the Company's Proxy Statement, specifically the section captioned "Proposal I—Election of Directors."

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information concerning security ownership of certain owners and management is incorporated herein by reference from the Company's Proxy Statement, specifically the Section captioned "Proposal I – Election of Directors."

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information concerning relationships and transactions is incorporated herein by reference from the Company's Proxy Statement, specifically the section captioned "Transactions with Certain Related Persons".

#### **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information concerning principal accountant fees and services is incorporated herein by reference to the Company's Proxy Statement, specifically the section captioned "Proposal II – Ratification of Appointment of Auditors."

#### **PART IV**

#### **ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

The exhibits filed as a part of this form 10-K are as follows:

- 3.1 Articles of Incorporation of First Federal of Northern Michigan Bancorp, Inc.\*
- 3.2 Bylaws of First Federal of Northern Michigan Bancorp, Inc.\*
- 4 Form of Common Stock Certificate of First Federal of Northern Michigan Bancorp, Inc.\*
- 10.1 Change in Control Agreements\*
- 10.2 1996 Stock Option Plan\*
- 10.3 1996 Recognition and Retention Plan\*
- 10.4 2006 Stock-Based Incentive Plan\*\*
- 13 Annual Report to Shareholders
- 14 Code of Ethics \*\*\*
- 21 Subsidiaries of Registrant
- 23 Consent of Plante & Moran PLLC
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document

\* Incorporated by reference to the Registration Statement on Form SB-2 of First Federal of Northern Michigan Bancorp, Inc. (Registration No. 333-121178), originally filed with the Commission on December 10, 2004.

\*\* Incorporate by reference to the Definitive Proxy materials filed on April 10, 2006 (No. 000-31957).

\*\*\* Incorporated by reference to the Annual Report on Form 10-K of Alpena Bancshares, Inc. filed with the Commission on March 30, 2004 (Registration No. 000-31957).

## **SIGNATURES**

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

FIRST FEDERAL OF  
NORTHERN MICHIGAN  
BANCORP, INC.

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

Date: March 28, 2012

Pursuant to the requirements of the Securities Exchange of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

By: /s/ Michael W. Mahler  
Michael W. Mahler, Director and  
Chief Executive Officer  
(Principal Executive Officer)  
Date: March 28, 2012

By: /s/ Amy E. Essex  
Amy E. Essex, Chief Financial Officer, Treasurer and  
Corporate Secretary  
(Principal Financial and Accounting Officer)  
Date: March 28, 2012

By: /s/ Martin A. Thomson  
Martin A. Thomson, Chairman  
Date: March 28, 2012

By: /s/ Keith D. Wallace  
Keith D. Wallace, Director  
Date: March 28, 2012

By: /s/ Gary C. VanMassenhove  
Gary C. VanMassenhove, Director  
Date: March 28, 2012

By: /s/ Thomas R. Townsend  
Thomas R. Townsend, Director  
Date: March 28, 2012

By: /s/ James C. Rapin  
James C. Rapin, Director  
Date: March 28, 2012