

First Federal of Northern Michigan Bancorp, Inc.
Form 10-Q
May 15, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2012

OR

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

For the transition period from _____ to _____

Commission File Number 000-31957

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

(Exact name of registrant as specified in its charter)

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

100 S. Second Avenue, Alpena, Michigan 49707
(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

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

| | |
|--------------------------------|-----------------------------|
| Common Stock, Par Value \$0.01 | Outstanding at May 15, 2012 |
| (Title of Class) | 2,884,049 shares |

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended March 31, 2012

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

of the Private Securities Litigation Reform Act of 1995.

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

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

PART I - FINANCIAL INFORMATION**ITEM 1 - FINANCIAL STATEMENTS****First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**

Consolidated Balance Sheet

| | March 31, 2012 (Unaudited) | December 31, 2011 |
|--|-------------------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents: | | |
| Cash on hand and due from banks | \$ 2,306,392 | \$ 2,713,701 |
| Overnight deposits with FHLB | 107,818 | 35,797 |
| Total cash and cash equivalents | 2,414,210 | 2,749,498 |
| Securities AFS | 52,850,362 | 53,048,503 |
| Securities HTM | 2,435,000 | 2,435,000 |
| Loans held for sale | 306,559 | - |
| Loans receivable, net of allowance for loan losses of \$1,663,310 and \$1,517,695 as of March 31, 2012 and December 31, 2011, respectively | 139,202,962 | 140,883,591 |
| Foreclosed real estate and other repossessed assets | 3,616,603 | 3,407,939 |
| Federal Home Loan Bank stock, at cost | 3,266,100 | 3,266,100 |
| Premises and equipment | 5,796,121 | 5,845,881 |
| Accrued interest receivable | 1,160,743 | 1,148,500 |
| Intangible assets | 261,742 | 334,855 |
| Prepaid FDIC premiums | 714,524 | 758,733 |
| Deferred tax asset | 1,296,110 | 387,065 |
| Other assets | 2,810,035 | 2,779,124 |
| Total assets | \$ 216,131,071 | \$ 217,044,789 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposits | \$ 151,106,333 | \$ 150,649,073 |
| Advances from borrowers for taxes and insurance | 304,027 | 128,028 |
| Advances from Federal Home Loan Bank | 32,725,000 | 34,500,000 |
| REPO sweep accounts | 5,606,417 | 5,592,326 |
| Accrued expenses and other liabilities | 1,263,213 | 1,606,569 |
| Total liabilities | 191,004,990 | 192,475,995 |
| Stockholders' equity: | | |
| | 31,918 | 31,918 |

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| | | | |
|--|----------------|---|----------------|
| Common stock (\$0.01 par value 20,000,000 shares authorized 3,191,799 shares issued) | | | |
| Additional paid-in capital | 23,853,361 | | 23,852,702 |
| Retained earnings | 3,580,851 | | 2,980,176 |
| Treasury stock at cost (307,750 shares) | (2,963,918 |) | (2,963,918 |
| Unearned compensation | (258 |) | (556 |
| Accumulated other comprehensive income | 624,127 | | 668,472 |
| Total stockholders' equity | 25,126,081 | | 24,568,794 |
| | | | |
| Total liabilities and stockholders' equity | \$ 216,131,071 | | \$ 217,044,789 |

See accompanying notes to consolidated financial statements.

First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**Consolidated Statement of Income**

| | For the Three Months Ended March 31, | |
|--|---|-------------|
| | 2012 | 2011 |
| | (Unaudited) | |
| Interest income: | | |
| Interest and fees on loans | \$2,040,208 | \$2,273,320 |
| Interest and dividends on investments | | |
| Taxable | 150,180 | 94,815 |
| Tax-exempt | 39,073 | 40,328 |
| Interest on mortgage-backed securities | 179,288 | 183,366 |
| Total interest income | 2,408,749 | 2,591,829 |
| Interest expense: | | |
| Interest on deposits | 280,544 | 437,253 |
| Interest on borrowings | 183,634 | 168,074 |
| Total interest expense | 464,178 | 605,327 |
| Net interest income | 1,944,571 | 1,986,502 |
| Provision for loan losses | 376,268 | 67,358 |
| Net interest income after provision for loan losses | 1,568,303 | 1,919,144 |
| Non-interest income: | | |
| Service charges and other fees | 169,953 | 164,491 |
| Mortgage banking activities | 220,560 | 235,983 |
| Net loss on sale of premises and equipment, real estate owned and other repossessed assets | (2,089) | (8,675) |
| Other | 58,399 | 57,553 |
| Total non-interest income | 446,823 | 449,352 |
| Non-interest expense: | | |
| Compensation and employee benefits | 1,271,958 | 1,168,936 |
| FDIC Insurance Premiums | 47,479 | 71,217 |
| Advertising | 33,115 | 23,021 |
| Occupancy | 241,916 | 270,042 |
| Amortization of intangible assets | 73,113 | 73,113 |
| Service bureau charges | 78,787 | 76,206 |
| Professional services | 94,735 | 87,577 |
| Other | 459,548 | 437,683 |
| Total non-interest expense | 2,300,651 | 2,207,795 |
| Income (loss) before income tax expense or benefit | (285,525) | 160,700 |
| Income tax benefit | (886,200) | - |

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| | | |
|---|-----------|-----------|
| Net Income | \$600,675 | \$160,701 |
| Other Comprehensive Income | | |
| Net Income | \$600,675 | \$160,701 |
| Change in unrealized gain (loss) on available-for-sale securities, net of tax | (44,346) | 59,183 |
| Comprehensive Income | \$556,329 | \$219,884 |
| Per share data: | | |
| Net Income per share | | |
| Basic | \$0.21 | \$0.06 |
| Diluted | \$0.21 | \$0.06 |
| Weighted average number of shares outstanding | | |
| Basic | 2,884,049 | 2,884,049 |
| Including dilutive stock options | 2,884,049 | 2,884,049 |
| Dividends per common share | \$- | \$- |

See accompanying notes to consolidated financial statements.

First Federal of Northern Michigan Bancorp Inc. and Subsidiaries

Consolidated Statement of Changes in Stockholders' Equity (Unaudited)

| | Common Stock | Treasury Stock | Additional Paid-in Capital | Unearned Compensation | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|---|-----------------|-------------------|----------------------------------|--------------------------|----------------------|---|--------------|
| Balance at December 31, 2011 | \$31,918 | \$(2,963,918) | \$23,852,701 | \$ (556) | \$2,980,176 | \$ 668,472 | \$24,568,794 |
| Cash paid in lieu of fractional shares | - | - | (20) | - | - | - | (20) |
| Stock Options/MRP shares expensed | - | - | 680 | 298 | - | - | 978 |
| Stock Options/MRP shares forfeited | - | - | - | - | - | - | - |
| Net income for the period | - | - | - | - | 600,675 | - | 600,675 |
| Change in unrealized gain on available-for-sale securities (net of tax of \$22,845) | - | - | - | - | - | (44,346) | (44,346) |
| Balance at March 31, 2012 | \$31,918 | \$(2,963,918) | \$23,853,361 | \$ (258) | \$3,580,851 | \$ 624,126 | \$25,126,081 |

See accompanying notes to the consolidated financial statements.

First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries**Consolidated Statement of Cash Flows**

| | For Three Months Ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| | (Unaudited) | |
| Cash Flows from Operating Activities: | | |
| Net income | \$600,675 | \$160,701 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization | 156,237 | 181,356 |
| Provision for loan loss | 376,268 | 67,358 |
| Amortization and accretion on securities | 112,413 | 70,989 |
| Stock-based compensation | 978 | 39,945 |
| Gain on sale of loans held for sale | (99,903) | (94,940) |
| Originations of loans held for sale | (7,697,851) | (6,846,031) |
| Proceeds from sale of loans held for sale | 7,491,195 | 6,788,734 |
| Loss (gain) on sale of fixed assets | 1,123 | (990) |
| Loss on sale of real estate owned and other repossessed assets | 967 | 8,932 |
| Net change in: | | |
| Accrued interest receivable | (12,243) | 84,186 |
| Other assets | (8,064) | (529,564) |
| Prepaid FDIC insurance premiums | 44,209 | 67,003 |
| Deferred income tax (benefit) expense | (909,045) | 56,112 |
| Accrued expenses and other liabilities | (343,376) | (82,493) |
| Net cash used in operating activities | (286,417) | (28,702) |
| Cash Flows from Investing Activities: | | |
| Net decrease in loans (loans originated, net of principal payments) | 654,797 | 5,821,245 |
| Proceeds from maturities and calls of available-for-sale securities | 3,046,478 | 2,414,843 |
| Proceeds from sale of property and equipment | - | 1,480 |
| Proceeds from sale of real estate and other repossessed assets | 439,933 | 119,137 |
| Purchase of securities | (3,027,942) | (5,904,403) |
| Purchase of premises and equipment | (34,487) | (64,708) |
| Net cash provided by investing activities | 1,078,779 | 2,387,594 |
| Cash Flows from Financing Activities: | | |
| Net increase in deposits | 457,260 | 765,859 |
| Net increase (decrease) in Repo Sweep accounts | 14,091 | (418,491) |
| Net increase in advances from borrowers | 175,999 | 186,939 |
| Advances from Federal Home Loan Bank and notes payable | 8,075,000 | 3,350,000 |
| Repayments of Federal Home Loan Bank advances and notes payable | (9,850,000) | (4,350,000) |
| Net cash used in financing activities | (1,127,650) | (465,693) |
| Net (decrease) increase in cash and cash equivalents | (335,288) | 1,893,199 |

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| | | |
|--|-------------|-------------|
| Cash and cash equivalents at beginning of period | 2,749,498 | 1,962,657 |
| Cash and cash equivalents at end of period | \$2,414,210 | \$3,855,856 |

Supplemental disclosure of cash flow information:

| | | |
|---|-----------|-----------|
| Cash paid during the period for interest | \$484,792 | \$608,921 |
| Cash refunded during the period for income taxes | - | (41,000) |
| Transfers of loans to foreclosed real estate and repossessed assets | 649,564 | 471,069 |

See accompanying notes to the consolidated financial statements.

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1—BASIS OF FINANCIAL STATEMENT PRESENTATION

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

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

Note 2— PRINCIPLES OF CONSOLIDATION

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

Note 3—SECURITIES

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

| | March 31, 2012 | | | |
|--|-------------------|------------------------------|---------------------------------|-----------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Market Value |
| | (in thousands) | | | |
| Securities Available for Sale | | | | |
| U.S. Government and agency obligations | \$15,237 | \$ 86 | \$ (1) | 15,322 |
| Municipal obligations | 6,919 | 370 | (12) | 7,277 |
| Mortgage-backed securities | 29,745 | 535 | (30) | 30,250 |
| Equity investments | 3 | - | (2) | 1 |
| Total | \$51,904 | \$ 991 | \$ (45) | \$52,850 |
| Securities Held to Maturity | | | | |
| Municipal notes | \$2,435 | \$ 210 | \$ - | \$2,645 |

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

The amortized cost and estimated market value of securities at March 31, 2012, by contract maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities with no specified maturity date are separately stated.

| | March 31, 2012 | |
|---------------------------------------|-------------------|-----------------|
| | Amortized Cost | Market Value |
| | (in thousands) | |
| Available For Sale: | | |
| Due in one year or less | \$1,790 | \$1,805 |
| Due after one year through five years | 16,469 | 16,673 |
| Due in five year through ten years | 3,534 | 3,669 |
| Due after ten years | 363 | 452 |
| Subtotal | 22,156 | 22,599 |
| Equity securities | 3 | 1 |
| Mortgage-backed securities | 29,745 | 30,250 |
| Total | \$51,904 | \$52,850 |
| Held To Maturity: | | |
| Due in one year or less | \$90 | \$91 |
| Due after one year through five years | 420 | 448 |
| Due in five year through ten years | 645 | 703 |
| Due after ten years | 1,280 | 1,403 |
| Total | \$2,435 | \$2,645 |

At March 31, 2012 and December 31, 2011, securities with a carrying value and fair value of \$28,872,000 and \$31,085,000, respectively, were pledged to secure our REPO sweep accounts, FHLB advances and our line of credit at the Federal Reserve.

There were no security sales in either the three months ended March 31, 2012 or 2011.

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

| | March 31, 2012 | | | |
|--|-------------------------|------------|-------------------------|-------------|
| | Gross Unrealized Losses | | Gross Unrealized Losses | |
| | Fair Value | <12 months | Fair Value | > 12 months |
| | (in thousands) | | | |
| Available For Sale: | | | | |
| U.S. Government and agency obligations | \$1,499 | \$ (1) | \$ - | \$ - |
| Corporate bonds and other obligations | - | - | - | - |
| Municipal obligations | 646 | (12) | - | - |
| Mortgage-backed securities | 2,105 | (7) | 1,364 | (23) |
| Equity securities | - | - | 1 | (2) |
| Total | \$4,250 | \$ (20) | \$ 1,365 | \$ (25) |
| Held to Maturity: | | | | |
| Municipal notes | \$- | \$ - | \$ - | \$ - |
| | | | | |
| | December 31, 2011 | | | |
| | Gross Unrealized Losses | | Gross Unrealized Losses | |
| | Fair Value | <12 months | Fair Value | > 12 months |
| | (in thousands) | | | |
| Available For Sale: | | | | |
| U.S. Government and agency obligations | \$1,999 | \$ (1) | \$ - | \$ - |
| Corporate bonds and other obligations | - | - | - | - |
| Municipal obligations | 646 | (12) | - | - |
| Mortgage-backed securities | 8,137 | (27) | 1,458 | (17) |
| Equity securities | - | - | 1 | (2) |
| Total | \$10,782 | \$ (40) | \$ 1,459 | \$ (19) |
| Held to Maturity: | | | | |
| Municipal notes | \$- | \$ - | \$ - | \$ - |

The unrealized losses on the securities held in the portfolio are not considered other than temporary and have not been recognized into income. This decision is based on the Company's ability and intent to hold any potentially impaired security until maturity. The performance of the security is based on the contractual terms of the agreement, the extent

of the impairment and the financial condition and credit quality of the issuer. The decline in market value is considered temporary and a result of changes in interest rates and other market variables.

Note 4—LOANS AND ALLOWANCE FOR LOAN LOSSES

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

| | At March 31, 2012 | At December 31, 2011 |
|---------------------------|-------------------------|-------------------------|
| | (in thousands) | |
| Real estate loans: | | |
| Residential mortgage | \$66,798 | \$ 66,599 |
| Commercial loans: | | |
| Secured by real estate | 53,313 | 54,202 |
| Other | 7,191 | 7,002 |
| Total commercial loans | 60,504 | 61,204 |
| Consumer loans: | | |
| Secured by real estate | 12,485 | 13,395 |
| Other | 1,359 | 1,477 |
| Total consumer loans | 13,844 | 14,872 |
| Total gross loans | \$141,146 | \$ 142,675 |
| Less: | | |
| Net deferred loan fees | (280) | (273) |
| Allowance for loan losses | (1,663) | (1,518) |
| Total loans, net | \$139,203 | \$ 140,884 |

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

As of March 31, 2012

| | 30 - 59 Days Past Due | 60 - 89 Days Past Due | Greater than 90 Days Past Due | Total Past Due | Current | Total Financing Receivables | Recorded Investment > 90 Days and Accruing |
|---------------------------------------|--------------------------|--------------------------|-------------------------------------|-------------------|------------|-----------------------------------|---|
| Commercial Real Estate: | | | | | | | |
| Commercial Real Estate - construction | \$ - | \$ - | \$ 173 | \$ 173 | \$- | \$ 173 | \$ - |
| Commercial Real Estate - other | 2,667 | 31 | 465 | 3,163 | 49,977 | 53,140 | 30 |
| Commercial - non real estate | 15 | - | - | 15 | 7,177 | 7,192 | - |
| Consumer: | | | | | | | |
| Consumer - Real Estate | 142 | - | 189 | 331 | 12,154 | 12,485 | 62 |
| Consumer - Other | 4 | 7 | 1 | 12 | 1,346 | 1,358 | 1 |
| Residential: | | | | | | | |
| Residential | 2,976 | 1,153 | 1,540 | 5,669 | 61,129 | 66,798 | 175 |
| Total | \$ 5,804 | \$ 1,191 | \$ 2,368 | \$ 9,363 | \$ 131,783 | \$ 141,146 | \$ 268 |

As of December 31, 2011

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

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

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

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

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

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

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

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

Risk Grade 6 (Substandard) - Loans are “substandard” whose full, final collectability does not appear to be a matter of serious doubt, but which nevertheless portray some form of well defined weakness that requires close supervision by Bank management. The noted weaknesses involve more than normal banking risk. One or more of the following characteristics may be exhibited in loans classified Substandard: (1) Loans possess a defined credit weakness and the likelihood that the loan shall be paid from the primary source of repayment is uncertain; (2) Loans are not adequately protected by the current net worth and/or paying capacity of the obligor; (3) primary source of repayment is gone, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees; (4) distinct possibility that the Bank shall sustain some loss if deficiencies are not corrected; (5) unusual courses of action are needed to maintain a high probability of repayment; (6) the borrower is not generating enough cash flow to repay loan principal, however, continues to make interest payments; (7) the Bank is forced into a subordinated or unsecured position due to flaws in documentation; (8) loans have been restructured so that payment schedules, terms, and collateral represent concessions to the borrower when compared to normal loan terms; (9) the Bank is contemplating foreclosure or legal action due to the apparent deterioration in the loan; or (10) there is a significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

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

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

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

As of March 31, 2012

| Loan Grade | Commercial Real Estate | Commercial Real Estate | Commercial |
|---------------|---------------------------|---------------------------|------------|
| | Construction | Other | |
| 1-2 | \$ - | \$ - | \$ 28 |
| 3 | - | 11,515 | 2,024 |
| 4 | - | 30,609 | 4,804 |
| 5 | - | 1,206 | - |
| 6 | 173 | 9,810 | 335 |
| 7 | - | - | - |
| 8 | - | - | - |
| Total | \$ 173 | \$ 53,140 | \$ 7,191 |

As of December 31, 2011

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

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

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

As of March 31, 2012

As of December 31, 2011

| Residential | | Residential | |
|-----------------|-----------|-----------------|-----------|
| Grade | | Grade | |
| Pass | \$ 64,832 | Pass | \$ 63,941 |
| Special Mention | - | Special Mention | - |
| Substandard | 1,966 | Substandard | 2,658 |
| Total | \$ 66,798 | Total | \$ 66,599 |

As of March 31, 2011

| | Consumer - Real Estate | Consumer - Other |
|---------------|---------------------------|------------------|
| Performing | \$ 12,337 | \$ 1,347 |
| Nonperforming | 148 | 11 |
| Total | \$ 12,485 | \$ 1,358 |

As of December 31, 2011

| | Consumer - Real Estate | Consumer - Other |
|---------------|---------------------------|------------------|
| Performing | \$ 13,248 | \$ 1,473 |
| Nonperforming | 147 | 4 |
| Total | \$ 13,395 | \$ 1,477 |

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

| | As of March 31, 2012 | December 31, 2011 |
|---------------------------------------|-------------------------------|-------------------|
| Commercial Real Estate: | | |
| Commercial Real Estate - construction | \$173 | \$ 173 |
| Commercial Real Estate - other | 435 | 356 |
| Commercial | - | - |
| Consumer: | | |
| Consumer - real estate | 145 | 152 |
| Consumer - other | 14 | - |
| Residential: | | |
| Residential | 1,966 | 2,420 |
| Total | \$2,733 | \$ 3,101 |

The key features of the Company's loan modifications are determined on a loan-by-loan basis. Generally, our restructurings have related to interest rate reductions and loan term extensions. In the past the Company has granted reductions in interest rates, payment extensions and short-term payment forbearances as a means to maximize

collectability of troubled credits. The Company has not forgiven principal to date, although this would be considered if necessary to ensure the long-term collectability of the loan. The Company's loan modifications are typically short-term in nature, although the Company would consider a long-term modification to ensure the long-term collectability of the credit. In general, a borrower must make at least six consecutive timely payments before the Company would consider a return of a restructured loan to accruing status in accordance with Federal Deposit Insurance Corporation guidelines regarding restoration of credits to accrual status.

The Bank has classified approximately \$3,034,000 of its impaired loans as troubled debt restructurings as of March 31, 2012.

| | Troubled Debt Restructurings | | | Troubled Debt Restructurings that Subsequently Defaulted | |
|---------------------------------------|---|--|---|--|---------------------|
| | For the Three Months Ended March 31, 2012 | | | For the Three Months Ended March 31, 2012 | |
| | Number of Loans | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment | Number of Loans | Recorded Investment |
| Commercial Loans | - | \$ - | \$ - | \$ - | \$ - |
| Commercial Real Estate - Construction | - | - | - | - | - |
| Commercial Real Estate - Other | 2 | 1,628 | 1,621 | - | - |
| Consumer - Real Estate | - | - | - | - | - |
| Consumer - Other | - | - | - | - | - |
| Residential | - | - | - | - | - |
| Total | 2 | \$ 1,628 | \$ 1,621 | - | \$ - |

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

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

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2012 and December 31, 2011:

As of March 31, 2012

| | Unpaid Principal Balance | Recorded Investment | Related Allowance |
|---------------------------------------|-----------------------------|------------------------|----------------------|
| With no related allowance recorded: | | | |
| Commercial | \$ - | \$ - | \$ - |
| Commercial Real Estate - Construction | 1,589 | 173 | - |
| Commercial Real Estate - Other | 1,208 | 943 | - |
| Consumer - Real Estate | 149 | 145 | - |
| Consumer - Other | 15 | 14 | - |
| Residential | 1,387 | 1,106 | - |
| With a specific allowance recorded: | | | |
| Commercial | - | - | - |
| Commercial Real Estate - Construction | - | - | - |
| Commercial Real Estate - Other | 2,390 | 2,390 | 213 |
| Consumer - Real Estate | - | - | - |
| Consumer - Other | - | - | - |
| Residential | 860 | 860 | 244 |
| Totals: | | | |
| Commercial | \$ - | \$ - | \$ - |
| Commercial Real Estate - Construction | \$ 1,589 | \$ 173 | \$ - |
| Commercial Real Estate - Other | \$ 3,598 | \$ 3,333 | \$ 213 |
| Consumer - Real Estate | \$ 149 | \$ 145 | \$ - |
| Consumer - Other | \$ 15 | \$ 14 | \$ - |
| Residential | \$ 2,247 | \$ 1,966 | \$ 244 |

As of December 31, 2011

| | Unpaid Principal Balance | Recorded Investment | Related Allowance |
|---------------------------------------|-----------------------------|------------------------|----------------------|
| With no related allowance recorded: | | | |
| Commercial | \$ - | \$ - | \$ - |
| Commercial Real Estate - Construction | 1,589 | 173 | - |
| Commercial Real Estate - Other | 626 | 626 | - |
| Consumer - Real Estate | 171 | 152 | - |
| Consumer - Other | - | - | - |
| Residential | 2,017 | 1,640 | - |
| With a specific allowance recorded: | | | |
| Commercial | - | - | - |

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| | | | |
|---------------------------------------|----------|----------|--------|
| Commercial Real Estate - Construction | - | - | - |
| Commercial Real Estate - Other | 1,337 | 1,128 | 85 |
| Consumer - Real Estate | - | - | - |
| Consumer - Other | - | - | - |
| Residential | 813 | 780 | 199 |
| Totals: | | | |
| Commercial | \$ - | \$ - | \$ - |
| Commercial Real Estate - Construction | \$ 1,589 | \$ 173 | \$ - |
| Commercial Real Estate - Other | \$ 1,963 | \$ 1,754 | \$ 85 |
| Consumer - Real Estate | \$ 171 | \$ 152 | \$ - |
| Consumer - Other | \$ - | \$ - | \$ - |
| Residential | \$ 2,830 | \$ 2,420 | \$ 199 |

The following table presents the average balance and interest income recognized on loans individually evaluated for impairment by class of loans as of March 31, 2012 and March 31, 2011:

| | As of March 31, 2012 | | 2011 | |
|---------------------------------------|--|------|--|------|
| | Average Interest Recorded Investment | | Average Interest Recorded Investment | |
| | Recognized | | Recognized | |
| With no related allowance recorded: | | | | |
| Commercial | \$- | \$ - | \$- | \$ - |
| Commercial Real Estate - Construction | 173 | - | - | - |
| Commercial Real Estate - Other | 924 | - | 467 | - |
| Consumer - Real Estate | 146 | - | 60 | - |
| Consumer - Other | 15 | - | 16 | - |
| Residential | 1,126 | - | 1,269 | - |
| With a specific allowance recorded: | | | | |
| Commercial | - | - | - | - |
| Commercial Real Estate - Construction | - | - | 1,772 | - |
| Commercial Real Estate - Other | 2,395 | - | 797 | - |
| Consumer - Real Estate | - | - | 99 | - |
| Consumer - Other | - | - | - | - |
| Residential | 859 | - | 1,456 | - |
| Totals: | | | | |
| Commercial | \$- | \$ - | \$- | \$ - |
| Commercial Real Estate - Construction | \$173 | \$ - | \$3,449 | \$ - |
| Commercial Real Estate - Other | \$3,319 | \$ - | \$1,290 | \$ - |
| Consumer - Real Estate | \$146 | \$ - | \$159 | \$ - |
| Consumer - Other | \$15 | \$ - | \$16 | \$ - |
| Residential | \$1,985 | \$ - | \$2,725 | \$ - |

The Allowance for Loan and Lease Losses has a direct impact on the provision expense. An increase in the Allowance for Loan and Lease Losses is funded through recoveries and provision expense.

Activity in the allowance for loan and lease losses was as follows for the three-month periods ended March 31, 2012 and 2011, respectively:

For the Three Months Ended March 31, 2012

| | Commercial Construction | Commercial Real Estate | Commercial | Consumer Real Estate | Consumer | Residential | Unallocated | Total |
|---|----------------------------|------------------------------|------------|----------------------------|----------|-------------|-------------|------------|
| Allowance for credit losses: | | | | | | | | |
| Beginning Balance | \$ 10 | \$ 393 | \$ 53 | \$ 146 | \$ 46 | \$ 870 | \$ - | \$ 1,518 |
| Charge-offs | - | (55) | - | (19) | (7) | (166) | - | (247) |
| Recoveries | - | 4 | - | 5 | 2 | 5 | - | 16 |
| Provision | (10) | 173 | (12) | (6) | 1 | 230 | - | 376 |
| Ending Balance | \$ - | \$ 515 | \$ 41 | \$ 126 | \$ 42 | \$ 939 | \$ - | \$ 1,663 |
| Ending balance: | | | | | | | | |
| individually evaluated for impairment | \$ - | \$ 213 | \$ - | \$ - | \$ - | \$ 245 | \$ - | \$ 458 |
| Ending balance: loans collectively evaluated for impairment | | | | | | | | |
| | \$ - | \$ 302 | \$ 41 | \$ 126 | \$ 42 | \$ 694 | \$ - | \$ 1,205 |
| Ending balance: loans acquired with deteriorated credit quality | | | | | | | | |
| | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Financing Receivables: | | | | | | | | |
| Ending Balance | \$ 173 | \$ 53,140 | \$ 7,191 | \$ 12,485 | \$ 1,359 | \$ 66,798 | \$ - | \$ 141,146 |
| Ending balance: | | | | | | | | |
| individually evaluated for impairment | \$ 173 | \$ 3,333 | \$ - | \$ 145 | \$ 14 | \$ 1,966 | \$ - | \$ 5,631 |
| Ending balance: loans collectively evaluated for impairment | | | | | | | | |
| | \$ - | \$ 49,807 | \$ 7,191 | \$ 12,340 | \$ 1,345 | \$ 64,832 | \$ - | \$ 135,515 |
| Ending balance: loans acquired with deteriorated credit quality | | | | | | | | |
| | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |

For the Three Months Ended March 31, 2011

Commercial Commercial Consumer

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| | Construction | Real Estate | Commercial | Real Estate | Consumer Residential | Unallocated | Total |
|---|--------------|-------------|------------|-------------|----------------------|-------------|----------------|
| Allowance for credit losses: | | | | | | | |
| Beginning Balance | \$ 535 | \$ 1,281 | \$ 192 | \$ 228 | \$ 59 | \$ 536 | \$ - \$2,831 |
| Charge-offs | - | (78) | (5) | (45) | (4) | (159) | - (291) |
| Recoveries | - | 1 | - | 18 | 5 | 1 | - 25 |
| Provision | (217) | 73 | 6 | 27 | (31) | 209 | - 67 |
| Ending Balance | \$ 318 | \$ 1,277 | \$ 193 | \$ 228 | \$ 29 | \$ 587 | \$ - \$2,632 |
| Ending balance: individually evaluated for impairment | | | | | | | |
| | \$ 305 | \$ 108 | \$ - | \$ 9 | \$ - | \$ 221 | \$ - \$643 |
| Ending balance: loans collectively evaluated for impairment | | | | | | | |
| | \$ 13 | \$ 1,169 | \$ 193 | \$ 219 | \$ 29 | \$ 366 | \$ - \$1,989 |
| Ending balance: loans acquired with deteriorated credit quality | | | | | | | |
| | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - \$- |
| Financing Receivables: | | | | | | | |
| Ending Balance | \$ 1,842 | \$ 57,323 | \$ 8,658 | \$ 15,739 | \$ 1,981 | \$ 68,603 | \$ - \$154,146 |
| Ending balance: individually evaluated for impairment | | | | | | | |
| | \$ 1,772 | \$ 1,261 | \$ - | \$ 158 | \$ 15 | \$ 2,832 | \$ - \$6,038 |
| Ending balance: loans collectively evaluated for impairment | | | | | | | |
| | \$ 70 | \$ 56,062 | \$ 8,658 | \$ 15,581 | \$ 1,966 | \$ 65,771 | \$ - \$148,108 |
| Ending balance: loans acquired with deteriorated credit quality | | | | | | | |
| | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - \$- |

Note 5—DIVIDENDS

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

Note 6—STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted FASB ASC 718-10, "Shareholder Based Payments", which requires that the grant-date fair value of awarded stock options be expensed over the requisite service period. The Company's 1996 Stock Option Plan (the "1996 Plan"), which was approved by shareholders, permits the grant of share options to its employees for up to 127,491 shares of common stock (retroactively adjusted for the exchange ratio applied in the Company's 2005 stock offering and related second-step conversion). The Company's 2006 Stock-Based Incentive Plan (the "2006 Plan"), which was approved by shareholders on May 17, 2006, permits the award of up to 242,740 shares of common stock of which the maximum number to be granted as Stock Options is 173,386 and the maximum that can be granted as Restricted Stock Awards is 69,354. Option awards are granted with an exercise price equal to the market price of the Company's stock at the date of grant; those option awards generally vest based on five years of continual service and have ten year contractual terms. Certain options provide for accelerated vesting if there is a change in control (as defined in the Plans).

During the three months ended March 31, 2012 no shares were awarded under either the 1996 Plan or the 2006 Plan. Shares issued under the plans and exercised pursuant to the exercise of the stock options awarded under the plans may be either authorized but unissued shares or reacquired shares held by the Company as treasury stock.

Stock Options - A summary of option activity under the Plans during the three months ended March 31, 2012 is presented below:

| Options | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|--------------------------------|---------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2012 | 182,682 | \$ 9.47 | 4.3 | \$ 0 |
| Granted | 0 | N/A | | |

| | | | | |
|---------------------------------------|----------|---------|-----|------|
| Exercised | 0 | N/A | | |
| Forfeited or expired | (5,542) | \$ 7.44 | | |
| Oustanding at March 31, 2012 | 177,140 | \$ 9.53 | 4.4 | \$ 0 |
| Options Exercisable at March 31, 2012 | 175,900 | \$ 9.54 | 4.4 | \$ 0 |

The aggregate intrinsic value of outstanding options shown in the table above represents the total pretax intrinsic value (i.e. the difference between the Company's closing stock price of \$3.90 on March 31, 2012 and the exercise price times the number of shares) that would have been received by the option holder had all option holders exercised their options on March 31, 2012. The amount changes based on the fair market value of the stock.

As of March 31, 2012 there was approximately \$500 of total unrecognized compensation cost, net of expected forfeitures, related to nonvested options under the Plan. That cost is expected to be recognized by June 30, 2012. There were no shares which vested during the quarter ended March 31, 2012.

A summary of the status of the Company's non-vested options as of March 31, 2012, and changes during the quarter, is presented below:

| Nonvested Options | Number of Options | Weighted-Average Grant-Date Fair Value |
|------------------------------|----------------------|--|
| Nonvested at January 1, 2012 | 1,240 | \$ 2.19 |
| Granted | 0 | N/A |
| Vested | 0 | \$ 1.94 |
| Forfeited | 0 | N/A |
| Nonvested at March 31, 2012 | 1,240 | \$ 2.19 |

Restricted Stock Awards - As of March 31, 2012 there was approximately \$500 of unrecognized compensation cost related to non-vested restricted stock awards under the Plans. That cost is expected to be recognized by June 30, 2012.

Note 7— COMMITMENTS TO EXTEND CREDIT.

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

At March 31, 2012, the Company had outstanding commitments to originate loans of \$34.6 million. These commitments included the following:

| | As of March 31, 2012 |
|--|-------------------------|
| Commitments to grant loans | \$ 21,945 |
| Unfunded commitments under lines of credit | 12,268 |
| Commercial and standby letters of credit | 404 |

Note 8-FAIR VALUE MEASUREMENTS

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

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2012

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance at March 31, 2012 |
|---|--|---|---|---------------------------|
| Assets | | | | |
| Investment securities- available-for-sale: | | | | |
| US Treasury securities and obligations of U.S. government corporations and agencies | \$ - | \$ 15,322 | \$ - | \$ 15,322 |
| Municipal notes | - | 7,277 | - | 7,277 |
| Mortgage-backed securities | - | 30,250 | - | 30,250 |
| Equity securities | - | 1 | - | 1 |
| Total investment securities - available-for-sale | \$ - | \$ 52,850 | \$ - | \$ 52,850 |

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

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance at December 31, 2011 |
|--|--|---|---|------------------------------|
| Assets | | | | |
| Investment securities- available-for-sale: | | | | |

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| | | | | | | |
|---|----|---|-----------|----|---|-----------|
| US Treasury securities and obligations of U.S. government corporations and agencies | \$ | - | \$ 14,863 | \$ | - | \$ 14,863 |
| Municipal notes | | - | 7,276 | | - | 7,276 |
| Mortgage-backed securities | | - | 30,909 | | - | 30,909 |
| Equity securities | | - | 1 | | - | 1 |
| Total investment securities - available-for-sale | \$ | - | \$ 53,049 | \$ | - | \$ 53,049 |

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

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

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

Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2012

| | Balance at March 31, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|------------------------------|---|---|--|
| Impaired loans accounted for under FASB ASC 310-10 | \$ 3,506 | \$ - | \$ - | \$ 3,506 |
| Other real estate owned -residential mortgages | \$ 1,379 | \$ - | \$ - | \$ 1,379 |
| Other Real estate owned - commercial | \$ 931 | \$ - | \$ - | \$ 931 |
| Other repossessed assets | \$ 1,307 | | | \$ 1,307 |
| Total assets at fair value on a non-recurring basis | | | | \$ 7,123 |

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

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

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

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

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

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

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

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

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

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

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

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

| March 31, 2012 | Carrying Value | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value |
|-------------------------------------|----------------|---------|---------|---------|----------------------------|
| Financial assets: | | | | | |
| Cash and cash equivalents | \$2,414 | \$2,414 | \$- | \$ - | \$ 2,414 |
| Securities available for sale | 52,850 | - | 52,850 | - | 52,850 |
| Securities held to maturity | 2,435 | - | 2,645 | - | 2,645 |
| Loans and loans held for sale - Net | 139,510 | - | 143,725 | - | 143,725 |
| Federal Home Loan Bank stock | 3,266 | 3,266 | - | - | 3,266 |
| Accrued interest receivable | 1,161 | 1,161 | - | - | 1,161 |
| Financial liabilities: | | | | | |
| Customer deposits | 151,106 | 152,215 | - | - | 152,215 |
| Federal Home Loan Bank advances | 32,725 | - | 33,004 | - | 33,004 |
| REPO sweep accounts | 5,606 | 5,606 | - | - | 5,606 |
| Accrued interest payable | 128 | 128 | - | - | 128 |
| | | | | | |
| December 31, 2011 | Carrying Value | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$2,749 | \$2,749 | \$- | \$ - | \$ 2,749 |
| Securities available for sale | 53,049 | - | 53,049 | - | 53,049 |
| Securities held to maturity | 2,435 | - | 2,665 | - | 2,665 |
| Loans and loans held for sale - Net | 140,884 | - | 146,018 | - | 146,018 |
| Federal Home Loan Bank stock | 3,266 | 3,266 | - | - | 3,266 |
| Accrued interest receivable | 1,149 | 1,149 | - | - | 1,149 |
| Financial liabilities: | | | | | |
| Customer deposits | 150,649 | 151,693 | - | - | 151,693 |
| Federal Home Loan Bank advances | 34,500 | - | 34,827 | - | 34,827 |
| REPO sweep accounts | 5,592 | 5,592 | - | - | 5,592 |
| Accrued interest payable | 148 | 148 | - | - | 148 |

Note 9 – RECENT ACCOUNTING PRONOUNCEMENTS.

ASC Topic 220: Comprehensive Income: Presentation of Comprehensive Income. On June 16, 2011, the FASB issued Accounting Standards Update (ASU) 2011-05. This ASU is intended to increase the prominence of other comprehensive income in financial statements. The new guidance does not change whether items are reported in net income or in other comprehensive income or whether and when items of other comprehensive income are reclassified to net income. ASU 2011-05 eliminates the option in current U.S. generally accepted accounting principles that permits the presentation of other comprehensive income in the statement of changes in equity. The new guidance in

the ASU requires that an entity report comprehensive income in either a single continuous statement that presents the components of net income or a separate but consecutive statement. The new guidance is to be applied retrospectively and early adoption is permitted. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted this pronouncement as of the interim period ended March 31, 2012. The adoption of this pronouncement did not have a material impact on the Company's financial statements.

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

PART - FINANCIAL INFORMATION

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

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

OVERVIEW

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

For the quarter ended March 31, 2012, the Company had net income of \$601,000, or \$0.21 per basic and diluted share, compared to \$161,000, or \$0.06 per basic and diluted share, for the year earlier period, an increase of \$440,000. Pre-tax loss for the three months ended March 31 2012 was \$286,000. The Company credited \$866,000 of the valuation allowance on its deferred tax assets to income tax expense during the quarter. See further discussion below in Income Taxes section.

Total assets decreased by \$914,000, or 0.4%, from \$217.0 million as of December 31, 2011 to \$216.1 million as of March 31, 2012. Investment securities available for sale decreased by \$198,000 and net loans receivable decreased \$1.7 million during this time . Total deposits increased \$457,000 from December 31, 2011 to March 31, 2012 while Federal Home Loan Bank advances decreased by \$1.8 million and stockholders' equity increased by \$557,000.

CRITICAL ACCOUNTING POLICIES

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

COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2012 AND DECEMBER 31, 2011

ASSETS: Total assets decreased \$914,000, or 0.4%, to \$216.1 million at March 31, 2012 from \$217.0 million at December 31, 2011. Net loans receivable decreased \$1.7 million, or 1.2%, to \$139.2 million at March 31, 2012 from \$140.9 million at December 31, 2011, resulting primarily from a decrease in our commercial loan portfolio. Our residential mortgage portfolio remained relatively unchanged as a result of our selective placing in our portfolio certain high-quality 10- and 15-year fixed rate residential mortgage loans. Investment securities AFS decreased \$198,000 from \$53.0 million at December 31, 2011 to \$52.8 million at March 31, 2012, due primarily to ordinary principal payments received on our mortgage back securities.

LIABILITIES: Deposits increased \$457,000 to \$151.1 million at March 31, 2012 from \$150.7 million at December 31, 2011. During this time period, we experienced an increase of \$2.9 million in our savings, money market and checking accounts, which was largely offset by a decrease of \$2.4 million in our certificates of deposit. FHLB advances decreased \$1.8 million, or 5.1%, from \$34.5 million at December 31, 2011 to \$32.7 million at March 31, 2012 as proceeds from loan payments and payoffs, as well as cash on hand, were used to pay off maturing advances.

EQUITY: Stockholders' equity was \$25.1 million at March 31, 2012 compared to \$24.6 million at December 31, 2011. The increase was due primarily to net earnings for the three-month period of \$601,000 partially offset by a decrease of \$44,000 in the unrealized gain on available-for-sale investment securities

RESULTS OF OPERATIONS

Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

General: Net income increased by \$440,00 to \$601,000 for the three months ended March 31, 2012 from \$161,000 for the same period ended March 31, 2011.

Interest Income: Interest income decreased to \$2.4 million for the three months ended March 31, 2012 from \$2.6 million for the comparable period in 2011. The average balance of interest earning assets decreased by \$1.0 million from \$201.9 million for the three months ended March 31, 2011 to \$200.9 million for the three months ended March 31, 2012 and the average yield on interest earning assets decreased 37 basis points over that same time period from 5.17% to 4.80%. The yield on our mortgage loan portfolio decreased by 21 basis points to 5.73% from 5.94% for the three month period ended March 31, 2012 from the year-earlier period, while the average balance of that portfolio decreased by \$4.0 million to \$66.7 million period over period. The average balance of our non-mortgage loan portfolio decreased \$13.0 million to \$74.9 million for the three months ended March 31, 2012 from the year-earlier period, while the yield on this portfolio increased 17 basis points to 5.81% from 5.64% period over period. The average balance of our investment portfolio increased \$17.0 million from the three months ended March 31, 2011 to the same period in 2012 as we purchased investment securities with the proceeds of loan pay-offs and paydowns over the time period. The yield on our investments decreased by 61 basis points period over period as many of our agency securities were called and replaced with securities with lower yields due to market interest rates.

Interest Expense: Interest expense decreased to \$464,000 for the three months ended March 31, 2012 from \$605,000 for the three months ended March 31, 2011. The decrease was due in part to a \$1.9 million decrease in the average balance of our interest-bearing liabilities and a decrease in our overall cost of funds of 32 basis points period over period. Most notably, the average balance of our certificates of deposit decreased \$6.6 million from the three-month period ended March 31, 2011 to the same period in 2012. The cost of these deposits decreased 54 basis points period

over period. In addition, our average balance in money market and NOW accounts decreased \$2.6 million and the cost of those deposits decreased 24 basis points from the three months ended March 31, 2011 to the same period in 2012. The average balance of our Federal Home Loan Bank advances increased \$6.6 million from the three-month period ended March 31, 2011 to the same period in 2012, while the cost of those advances decreased 24 basis points period over period.

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

| | Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011 Increase (Decrease) Due to: | | |
|--|--|------------|--------------|
| | Volume | Rate | Total |
| | (In thousands) | | |
| Interest-earning assets: | | | |
| Loans receivable | \$ (226) | \$ (7) | \$ (233) |
| Investment securities | 86 | (37) | \$ 49 |
| Other investments | (8) | 9 | \$ 1 |
| Total interest-earning assets | (148) | (35) | (183) |
| Interest-bearing liabilities: | | | |
| Savings Deposits | - | - | - |
| Money Market/NOW accounts | (3) | (24) | (27) |
| Certificates of Deposit | (37) | (93) | (130) |
| Deposits | (40) | (117) | (157) |
| Borrowed funds | 37 | (21) | 16 |
| Total interest-bearing liabilities | (3) | (138) | (141) |
| Change in net interest income | \$ (145) | \$ 103 | \$ (42) |

Net Interest Income: Net interest income decreased by \$42,000, to \$1.9 million for the three months ended March 31, 2012 from \$2.0 million for the prior year period. For the three months ended March 31, 2012, average interest-earning assets decreased \$1.6 million, or 0.5%, to \$200.9 million when compared to the same period in 2011. Average interest-bearing liabilities decreased \$1.9 million, or 1.1%, to \$177.4 million for the quarter ended March 31, 2012 from \$179.3 million for the quarter ended March 31, 2011. The yield on average interest-earning assets decreased to 4.80% for the three month period ended March 31, 2012 from 5.17% for the same period ended in 2011. In addition, the cost of average interest-bearing liabilities decreased to 1.05% from 1.37% for the three month periods ended March 31, 2012 and 2011, respectively. Our interest rate spread decreased by 5 basis points to 3.75% while our net interest margin decreased by 8 basis points to 3.87% for the three month period ended March 31, 2012 from 3.95% for same period in 2011.

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

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

The provision for loan losses for the three-month period ended March 31, 2012 was \$376,000, as compared to \$67,000 for the prior year period. Prior to 2012, our provision for loan losses was based on an eight-quarter rolling average of actual net charge-offs adjusted for environmental factors for each segment of loans in our portfolio. Management has decided that eight quarters is no longer reflective of the inherent loss in the loan portfolios. Beginning with the quarter ended March 31, 2012, we began moving towards a twelve-quarter rolling average of actual net charge-offs by adding an additional quarter of net charge-offs each quarter in 2012. By the end of 2012 we will be using a twelve-quarter rolling average. During the quarter ended March 31, 2011, we moved a large commercial loan out of construction status into our general pool of commercial loans, which allowed us to reduce the amount of general reserves we needed to record. Construction loans carry a higher degree of risk and therefore a higher level of reserve. This resulted in a lower than anticipated provision during the quarter ended March 31, 2011. During the quarter ended March 31, 2012, we added specific reserves of approximately \$200,000 on two commercial credit relationships which were reclassified as Troubled Debt Restructurings. In addition, we recorded specific reserves of approximately \$200,000 on several residential mortgage loans which had progressed in the foreclosure process during the quarter. The provision was based on management's review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

The following table sets forth the details of our loan portfolio at the dates indicated:

| | Portfolio Balance (Dollars in thousands) | Delinquent Loans Over 90 Days | Non-Accrual Loans |
|---|--|-------------------------------------|----------------------|
| At March 31, 2012 | | | |
| Real estate loans: | | | |
| Construction | 1,065 | - | 173 |
| One - to four - family | 65,906 | 175 | 1,966 |
| Commercial Mortgages | 53,140 | 30 | 435 |
| Home equity lines of credit/ Junior liens | 12,485 | 62 | 145 |
| Commercial loans | 7,191 | - | - |
| Consumer loans | 1,359 | 1 | 14 |
| Total gross loans | \$ 141,146 | \$ 268 | \$ 2,733 |
| Less: | | | |
| Net deferred loan fees | (280) | (1) | (8) |
| Allowance for loan losses | (1,663) | - | (316) |
| Total loans, net | \$ 139,203 | \$ 267 | \$ 2,409 |
| At December 31, 2011 | | | |
| Real estate loans: | | | |
| Construction | 762 | - | 1,772 |
| One - to four - family | 66,101 | 282 | 3,114 |
| Commercial Mortgages | 53,938 | 82 | 1,148 |
| Home equity lines of credit/Junior liens | 13,395 | - | 206 |
| Commercial loans | 7,002 | - | - |
| Consumer loans | 1,477 | 2 | - |
| Total gross loans | \$ 142,675 | \$ 366 | \$ 6,240 |
| Less: | | | |
| Net deferred loan fees | (273) | (1) | (11) |
| Allowance for loan losses | (1,518) | - | (261) |
| Total loans, net | \$ 140,884 | \$ 365 | \$ 5,968 |

Non Interest Income: Non-interest income was relatively unchanged for the quarters ended March 31, 2011 and 2012. Due to continued historically low mortgage rates, mortgage banking activities income has remained strong year over year.

Non Interest Expense: Non interest expense increased by \$93,000 from \$2.2 million for the three months ended March 31, 2011 to \$2.3 million for the 2012 period. Most notably, compensation and employee benefits increased by \$103,000 period over period as we added a commercial lender and Treasury Management professional and due to the

reinstatement of the elective contribution to the Company's 401(k) plan, for which the Company has begun accruing.

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

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

Despite the Company's loss for the quarter ended March 31, 2012, we fully expect that trend to reverse for the remaining quarters in 2012.

The quarter ended March 31, 2012 included expenses associated with the decline in value of certain of our REO properties that we consider to be "one-time expenses" in 2012.

The level of our non-performing assets continues to decrease each quarter, from \$10.0 million at March 31, 2011 to \$6.7 million at March 31, 2012. We expect that trend to continue, which will have a positive impact on earnings in future quarters.

We sold our two largest pieces of REO property at the end of 2011, therefore 2012 earnings will not be burdened with carrying costs on those properties.

A valuation allowance of \$2.2 million remains on \$3.8 million of the current deferred tax asset at March 31, 2012.

As of March 31, 2012 the Company had a net operating loss carryforward for tax purposes of approximately \$10.0 million and related deferred tax asset of \$3.4 million. The Company will continue to evaluate the future benefits from these carryforwards and at such time as it becomes "more likely than not" that they would be utilized prior to expiration, the Company will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will expire in the year 2031.

LIQUIDITY

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

Liquidity represents the amount of an institution's assets that can be quickly and easily converted into cash without significant loss. The most liquid assets are cash, short-term U.S. Government securities, U.S. Government agency securities and certificates of deposit. The Company is required to maintain sufficient levels of liquidity as defined by OCC regulations. This requirement may be varied at the direction of the OCC. Regulations currently in effect require that the Bank must maintain sufficient liquidity to ensure its safe and sound operation. The Company's objective for

liquidity is to be above 20%. Liquidity as of March 31, 2012 was \$45.7 million, or 39.3% compared to \$44.6 million, or 39.9% at December 31, 2011. The levels of these assets are dependent on the Company's operating, financing, lending and investing activities during any given period. The liquidity calculated by the Company includes additional borrowing capacity available with the FHLB. This borrowing capacity is based on pledged collateral. As of March 31, 2012, the Bank had unused borrowing capacity totaling \$16.1 million at the FHLB based on pledged collateral.

The Company intends to retain for its portfolio certain originated residential mortgage loans (primarily adjustable rate and shorter term fixed rate mortgage loans) and to generally sell the remainder in the secondary market. The Bank will from time to time participate in or originate commercial real estate loans, including real estate development loans. During the three month period ended March 31, 2012, the Company originated \$11.7 million in residential mortgage loans, of which \$4.0 million were retained in portfolio while the remainder were sold in the secondary market or are being held for sale. This compares to \$7.2 million in originations during the first three months of 2011 of which \$287,000 were retained in portfolio. The Company also originated \$3.0 million of commercial loans and \$179,000 of consumer loans in the first three months of 2012 compared to \$4.5 million of commercial loans and \$319,000 of consumer loans for the same period in 2011. Of total loans receivable, excluding loans held for sale, mortgage loans comprised 47.3% and 44.5%, commercial loans 42.9% and 44.0% and consumer loans 9.8% and 11.5% at March 31, 2012 and March 31, 2011, respectively.

Deposits are a primary source of funds for use in lending and for other general business purposes. At March 31, 2012 deposits funded 69.9% of the Company's total assets compared to 69.4% at December 31, 2011. Certificates of deposit scheduled to mature in less than one year at March 31, 2012 totaled \$40.6 million. Management believes that a significant portion of such deposits will remain with the Bank. The Bank monitors the deposit rates offered by competition in the area and sets rates that take into account the prevailing market conditions along with the Bank's liquidity position. Future liquidity needs are expected to be satisfied through the use of FHLB 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.

Borrowings may be used to compensate for seasonal or other reductions in normal sources of funds or for deposit outflows at more than projected levels. Borrowings may also be used on a longer-term basis to support increased lending or investment activities. At March 31, 2012 the Company had \$32.7 million in FHLB advances. FHLB borrowings as a percentage of total assets were 15.1% at March 31, 2012 as compared to 15.9% at December 31, 2011. The Company has sufficient available collateral to obtain additional advances of \$16.1 million.

CAPITAL RESOURCES

Stockholders' equity at March 31, 2012 was \$25.1 million, or 11.6% of total assets, compared to \$24.6 million, or 11.3% of total assets, at December 31, 2011 (See "Consolidated Statement of Changes in Stockholders' Equity"). The Bank is subject to certain capital-to-assets levels in accordance with OCC regulations. The Bank exceeded all regulatory capital requirements at March 31, 2012. The following table summarizes the Bank's actual capital with the regulatory capital requirements and with requirements to be "Well Capitalized" under prompt corrective action provisions, as of March 31, 2012:

| | Actual | | Regulatory | | Minimum to be | |
|--|----------------------|---------|------------|--------|------------------|---------|
| | Amount | Ratio | Minimum | Ratio | Well Capitalized | Ratio |
| | Dollars in Thousands | | | | | |
| Tier 1 (Core) capital (to adjusted assets) | \$22,266 | 10.38 % | \$8,577 | 4.00 % | \$10,721 | 5.00 % |
| Total risk-based capital (to risk- weighted assets) | \$23,931 | 17.75 % | \$10,785 | 8.00 % | \$13,482 | 10.00 % |
| Tier 1 risk-based capital (to risk weighted assets) | \$22,266 | 16.52 % | \$5,393 | 4.00 % | \$8,089 | 6.00 % |
| Tangible Capital (to tangible assets) | \$22,266 | 10.38 % | \$3,216 | 1.50 % | \$4,288 | 2.00 % |

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable to smaller reporting companies.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934 (1) is recorded, processed, summarized and reported, within the time periods specified by the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

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

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended March 31, 2012

PART II – OTHER INFORMATION

Item 1 - Legal
Proceedings:

At March 31,
2012 there were
no material legal
proceedings to
which the
Company is a
party or of which
any of its

property is
subject. From
time to time the
Company is a
party to various
legal proceedings
incident to its
business.

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

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

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

Item 3 - Defaults upon
Senior Securities:
Not applicable.

Item 4 - Mine Safety
Disclosures
Not applicable

Item 5 - Other
Information:
Not applicable

Item 6 - Exhibits

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

Exhibit 31.2
Certification by
Chief Financial
Officer pursuant
to section 302 of

the
Sarbanes-Oxley
Act of 2002

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

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

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

FORM 10-Q

Quarter Ended March 31, 2012

SIGNATURES

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

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

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

Date: May 15, 2012

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

Date: May 15, 2012

