

MACATAWA BANK CORP
Form 10-Q
April 26, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2012

OR

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

For the transition period from _____ to _____

Commission file number: 000-25927

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

Michigan
(State or other jurisdiction of incorporation or organization)

38-3391345
(I.R.S. Employer Identification No.)

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

Registrant's telephone number, including area code: (616) 820-1444

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

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

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

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 27,082,825 shares of the Company's Common Stock (no par value) were outstanding as of April 26, 2012.

Forward-Looking Statements

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

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2011. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

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Part I Financial Information

Item 1.

MACATAWA BANK CORPORATION
 CONSOLIDATED BALANCE SHEETS
 As of March 31, 2012 (unaudited) and December 31, 2011

| (dollars in thousands, except per share data) | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 22,278 | \$ 30,971 |
| Federal funds sold and other short -term investments | 184,362 | 212,071 |
| Cash and cash equivalents | 206,640 | 243,042 |
| Securities available for sale, at fair value | 88,745 | 54,746 |
| Securities held to maturity (fair value 2012 and 2011 - \$300) | 300 | 300 |
| Federal Home Loan Bank (FHLB) stock | 11,236 | 11,236 |
| Loans held for sale, at fair value | 8,562 | 1,026 |
| Total loans | 1,059,935 | 1,070,975 |
| Allowance for loan losses | (29,451) | (31,641) |
| Net loans | 1,030,484 | 1,039,334 |
| Premises and equipment – net | 54,819 | 55,358 |
| Accrued interest receivable | 3,802 | 3,595 |
| Bank-owned life insurance | 26,180 | 25,957 |
| Other real estate owned | 66,236 | 66,438 |
| Other assets | 5,990 | 6,635 |
| Total assets | \$ 1,502,994 | \$ 1,507,667 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing | \$ 300,617 | \$ 324,253 |
| Interest-bearing | 913,854 | 891,036 |
| Total deposits | 1,214,471 | 1,215,289 |
| Other borrowed funds | 137,489 | 148,603 |
| Long-term debt | 41,238 | 41,238 |
| Subordinated debt | 1,650 | 1,650 |
| Accrued expenses and other liabilities | 9,259 | 6,461 |
| Total liabilities | 1,404,107 | 1,413,241 |
| Commitments and contingent liabilities | --- | --- |
| Shareholders' equity | | |
| Preferred stock, no par value, 500,000 shares authorized; | | |
| Series A Noncumulative Convertible Perpetual Preferred Stock, liquidation value of \$1,000 per share, 31,290 shares issued and outstanding | 30,604 | 30,604 |
| Series B Noncumulative Convertible Perpetual Preferred Stock, liquidation value of \$1,000 per share, 2,600 shares issued and outstanding | 2,560 | 2,560 |
| | 187,709 | 187,709 |

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| | | |
|--|--------------|--------------|
| Common stock, no par value, 200,000,000 shares authorized; 27,082,825 and 27,082,823 shares issued and outstanding at March 31, 2012 and December 31, 2011 | | |
| Retained deficit | (122,340) | (126,825) |
| Accumulated other comprehensive income | 354 | 378 |
| Total shareholders' equity | 98,887 | 94,426 |
| Total liabilities and shareholders' equity | \$ 1,502,994 | \$ 1,507,667 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Three Month Periods Ended March 31, 2012 and 2011
(unaudited)

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|---|---|---|
| (dollars in thousands, except per share data) | | |
| Interest income | | |
| Loans, including fees | \$ 13,526 | \$ 15,582 |
| Securities | | |
| Taxable | 318 | 27 |
| Tax-exempt | 42 | --- |
| FHLB Stock | 85 | 76 |
| Federal funds sold and other short-term investments | 128 | 168 |
| Total interest income | 14,099 | 15,853 |
| Interest expense | | |
| Deposits | 1,650 | 2,912 |
| Debt and other borrowed funds | 1,168 | 1,343 |
| Total interest expense | 2,818 | 4,255 |
| Net interest income | 11,281 | 11,598 |
| Provision for loan losses | (3,600) | (1,450) |
| Net interest income after provision for loan losses | 14,881 | 13,048 |
| Noninterest income | | |
| Service charges and fees | 795 | 949 |
| Net gains on mortgage loans | 471 | 435 |
| Trust fees | 609 | 651 |
| ATM and debit card fees | 981 | 918 |
| Other | 855 | 726 |
| Total noninterest income | 3,711 | 3,679 |
| Noninterest expense | | |
| Salaries and benefits | 5,720 | 5,347 |
| Occupancy of premises | 971 | 1,011 |
| Furniture and equipment | 828 | 817 |
| Legal and professional | 212 | 270 |
| Marketing and promotion | 210 | 224 |
| Data processing | 351 | 304 |
| FDIC assessment | 710 | 978 |
| ATM and debit card processing | 288 | 271 |
| Bond and D&O Insurance | 268 | 379 |
| Losses on repossessed and foreclosed properties | 1,596 | 2,493 |
| Administration and disposition of problem assets | 1,462 | 1,941 |

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| | | |
|--|----------|----------|
| Other | 1,491 | 1,401 |
| Total noninterest expenses | 14,107 | 15,436 |
| Income before income tax | 4,485 | 1,291 |
| Income tax expense (benefit) | --- | --- |
| Net income | 4,485 | 1,291 |
| Dividends declared on preferred shares | --- | --- |
| Net income available to common shares | \$ 4,485 | \$ 1,291 |
| Basic earnings per common share | \$ 0.17 | \$ 0.07 |
| Diluted earnings per common share | \$ 0.17 | \$ 0.07 |
| Cash dividends per common share | \$ --- | \$ --- |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 Three Month Periods Ended March 31, 2012 and 2011
 (unaudited)

| (dollars in thousands) | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|--|---|---|
| Net income | \$ 4,485 | \$ 1,291 |
| Other comprehensive income (loss), net of tax: | | |
| Net unrealized gains (losses) on securities available for sale arising during period | (24) | 3 |
| Less: reclassification adjustment for gain recognized in earnings, net of tax | --- | --- |
| Other comprehensive income (loss), net of tax | (24) | 3 |
| Comprehensive income | \$ 4,461 | \$ 1,294 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Three Month Periods Ended March 31, 2012 and 2011
(unaudited)

| (dollars in thousands, except per share data) | Preferred Stock | | Common | Retained | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|--|-----------------|----------|------------|--------------|---|----------------------------------|
| | Series A | Series B | Stock | (Deficit) | | |
| Balance, January 1, 2011 | \$ 30,604 | \$ 2,560 | \$ 167,321 | \$ (132,654) | \$ 11 | \$ 67,842 |
| Net income for three months ended March 31, 2011 | | | | 1,291 | | 1,291 |
| Net change in unrealized gain (loss) on securities available for sale, net of tax | | | | | 3 | 3 |
| Stock compensation expense | | | 17 | | | 17 |
| Balance, March 31, 2011 | \$ 30,604 | \$ 2,560 | \$ 167,338 | \$ (131,363) | \$ 14 | \$ 69,153 |
| Balance, January 1, 2012 | \$ 30,604 | \$ 2,560 | \$ 187,709 | \$ (126,825) | \$ 378 | \$ 94,426 |
| Net income for three months ended March 31, 2012 | | | | 4,485 | | 4,485 |
| Net change in unrealized gain (loss) on securities available for sale, net of tax | | | | | (24) | (24) |
| Balance, March 31, 2012 | \$ 30,604 | \$ 2,560 | \$ 187,709 | \$ (122,340) | \$ 354 | \$ 98,887 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Three Month Periods Ended March 31, 2012 and 2011
(unaudited)

| (dollars in thousands) | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|--|--|--|
| Cash flows from operating activities | | |
| Net income | \$ 4,485 | \$ 1,291 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization | 704 | 781 |
| Stock compensation expense | --- | 17 |
| Provision for loan losses | (3,600) | (1,450) |
| Origination of loans for sale | (26,524) | (16,671) |
| Proceeds from sales of loans originated for sale | 19,459 | 18,701 |
| Net gains on mortgage loans | (471) | (435) |
| Write-down of other real estate | 1,690 | 2,699 |
| Net gain on sales of other real estate | (94) | (212) |
| Decrease (increase) in accrued interest receivable and other assets | 450 | (2,157) |
| Earnings in bank-owned life insurance | (223) | (215) |
| Increase in accrued expenses and other liabilities | 2,798 | 684 |
| Net cash from operating activities | (1,326) | 3,033 |
| Cash flows from investing activities | | |
| Loan originations and payments, net | 6,639 | 45,092 |
| Purchases of securities available for sale | (44,921) | (10,549) |
| Proceeds from: | | |
| Maturities and calls of securities available for sale | 10,470 | 6,988 |
| Principal paydowns on securities | 334 | 85 |
| Sales of other real estate | 4,417 | 4,984 |
| Additions to premises and equipment | (83) | (112) |
| Net cash from investing activities | (23,144) | 46,488 |
| Cash flows from financing activities | | |
| Net decrease in in-market deposits | (818) | (6,360) |
| Decrease in brokered deposits | --- | (5,595) |
| Repayments of other borrowed funds | (11,114) | (11,066) |
| Net cash from financing activities | (11,932) | (23,021) |
| Net change in cash and cash equivalents | (36,402) | 26,500 |
| Cash and cash equivalents at beginning of period | 243,042 | 236,127 |
| Cash and cash equivalents at end of period | \$ 206,640 | \$ 262,627 |
| Supplemental cash flow information | | |
| Interest paid | \$ 2,462 | \$ 3,950 |
| Supplemental noncash disclosures: | | |
| Transfers from loans to other real estate | 5,811 | 14,479 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation ("the Company", "our", "we") and its wholly-owned subsidiary, Macatawa Bank ("the Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The Bank operates 26 full service branch offices providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan.

The Company owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company under accounting principles generally accepted in the United States of America.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) believed necessary for a fair presentation have been included.

Operating results for the three month period ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, valuation of deferred tax assets, loss contingencies, fair value of other real estate owned and fair values of financial instruments are particularly subject to change.

Regulatory Developments:

Termination of Consent Order with Macatawa Bank and its Regulators

On February 22, 2010, the Bank entered into a Consent Order with the Federal Deposit Insurance Corporation ("FDIC") and the Michigan Office of Financial and Insurance Regulation ("OFIR"), the primary banking regulators of the Bank. The Bank agreed to the terms of the negotiated Consent Order without admitting or denying any charges of unsafe or unsound banking practices. The Consent Order imposed no fines or penalties on the Bank. As a result of the improvement in our financial condition and results of operations, our implementation of additional corporate governance practices and disciplined business and banking principles, and our compliance with the Consent Order, upon completion of the Bank's 2011 joint examination by the FDIC and OFIR, the FDIC and OFIR terminated the Consent Order effective March 2, 2012.

In connection with the termination of the Consent Order, the Bank reached an understanding with the regulators in the form of a memorandum of understanding (“MOU”), which maintains many of the controls and procedures put in place by the Bank in response to the Consent Order, including: maintenance of a Tier 1 Leverage Capital Ratio of at least 8%, formulating and submitting a written plan of action on each asset classified as Substandard in the Report of Examination (“ROE”), charge-off of all assets classified as “Loss” in the ROE, submission of a written Profit Plan, Board review of the adequacy of the allowance for loan losses each quarter and the receipt of prior written consent of the FDIC and OFIR before the Bank declares or pays any dividends. The Bank was in compliance with each of these requirements as of March 31, 2012.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Written Agreement with Macatawa and its Regulator

The Company has formally entered into a Written Agreement with the Federal Reserve Bank of Chicago ("FRB"). The Written Agreement became effective on July 29, 2010, when it was executed and published by the FRB, and was assigned an effective date of July 23, 2010. Among other things, the Written Agreement provides that: (i) the Company must take appropriate steps to fully utilize its financial and managerial resources to serve as a source of strength to Macatawa Bank; (ii) the Company may not declare or pay any dividends without prior FRB approval; (iii) the Company may not take dividends or any other payment representing a reduction in capital from Macatawa Bank without prior FRB approval; (iv) the Company may not make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities without prior FRB approval; (v) the Company may not incur, increase or guarantee any debt without prior FRB approval; (vi) the Company may not purchase or redeem any shares of its stock without prior FRB approval; (vii) the Company must submit a written capital plan to the FRB within 60 days of the Written Agreement; and (viii) the Company may not appoint any new director or senior executive officer, or change the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position, without prior regulatory approval. The Company separately requested and received approval from the FRB to make the first quarter 2012 quarterly interest payments on its \$1.65 million in outstanding subordinated debt. Each quarter the Company requests approval from the FRB to make the next quarter's interest payment on its subordinated debt and is continuing to accrue the interest amounts due.

We believe that as of March 31, 2012, the Company was in compliance in all material respects with all the provisions of the Written Agreement.

Reclassifications: Some items in the prior period financial statements were reclassified to conform to the current presentation.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses inherent in our loan portfolio, increased by the provision for loan losses and recoveries, and decreased by charge-offs of loans. Management believes the allowance for loan losses balance to be adequate based on known and inherent risks in the portfolio, past loan loss experience, information about specific borrower situations and estimated collateral values, economic conditions and other relevant factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Management continues its collection efforts on previously charged-off balances and applies recoveries as additions to the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current qualitative factors. The Company maintains a loss migration analysis that tracks loan losses and recoveries based on loan class and the loan risk grade assignment for commercial loans. At March 31, 2012, an 18 month annualized historical loss experience was used for commercial loans and a 12 month historical loss experience period was applied to residential mortgage and consumer loan portfolios. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative factors, including economic trends, credit quality

trends, valuation trends, concentration risk, quality of loan review, changes in personnel, external factors and other considerations.

A loan is impaired when, based on current information and events, it is believed to be probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified and a concession has been made, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Commercial and commercial real estate loans with relationship balances exceeding \$500,000 and an internal risk grading of 6 or worse are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated and the loan is reported at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment and they are not separately identified for impairment disclosures. Troubled debt restructurings are also considered impaired with impairment generally measured at the present value of estimated future cash flows using the loan's effective rate at inception or using the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed unless they add value to the property.

Income Taxes: Income tax expense is the sum of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

We recognize a tax position as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. We recognize interest and penalties related to income tax matters in income tax expense.

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider all relevant positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and available tax planning strategies.

As of January 1, 2010, we no longer have the ability to carryback losses to prior years. The realization of our deferred tax assets is largely dependent on generating income in future years. At March 31, 2012, the need to maintain a full valuation allowance was based primarily on our net operating losses for recent years and the continuing weak economic conditions that could impact our ability to generate future earnings. The valuation allowance may be reversed to income in future periods to the extent that the related deferred tax assets are realized or the valuation allowance is no longer required.

Adoption of New Accounting Standards: The FASB has issued ASU 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements. The ASU is intended to improve financial reporting of repurchase agreements ("repos") and other agreements that both entitle and obligate a transferor to repurchase or

redeem financial assets before their maturity. In a typical repo transaction, an entity transfers financial assets to a counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Codification Topic 860, Transfers and Servicing, prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repo agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. The amendments to the Codification in this ASU are intended to improve the accounting for these transactions by removing from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets. The guidance in the ASU is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Adoption of this ASU did not have any effect as the Company does not currently hold any such repurchase agreements.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The FASB has issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU represents the converged guidance of the FASB and the IASB (the Boards) on fair value measurement. The collective efforts of the Boards and their staffs, reflected in ASU 2011-04, have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term “fair value.” The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and IFRSs. The amendments to the Codification in this ASU are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. Disclosure of the fair value levels of our financial assets and financial liabilities was added to Note 5 upon adoption of this standard in the first quarter of 2012.

The FASB has issued ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU amends accounting standards to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in the ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 should be applied retrospectively effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We early adopted this standard with our 2011 annual financial statements by adding a statement of comprehensive income.

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 2 – SECURITIES

The amortized cost and fair value of securities at period-end were as follows (dollars in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2012 | | | | |
| Available for Sale: | | | | |
| U.S. Treasury and federal agency securities | \$ 36,295 | \$ 212 | \$ (133) | \$ 36,374 |
| U.S. Agency MBS and CMOs | 18,969 | 124 | (32) | 19,061 |
| Tax-exempt state and municipal bonds | 8,367 | 101 | (101) | 8,367 |
| Taxable state and municipal bonds | 18,834 | 367 | (28) | 19,173 |
| Corporate bonds and other debt securities | 4,233 | 22 | (28) | 4,227 |
| Other equity securities | 1,500 | 43 | --- | 1,543 |
| | \$ 88,198 | \$ 869 | \$ (322) | \$ 88,745 |
| Held to Maturity | | | | |
| State and municipal bonds | \$ 300 | \$ --- | \$ --- | \$ 300 |
| December 31, 2011 | | | | |
| Available for Sale: | | | | |
| U.S. Treasury and federal agency securities | \$ 27,408 | \$ 205 | \$ --- | \$ 27,613 |
| U. S. Agency MBS and CMOs | 3,853 | 33 | --- | 3,886 |
| Tax-exempt state and municipal bonds | 4,292 | 116 | --- | 4,408 |
| Taxable state and municipal bonds | 16,531 | 239 | (54) | 16,716 |
| Corporate bonds | 1,081 | 1 | (1) | 1,081 |
| Other equity securities | 1,000 | 42 | --- | 1,042 |
| | \$ 54,165 | \$ 636 | \$ (55) | \$ 54,746 |
| Held to Maturity: | | | | |
| State and municipal bonds | \$ 300 | \$ --- | \$ --- | \$ 300 |

There were no sales of securities in the three month periods ended March 31, 2012 and 2011.

Contractual maturities of debt securities at March 31, 2012 were as follows (dollars in thousands):

| | Held-to-Maturity Securities | | Available-for-Sale Securities | |
|----------------------------|--------------------------------|---------------|----------------------------------|---------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$--- | \$--- | \$--- | \$--- |
| Due from one to five years | --- | --- | 33,569 | 33,914 |
| Due from five to ten years | --- | --- | 29,468 | 29,566 |
| Due after ten years | 300 | 300 | 23,661 | 23,722 |

| | | | | |
|--|-------|-------|----------|----------|
| | \$300 | \$300 | \$86,698 | \$87,202 |
|--|-------|-------|----------|----------|

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 2 – SECURITIES (Continued)

Securities with unrealized losses at March 31, 2012 and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (dollars in thousands):

| March 31, 2012 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-----------------|------------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury and federal agency securities | \$ 8,868 | \$ (133) | \$ --- | \$ --- | \$ 8,868 | \$ (133) |
| U.S. Agency MBS and CMOs | 3,693 | (32) | | | 3,693 | (32) |
| Tax-exempt state and municipal bonds | 3,882 | (101) | --- | --- | 3,882 | (101) |
| Taxable state and municipal bonds | 3,106 | (28) | --- | --- | 3,106 | (28) |
| Corporate bonds and other debt securities | 2,605 | (28) | --- | - | 2,605 | (28) |
| Other equity securities | --- | --- | --- | --- | --- | --- |
| Total temporarily impaired | \$ 22,154 | \$ (322) | \$ --- | \$ --- | \$ 22,154 | \$ (322) |
| December 31, 2011 | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury and federal agency securities | \$ --- | \$ --- | \$ --- | \$ --- | \$ --- | \$ --- |
| U.S. Agency MBS and CMOs | --- | --- | --- | --- | --- | --- |
| Tax-exempt state and municipal bonds | --- | --- | --- | --- | --- | --- |
| Taxable state and municipal bonds | 6,196 | (54) | --- | --- | 6,196 | (54) |
| Corporate bonds | 539 | (1) | | | 539 | (1) |
| Other equity securities | --- | --- | --- | --- | --- | --- |
| Total temporarily impaired | \$ 6,735 | \$ (55) | \$ --- | \$ --- | \$ 6,735 | \$ (55) |

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Management determined that no OTTI charges were necessary during the three month periods ended March 31, 2012 and 2011.

At both March 31, 2012 and December 31, 2011, securities with a carrying value of approximately \$2.0 million were pledged as security for public deposits, letters of credit and for other purposes required or permitted by law.

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

| | March 31, 2012 | December 31, 2011 |
|-------------------------------------|-------------------|----------------------|
| Commercial and industrial | \$ 228,771 | \$ 227,051 |
| Commercial real estate: | | |
| Residential developed | 31,553 | 33,829 |
| Unsecured to residential developers | 5,995 | 5,937 |
| Vacant and unimproved | 58,448 | 66,046 |
| Commercial development | 5,239 | 4,586 |
| Residential improved | 81,570 | 82,337 |
| Commercial improved | 291,014 | 304,070 |
| Manufacturing and industrial | 70,556 | 71,462 |
| Total commercial real estate | 544,375 | 568,267 |
| Consumer | | |
| Residential mortgage | 169,491 | 156,891 |
| Unsecured | 1,808 | 1,952 |
| Home equity | 100,492 | 101,074 |
| Other secured | 14,998 | 15,740 |
| Total consumer | 286,789 | 275,657 |
| Total loans | 1,059,935 | 1,070,975 |
| Allowance for loan losses | (29,451) | (31,641) |
| | \$ 1,030,484 | \$ 1,039,334 |

Activity in the allowance for loan losses by portfolio segment was as follows (dollars in thousands):

| | Commercial and Industrial | Commercial Real Estate | Consumer | Unallocated | Total |
|------------------------------------|---------------------------------|---------------------------|----------|-------------|-----------|
| Three months ended March 31, 2012: | | | | | |
| Beginning balance | \$ 6,313 | \$ 20,475 | \$ 4,821 | \$ 32 | \$ 31,641 |
| Charge-offs | (968) | (1,707) | (822) | --- | (3,497) |
| Recoveries | 171 | 4,683 | 53 | --- | 4,907 |
| Provision for loan losses | 1,991 | (5,886) | 314 | (19) | (3,600) |
| Ending Balance | \$ 7,507 | \$ 17,565 | \$ 4,366 | \$ 13 | \$ 29,451 |
| Three months ended March 31, 2011: | Commercial and | Commercial Real Estate | Consumer | Unallocated | Total |

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| | Industrial | | | | | | | | | |
|---------------------------|------------|-------|----|---------|----|-------|----|-----|----|---------|
| Beginning balance | \$ | 7,012 | \$ | 34,973 | \$ | 5,415 | \$ | 26 | \$ | 47,426 |
| Charge-offs | | (804) | | (2,397) | | (931) | | --- | | (4,132) |
| Recoveries | | 193 | | 250 | | 56 | | --- | | 499 |
| Provision for loan losses | | 790 | | (2,119) | | (117) | | (4) | | (1,450) |
| Ending Balance | \$ | 7,191 | \$ | 30,707 | \$ | 4,423 | \$ | 22 | \$ | 42,343 |

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MACATAWA BANK CORPORATION
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NOTE 3 – LOANS (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (dollars in thousands):

March 31, 2012:

| | Commercial and Industrial | Commercial Real Estate | Consumer | Unallocated | Total |
|---|---------------------------------|---------------------------|----------|-------------|-----------|
| Allowance for loan losses: | | | | | |
| Ending allowance attributable to loans: | | | | | |
| Individually reviewed for impairment | \$ 4,705 | \$ 3,778 | \$ 1,938 | \$ --- | \$ 10,421 |
| Collectively evaluated for impairment | 2,802 | 13,787 | 2,428 | 13 | 19,030 |
| Total ending allowance balance | \$ 7,507 | \$ 17,565 | \$ 4,366 | \$ 13 | \$ 29,451 |

Loans:

| | | | | | |
|---------------------------------------|------------|------------|------------|--------|--------------|
| Individually reviewed for impairment | \$ 17,002 | \$ 53,544 | \$ 16,040 | \$ --- | \$ 86,586 |
| Collectively evaluated for impairment | 211,769 | 490,831 | 270,749 | --- | 973,349 |
| Total ending loans balance | \$ 228,771 | \$ 544,375 | \$ 286,789 | \$ --- | \$ 1,059,935 |

December 31, 2011:

| | Commercial and Industrial | Commercial Real Estate | Consumer | Unallocated | Total |
|---|---------------------------------|---------------------------|----------|-------------|-----------|
| Allowance for loan losses: | | | | | |
| Ending allowance attributable to loans: | | | | | |
| Individually reviewed for impairment | \$ 3,478 | \$ 4,367 | \$ 1,752 | \$ --- | \$ 9,597 |
| Collectively evaluated for impairment | 2,835 | 16,108 | 3,069 | 32 | 22,044 |
| Total ending allowance balance | \$ 6,313 | \$ 20,475 | \$ 4,821 | \$ 32 | \$ 31,641 |

Loans:

| | | | | | |
|---------------------------------------|------------|------------|------------|--------|--------------|
| Individually reviewed for impairment | \$ 17,331 | \$ 52,195 | \$ 15,085 | \$ --- | \$ 84,611 |
| Collectively evaluated for impairment | 209,720 | 516,072 | 260,572 | --- | 986,364 |
| Total ending loans balance | \$ 227,051 | \$ 568,267 | \$ 275,657 | \$ --- | \$ 1,070,975 |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2012 (dollars in thousands):

| | Unpaid Principal Balance | Recorded Investment | Allowance Allocated |
|-------------------------------------|--------------------------------|------------------------|------------------------|
| With no related allowance recorded: | | | |
| Commercial and industrial | \$ 7,934 | \$ 5,176 | \$ --- |
| Commercial real estate: | | | |
| Residential developed | 6,206 | 5,310 | --- |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 2,257 | 1,559 | --- |
| Commercial development | 218 | 218 | --- |
| Residential improved | 6,095 | 5,277 | --- |
| Commercial improved | 9,033 | 7,900 | --- |
| Manufacturing and industrial | 4,409 | 4,409 | --- |
| | 28,218 | 24,673 | |
| Consumer: | | | |
| Residential mortgage | --- | --- | --- |
| Unsecured | --- | --- | --- |
| Home equity | 200 | 200 | --- |
| Other secured | --- | --- | --- |
| | 200 | 200 | --- |
| | \$ 36,352 | \$ 30,049 | \$ --- |
| With an allowance recorded: | | | |
| Commercial and industrial | \$ 11,826 | \$ 11,826 | \$ 4,705 |
| Commercial real estate: | | | |
| Residential developed | 3,291 | 3,291 | 1,381 |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 1,923 | 1,923 | 399 |
| Commercial development | --- | --- | --- |
| Residential improved | 9,170 | 9,170 | 808 |
| Commercial improved | 9,917 | 9,917 | 1,020 |
| Manufacturing and industrial | 4,571 | 4,571 | 170 |
| | 28,872 | 28,872 | 3,778 |
| Consumer: | | | |
| Residential mortgage | 15,174 | 15,054 | 1,894 |
| Unsecured | --- | --- | --- |
| Home equity | 785 | 785 | 44 |

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| | | | |
|---------------|-----------|-----------|-----------|
| Other secured | --- | --- | --- |
| | 15,959 | 15,839 | 1,938 |
| | \$ 56,657 | \$ 56,537 | \$ 10,421 |
| Total | \$ 93,009 | \$ 86,586 | \$ 10,421 |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2011 (dollars in thousands):

| | Unpaid Principal Balance | Recorded Investment | Allowance Allocated |
|-------------------------------------|--------------------------------|------------------------|------------------------|
| With no related allowance recorded: | | | |
| Commercial and industrial | \$ 3,485 | \$ 3,485 | \$ --- |
| Commercial real estate: | | | |
| Residential developed | 6,432 | 2,021 | --- |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 5,226 | 4,265 | --- |
| Commercial development | --- | --- | --- |
| Residential improved | 1,943 | 1,858 | --- |
| Commercial improved | 5,428 | 5,162 | --- |
| Manufacturing and industrial | 3,997 | 3,997 | --- |
| | 23,026 | 17,303 | |
| Consumer: | | | |
| Residential mortgage | --- | --- | --- |
| Unsecured | --- | --- | --- |
| Home equity | 200 | 200 | --- |
| Other secured | --- | --- | --- |
| | 200 | 200 | --- |
| | \$ 26,711 | \$ 20,988 | \$ --- |
| With an allowance recorded: | | | |
| Commercial and industrial | \$ 17,052 | \$ 13,846 | \$ 3,478 |
| Commercial real estate: | | | |
| Residential developed | 4,941 | 4,941 | 1,960 |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 3,378 | 2,462 | 154 |
| Commercial development | 220 | 220 | 17 |
| Residential improved | 12,312 | 11,809 | 1,176 |
| Commercial improved | 10,590 | 10,555 | 844 |
| Manufacturing and industrial | 4,905 | 4,905 | 216 |
| | 36,346 | 34,892 | 4,367 |
| Consumer: | | | |
| Residential mortgage | 14,235 | 14,114 | 1,713 |
| Unsecured | --- | --- | --- |
| Home equity | 771 | 771 | 39 |
| Other secured | --- | --- | --- |
| | 15,006 | 14,885 | 1,752 |

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| | | | | | | |
|-------|----|--------|----|--------|----|-------|
| | \$ | 68,404 | \$ | 63,623 | \$ | 9,597 |
| Total | \$ | 95,115 | \$ | 84,611 | \$ | 9,597 |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents information regarding average balances of impaired loans and interest recognized on impaired loans for the three month periods ended March 31, 2012 and 2011 (dollars in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|---|---|---|
| Average of impaired loans during the period: | | |
| Commercial and industrial | \$ 18,960 | \$ 4,725 |
| Commercial real estate: | | |
| Residential developed | 9,468 | 16,141 |
| Unsecured to residential developers | --- | 915 |
| Vacant and unimproved | 3,483 | 4,948 |
| Commercial development | 219 | 825 |
| Residential improved | 14,545 | 8,695 |
| Commercial improved | 16,100 | 21,909 |
| Manufacturing and industrial | 9,468 | 8,349 |
| Consumer | 15,924 | 12,755 |
| Interest income recognized during impairment: | | |
| Commercial and industrial | 340 | (14) |
| Commercial real estate | 654 | 523 |
| Consumer | 140 | 110 |
| Cash-basis interest income recognized | | |
| Commercial and industrial | 319 | 52 |
| Commercial real estate | 619 | 509 |
| Consumer | 138 | 110 |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 3 – LOANS (Continued)

Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of March 31, 2012:

| | Nonaccrual | Over 90 days Accruing |
|-------------------------------------|------------|-----------------------------|
| Commercial and industrial | \$ 9,187 | \$ --- |
| Commercial real estate: | | |
| Residential developed | 5,882 | --- |
| Unsecured to residential developers | --- | --- |
| Vacant and unimproved | 155 | --- |
| Commercial development | 426 | --- |
| Residential improved | 2,492 | --- |
| Commercial improved | 3,115 | 26 |
| Manufacturing and industrial | 261 | --- |
| | 12,331 | 26 |
| Consumer: | | |
| Residential mortgage | 1,504 | --- |
| Unsecured | 22 | --- |
| Home equity | 424 | --- |
| Other secured | --- | --- |
| | 1,950 | --- |
| Total | \$ 23,468 | \$ 26 |

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2011:

| | Nonaccrual | Over 90 days Accruing |
|-------------------------------------|------------|-----------------------------|
| Commercial and industrial | \$ 9,270 | \$ 290 |
| Commercial real estate: | | |
| Residential developed | 3,577 | 126 |
| Unsecured to residential developers | --- | --- |
| Vacant and unimproved | 3,715 | --- |
| Commercial development | 49 | --- |

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| | | |
|------------------------------|-----------|----------|
| Residential improved | 5,144 | 286 |
| Commercial improved | 2,654 | 1,255 |
| Manufacturing and industrial | 134 | --- |
| | 15,273 | 1,667 |
| Consumer: | | |
| Residential mortgage | 1,777 | 111 |
| Unsecured | 22 | --- |
| Home equity | 534 | --- |
| Other secured | --- | 2 |
| | 2,333 | 113 |
| Total | \$ 26,876 | \$ 2,070 |

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MACATAWA BANK CORPORATION
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 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of March 31, 2012 by class of loans (dollars in thousands):

| | 30-90 Days | Greater Than 90 Days | Total Past Due | Loans Not Past Due | Total |
|-------------------------------------|---------------|----------------------------|-------------------|-----------------------|--------------|
| Commercial and industrial | \$ 770 | \$ 490 | \$ 1,260 | \$ 227,511 | \$ 228,771 |
| Commercial real estate: | | | | | |
| Residential developed | 435 | --- | 435 | 31,118 | 31,553 |
| Unsecured to residential developers | 340 | --- | 340 | 5,655 | 5,995 |
| Vacant and unimproved | 27 | 81 | 108 | 58,340 | 58,448 |
| Commercial development | --- | 425 | 425 | 4,814 | 5,239 |
| Residential improved | 682 | 1,229 | 1,911 | 79,659 | 81,570 |
| Commercial improved | 1,108 | 1,181 | 2,289 | 288,725 | 291,014 |
| Manufacturing and industrial | --- | 32 | 32 | 70,524 | 70,556 |
| | 2,592 | 2,948 | 5,540 | 538,835 | 544,375 |
| Consumer: | | | | | |
| Residential mortgage | 74 | 1,206 | 1,280 | 168,211 | 169,491 |
| Unsecured | 6 | --- | 6 | 1,802 | 1,808 |
| Home equity | 411 | 389 | 800 | 99,692 | 100,492 |
| Other secured | 4 | --- | 4 | 14,994 | 14,998 |
| | 495 | 1,595 | 2,090 | 284,699 | 286,789 |
| Total | \$ 3,857 | \$ 5,033 | \$ 8,890 | \$ 1,051,045 | \$ 1,059,935 |

The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans (dollars in thousands):

| | 30-90 Days | Greater Than 90 Days | Total Past Due | Loans Not Past Due | Total |
|-------------------------------------|---------------|----------------------------|-------------------|-----------------------|------------|
| Commercial and industrial | \$ 218 | \$ 1,230 | \$ 1,448 | \$ 225,603 | \$ 227,051 |
| Commercial real estate: | | | | | |
| Residential developed | 472 | 613 | 1,085 | 32,744 | 33,829 |
| Unsecured to residential developers | --- | --- | --- | 5,937 | 5,937 |
| Vacant and unimproved | 442 | 388 | 830 | 65,216 | 66,046 |
| Commercial development | --- | 49 | 49 | 4,537 | 4,586 |
| Residential improved | 549 | 1,343 | 1,892 | 80,445 | 82,337 |
| Commercial improved | 1,355 | 3,266 | 4,621 | 299,449 | 304,070 |

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| | | | | | |
|------------------------------|----------|----------|-----------|--------------|--------------|
| Manufacturing and industrial | --- | 134 | 134 | 71,328 | 71,462 |
| | 2,818 | 5,793 | 8,611 | 559,656 | 568,267 |
| Consumer: | | | | | |
| Residential mortgage | 313 | 1,517 | 1,830 | 155,061 | 156,891 |
| Unsecured | 35 | --- | 35 | 1,917 | 1,952 |
| Home equity | 663 | 498 | 1,161 | 99,913 | 101,074 |
| Other secured | 51 | 2 | 53 | 15,687 | 15,740 |
| | 1,062 | 2,017 | 3,079 | 272,578 | 275,657 |
| Total | \$ 4,098 | \$ 9,040 | \$ 13,138 | \$ 1,057,837 | \$ 1,070,975 |

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NOTE 3 – LOANS (Continued)

The Company had allocated \$9,072,000 and \$6,905,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of March 31, 2012 and December 31, 2011, respectively. These loans involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. The Company has been active at utilizing these programs and working with its customers to reduce the risk of foreclosure. For commercial loans, these modifications typically include an interest only period and, in some cases, a lowering of the interest rate on the loan. In some cases, the modification will include separating the note into two notes with the first note structured to be supported by current cash flows and collateral, and the second note made for the remaining unsecured debt. The second note is charged off immediately and collected only after the first note is paid in full. This modification type is commonly referred to as an A-B note structure. For consumer mortgage loans, the restructuring typically includes a lowering of the interest rate to provide payment and cash flow relief. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status.

Typically, once a loan is identified as a TDR, it will retain that designation until it is paid off, since the restructured loans generally are not at market rates at the time of restructuring. An exception to this would be a loan that is modified under an A-B note structure. If the remaining “A” note is at a market rate at the time of restructuring (taking into account the borrower’s credit risk and prevailing market conditions), the loan can be removed from TDR designation in a subsequent calendar year after six months of performance in accordance with the new terms. The market rate relative to the borrower’s credit risk is determined through analysis of market pricing information gathered from peers and use of a loan pricing model. The general objective of the model is to achieve a consistent return on equity from one credit to the next, taking into consideration their differences in credit risk. In the model, credits with higher risk receive a higher potential loss allocation, and therefore require a higher interest rate to achieve the target return on equity. In general, when a loan is removed from TDR status it would no longer be considered impaired. As a result, allowance allocations for loans removed from TDR status would be based on the historical based allocation for the applicable loan grade and loan class. During the three months ended March 31, 2012 and throughout 2011, no loans were removed from TDR status. Given the nature of the TDRs outstanding at March 31, 2012, it is unlikely that any such loans will be removed from TDR status in 2012.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by

measuring cash flows using the new payment terms discounted at the original contractual rate.

The following table presents information regarding troubled debt restructurings as of March 31, 2012 and December 31, 2011 (dollars in thousands):

| | March 31, 2012 | | December 31, 2011 | |
|---------------------------|----------------|-------------|-------------------|-------------|
| | Number of | Outstanding | Number of | Outstanding |
| | Loans | Recorded | Loans | Recorded |
| | | Balance | | Balance |
| Commercial and industrial | 115 | \$ 17,267 | 98 | \$ 15,395 |
| Commercial real estate | 141 | 47,558 | 120 | 46,414 |
| Consumer | 97 | 16,361 | 90 | 15,373 |
| | 353 | \$ 81,186 | 308 | \$ 77,182 |

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NOTE 3 – LOANS (Continued)

The following table presents information regarding troubled debt restructurings executed during the three month periods ended March 31, 2012 and 2011 (dollars in thousands):

| | Three Months Ended March 31, 2012 | | | Three Months Ended March 31, 2011 | | |
|---------------------------|--------------------------------------|------------------------------------|--|--------------------------------------|------------------------------------|--|
| | Number of Loans | Outstanding Recorded Balance | Principal Writedown upon Modification | Number of Loans | Outstanding Recorded Balance | Principal Writedown upon Modification |
| Commercial and industrial | 10 | \$ 1,243 | \$ --- | 48 | \$ 1,423 | \$ --- |
| Commercial real estate | 30 | 6,396 | 86 | 31 | 9,569 | 524 |
| Consumer | 7 | 1,188 | 260 | 6 | 911 | --- |
| | 47 | \$ 8,827 | \$ 346 | 85 | \$ 11,903 | \$ 524 |

According to the accounting standards, not all loan modifications are TDRs. TDRs are modifications or renewals where the Company has granted a concession to a borrower in financial distress. The Company reviews all modifications and renewals for determination of TDR status. In some situations a borrower may be experiencing financial distress, but the Company does not provide a concession. These modifications are not considered TDRs. In other cases, the Company might provide a concession, such as a reduction in interest rate, but the borrower is not experiencing financial distress. This could be the case if the Company is matching a competitor's interest rate. These modifications would also not be considered TDRs. Finally, any renewals at existing terms for borrowers not experiencing financial distress would not be considered TDRs. The following table presents information regarding modifications and renewals executed during the three month periods ended March 31, 2012 and March 31, 2011 that are not considered TDRs (dollars in thousands):

| | Three Months Ended March 31, 2012 | | Three Months Ended March 31, 2011 | |
|---------------------------|--------------------------------------|------------------------------------|--------------------------------------|------------------------------------|
| | Number of Loans | Outstanding Recorded Balance | Number of Loans | Outstanding Recorded Balance |
| Commercial and industrial | 94 | \$33,290 | 110 | \$30,110 |
| Commercial real estate | 79 | 36,800 | 117 | 42,963 |
| Consumer | 24 | 872 | 6 | 233 |
| | 197 | \$70,962 | 233 | \$73,306 |

The table below presents by class, information regarding troubled debt restructured loans which had payment defaults during the three month periods ended March 31, 2012 and 2011 (dollars in thousands). Included are loans that became delinquent more than 90 days past due or transferred to nonaccrual within 12 months of restructuring.

Three Months Ended Three Months Ended

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| | March 31, 2012 | | March 31, 2011 | |
|---------------------------|----------------|-------------|----------------|-------------|
| | Number of | Outstanding | Number of | Outstanding |
| | Loans | Recorded | Loans | Recorded |
| | | Balance | | Balance |
| Commercial and industrial | 2 | \$92 | 3 | \$763 |
| Commercial real estate | 1 | 76 | 2 | 259 |
| Consumer | 1 | 70 | 2 | 402 |

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NOTE 3 – LOANS (Continued)

Credit Quality Indicators: The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually and classifies these relationships by credit risk grading. The Company uses an eight point grading system, with grades 5 through 8 being considered classified, or watch, credits. All commercial loans are assigned a grade at origination, at each renewal or any amendment. When a credit is first downgraded to a watch credit (either through renewal, amendment, loan officer identification or the loan review process), an Administrative Loan Review (“ALR”) is generated by credit and the loan officer. All watch credits have an ALR completed monthly which analyzes the collateral position and cash flow of the borrower and its guarantors. The loan officer is required to complete both a short term and long term plan to rehabilitate or exit the credit and to provide monthly comments on the progress to these plans. Management meets quarterly with loan officers to discuss each of these credits in detail and to help attempt to formulate solutions where progress has stalled. When necessary, the loan officer proposes changes to the assigned loan grade as part of the ALR. Additionally, Loan Review reviews all loan grades upon origination, renewal or amendment and again as loans are selected through the loan review process. The credit will stay on the ALR until either its grade has improved to a 4 or better or the credit relationship is at a zero balance. The Company uses the following definitions for the risk grades:

1. Excellent - Borrowings supported by extremely strong financial condition or secured by the Bank’s own deposits. Minimal risk to the Bank and the probability of serious rapid financial deterioration is extremely small.
2. Above Average - Borrowings supported by sound financial statements that indicate the ability to repay or borrowings secured (and margined properly) with marketable securities. Nominal risk to the Bank and probability of serious financial deterioration is highly unlikely. The overall quality of these credits is very high.
3. Good Quality - Average borrowings supported by satisfactory asset quality and liquidity, good debt capacity coverage, and good management in all critical positions. Loans are secured by acceptable collateral with adequate margins. There is a slight risk of deterioration if adverse market conditions prevail.
4. Acceptable Risk - This is an acceptable risk to the Bank, which may be slightly below average quality. The borrower has limited financial strength with considerable leverage. There is some probability of deterioration if adverse market conditions prevail. These credits should be monitored closely by the Relationship Manager.
5. Marginally Acceptable - Loans are of marginal quality with above normal risk to the Bank. The borrower shows acceptable asset quality but very little liquidity with high leverage. There is inconsistent earning performance without the ability to sustain adverse market conditions. The primary source of repayment is questionable, but the secondary source of repayment still remains an option. Very close attention by the Relationship Manager and management is needed.
6. Substandard - Loans are inadequately protected by the net worth and paying capacity of the borrower or the collateral pledged. The primary and secondary sources of repayment are questionable. Heavy debt condition may be evident and volume and earnings deterioration may be underway. It is possible that the Bank will sustain some loss if the deficiencies are not immediately addressed and corrected.

7. Doubtful - Borrowings supported by weak or no financial statements. The ability to repay the entire loan is questionable. Loans in this category are normally characterized with less than adequate collateral, insolvent, or extremely weak financial condition. A loan classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses makes collection or liquidation in full highly questionable. The possibility of loss is extremely high, however, activity may be underway to minimize the loss or maximize the recovery.

8. Loss - Loan are considered uncollectible and of little or no value as a bank asset.

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NOTE 3 – LOANS (Continued)

As of March 31, 2012, the risk grade category of commercial loans by class of loans was as follows (dollars in thousands):

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|-------------------------------------|--------|----------|------------|------------|------------|-----------|-----------|--------|
| Commercial and industrial | \$ 586 | \$ 6,934 | \$ 60,954 | \$ 117,103 | \$ 27,867 | \$ 6,126 | \$ 9,201 | \$ --- |
| Commercial real estate: | | | | | | | | |
| Residential developed | --- | --- | 283 | 8,706 | 8,870 | 7,812 | 5,882 | --- |
| Unsecured to residential developers | --- | --- | 5,059 | 580 | 16 | 340 | --- | --- |
| Vacant and unimproved | --- | --- | 13,808 | 23,946 | 18,669 | 1,871 | 155 | --- |
| Commercial development | --- | --- | 60 | 2,248 | 1,403 | 1,103 | 426 | --- |
| Residential improved | --- | 119 | 8,359 | 39,453 | 18,370 | 12,776 | 2,492 | --- |
| Commercial improved | --- | 209 | 60,984 | 160,223 | 46,534 | 19,947 | 3,115 | --- |
| Manufacturing and industrial | --- | 2,172 | 10,828 | 39,005 | 11,402 | 6,889 | 261 | --- |
| | \$ 586 | \$ 9,434 | \$ 160,335 | \$ 391,264 | \$ 133,131 | \$ 56,864 | \$ 21,532 | \$ --- |

As of December 31, 2011, the risk grade category of commercial loans by class of loans was as follows (dollars in thousands):

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|-------------------------------------|--------|----------|-----------|------------|-----------|----------|----------|--------|
| Commercial and industrial | \$ 595 | \$ 8,447 | \$ 56,457 | \$ 117,015 | \$ 27,674 | \$ 7,593 | \$ 9,270 | \$ --- |
| Commercial real estate: | | | | | | | | |
| Residential developed | --- | --- | 283 | 9,688 | 11,410 | 8,725 | 3,723 | --- |
| Unsecured to residential developers | --- | --- | 4,773 | 647 | 177 | 340 | --- | --- |
| Vacant and unimproved | --- | --- | 14,707 | 24,344 | 21,362 | 1,918 | 3,715 | --- |
| Commercial development | --- | --- | 60 | 2,261 | 1,109 | 1,107 | 49 | --- |
| Residential improved | --- | 121 | 2,650 | 45,813 | 18,642 | 9,968 | 5,143 | --- |
| Commercial improved | --- | 5 | 62,510 | 173,697 | 43,493 | 21,712 | 2,653 | --- |
| | --- | 2,242 | 12,209 | 38,533 | 11,344 | 7,000 | 134 | --- |

Manufacturing and
industrial

\$ 595 \$ 10,815 \$ 153,649 \$ 411,998 \$ 135,211 \$ 58,363 \$ 24,687 \$ ---

Commercial loans rated a 6 or worse per the Company's internal risk rating system are considered substandard, doubtful or loss. Commercial loans classified as substandard or worse were as follows at period-end (dollars in thousands):

| | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Not classified as impaired | \$ 25,506 | \$ 29,687 |
| Classified as impaired | 52,890 | 53,363 |
| Total commercial loans classified substandard or worse | \$ 78,396 | \$ 83,050 |

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NOTE 3 – LOANS (Continued)

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For consumer loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in consumer loans based on payment activity (dollars in thousands):

| | Residential Mortgage | Consumer Unsecured | Home Equity | Consumer Other |
|-------------------|-------------------------|-----------------------|----------------|-------------------|
| March 31, 2012 | | | | |
| Performing | \$ 168,285 | \$ 1,808 | \$ 100,103 | \$ 14,998 |
| Nonperforming | 1,206 | --- | 389 | --- |
| Total | \$ 169,491 | \$ 1,808 | \$ 100,492 | \$ 14,998 |
| December 31, 2011 | | | | |
| Performing | \$ 155,374 | \$ 1,952 | \$ 100,576 | \$ 15,738 |
| Nonperforming | 1,517 | --- | 498 | 2 |
| Total | \$ 156,891 | \$ 1,952 | \$ 101,074 | \$ 15,740 |

NOTE 4 – OTHER REAL ESTATE OWNED

Period-end other real estate owned was as follows (dollars in thousands):

| | Three Months Ended March 31, 2012 | Year Ended December 31, 2011 | Three Months Ended March 31, 2011 |
|--|---|---------------------------------------|---|
| Beginning balance | \$ 83,663 | \$ 68,388 | \$ 68,388 |
| Additions, transfers from loans and fixed assets | 5,811 | 38,358 | 14,479 |
| Proceeds from sales of other real estate owned | (4,417) | (21,540) | (4,984) |
| Valuation allowance reversal upon sale | (1,463) | (3,058) | (1,083) |
| Gain (loss) on sale of other real estate owned | 94 | 1,515 | 212 |
| | 83,688 | 83,663 | 77,012 |
| Less: valuation allowance | (17,452) | (17,225) | (12,020) |
| Ending balance | \$ 66,236 | \$ 66,438 | \$ 64,992 |

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NOTE 4 – OTHER REAL ESTATE OWNED (Continued)

Activity in the valuation allowance was as follows (dollars in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|------------------------------|---|---|
| Beginning balance | \$ 17,225 | \$ 10,404 |
| Additions charged to expense | 1,690 | 2,699 |
| Reversals upon sale | (1,463) | (1,083) |
| Ending balance | \$ 17,452 | \$ 12,020 |

NOTE 5 – FAIR VALUE

ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from 3rd party investors (Level 2 inputs)

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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NOTE 5 – FAIR VALUE (Continued)

Other Real Estate Owned: Adjustments to commercial and residential real estate properties classified as other real estate owned (OREO) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized through a valuation allowance.

Assets measured at fair value on a recurring basis are summarized below (in thousands):

| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|------------|--|---|---|
| March 31, 2012 | | | | |
| U.S. Treasury and federal agency securities | \$ 36,374 | \$ --- | \$ 36,374 | \$ --- |
| U.S. Agency MBS and CMOs | 19,061 | --- | 19,061 | --- |
| Tax-exempt state and municipal bonds | 8,367 | --- | 8,367 | --- |
| Taxable state and municipal bonds | 19,173 | --- | 19,173 | --- |
| Corporate bonds and other debt securities | 4,227 | --- | 4,227 | --- |
| Other equity securities | 1,543 | --- | 1,543 | --- |
| Loans held for sale | 8,562 | --- | 8,562 | --- |
| December 31, 2011 | | | | |
| U.S. Treasury and federal agency securities | \$ 27,613 | \$ --- | \$ 27,613 | \$ --- |
| U.S. Agency MBS and CMOs | 3,886 | --- | 3,886 | --- |
| Tax-exempt state and municipal bonds | 4,408 | --- | 4,408 | --- |
| Taxable state and municipal bonds | 16,716 | --- | 16,716 | --- |
| Corporate bonds | 1,081 | --- | 1,081 | --- |
| Other equity securities | 1,042 | --- | 1,042 | --- |
| Loans held for sale | 1,026 | --- | 1,026 | --- |

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|------------|--|---|---|
|--|------------|--|---|---|

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March 31, 2012

| | | | | |
|-------------------------|-----------|--------|--------|-----------|
| Impaired loans | \$ 37,965 | \$ --- | \$ --- | \$ 37,965 |
| Other real estate owned | 41,947 | --- | --- | 41,947 |

December 31, 2011

| | | | | |
|-------------------------|-----------|--------|--------|-----------|
| Impaired loans | \$ 22,525 | \$ --- | \$ --- | \$ 22,525 |
| Other real estate owned | 39,730 | --- | --- | 39,730 |

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NOTE 5 – FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows at March 31, 2012 and December 31, 2011 (dollars in thousands).

| | Level in Fair Value Hierarchy | March 31, 2012 | | December 31, 2011 | |
|---|-------------------------------------|--------------------|---------------|--------------------|---------------|
| | | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets | | | | | |
| Cash and due from banks | Level 1 | \$ 22,278 | \$ 22,278 | \$ 30,971 | \$ 30,971 |
| Cash equivalents | Level 2 | 184,362 | 184,362 | 212,071 | 212,071 |
| Securities held to maturity | Level 2 | 300 | 300 | 300 | 300 |
| FHLB stock | | 11,236 | NA | 11,236 | NA |
| Loans, net | Level 2 | 1,030,484 | 1,036,948 | 1,039,334 | 1,047,291 |
| Bank owned life insurance | Level 3 | 26,180 | 26,180 | 25,957 | 25,957 |
| Accrued interest receivable | Level 2 | 3,802 | 3,802 | 3,595 | 3,595 |
| Financial liabilities | | | | | |
| Deposits | Level 2 | (1,214,471) | (1,215,399) | (1,215,289) | (1,216,452) |
| Other borrowed funds | Level 2 | (137,489) | (140,415) | (148,603) | (151,566) |
| Long-term debt | Level 2 | (41,238) | (34,109) | (41,238) | (34,820) |
| Subordinated debt | Level 2 | (1,650) | (1,650) | (1,650) | (1,650) |
| Accrued interest payable | Level 2 | (3,873) | (3,873) | (3,517) | (3,517) |
| Off-balance sheet credit-related items | | | | | |
| Loan commitments | | --- | --- | --- | --- |

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, bank owned life insurance, accrued interest receivable and payable, demand deposits, short-term borrowings and variable rate loans or deposits that reprice frequently and fully. Security fair values are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities as discussed above. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet credit-related items is not significant.

NOTE 6 – DEPOSITS

Deposits are summarized as follows (in thousands):

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| | March 31, 2012 | December 31, 2011 |
|-----------------------------------|-------------------|----------------------|
| Noninterest-bearing demand | \$ 300,617 | \$ 324,253 |
| Interest bearing demand | 218,713 | 204,402 |
| Savings and money market accounts | 413,075 | 381,498 |
| Certificates of deposit | 282,066 | 305,136 |
| | \$ 1,214,471 | \$ 1,215,289 |

Approximately \$100.0 million and \$106.3 million in certificates of deposit were in denominations of \$100,000 or more at March 31, 2012 and December 31, 2011, respectively.

The Bank had no brokered deposits at March 31, 2012 and December 31, 2011.

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NOTE 7 - OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and borrowings from the Federal Reserve Bank.

Federal Home Loan Bank Advances

At period-end, advances from the Federal Home Loan Bank were as follows (dollars in thousands):

| Principal Terms | Advance Amount | Range of Maturities | Weighted Average Interest Rate |
|-------------------------------------|-------------------|------------------------------|--------------------------------------|
| March 31, 2012 | | | |
| Single maturity fixed rate advances | \$ 125,000 | April 2012 to September 2016 | 1.73% |
| Amortizable mortgage advances | 12,489 | March 2018 to July 2018 | 3.77% |
| | \$ 137,489 | | |

| Principal Terms | Advance Amount | Range of Maturities | Weighted Average Interest Rate |
|-------------------------------------|-------------------|------------------------------|--------------------------------------|
| December 31, 2011 | | | |
| Single maturity fixed rate advances | \$ 135,000 | March 2012 to September 2016 | 1.79% |
| Amortizable mortgage advances | 13,603 | March 2018 to July 2018 | 3.77% |
| | \$ 148,603 | | |

Each advance is subject to a prepayment penalty if paid prior to its maturity date. Fixed rate advances are payable at maturity. Amortizable mortgage advances are fixed rate advances with scheduled repayments based upon amortization to maturity. These advances were collateralized by residential and commercial real estate loans totaling \$358.6 million and \$389.8 million under a physical loan collateral delivery arrangement at March 31, 2012 and December 31, 2011, respectively.

Scheduled repayments of FHLB advances as of March 31, 2012 were as follows (in thousands):

| | |
|------------|------------|
| 2012 | \$ 25,667 |
| 2013 | 1,831 |
| 2014 | 21,884 |
| 2015 | 21,938 |
| 2016 | 61,996 |
| Thereafter | 4,173 |
| | \$ 137,489 |

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NOTE 8 - EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the three month periods ended March 31, 2012 and 2011 are as follows (dollars in thousands, except per share data):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|---|---|---|
| Net income | \$ 4,485 | \$ 1,291 |
| Dividends declared on preferred shares | --- | --- |
| Net income available to common shares | \$ 4,485 | \$ 1,291 |
| Weighted average shares outstanding, including participating stock awards - Basic | 27,082,825 | 17,679,621 |
| Dilutive potential common shares: | | |
| Stock options | --- | --- |
| Conversion of preferred stock | --- | --- |
| Stock warrants | --- | --- |
| Weighted average shares outstanding - Diluted | 27,082,825 | 17,679,621 |
| Basic earnings per common share | \$ 0.17 | \$ 0.07 |
| Diluted earnings per common share | \$ 0.17 | \$ 0.07 |

Stock options for 632,404 and 714,766 shares of common stock for the three month periods ended March 31, 2012 and 2011, respectively, were not considered in computing diluted earnings per share because they were antidilutive. Potential common shares associated with convertible preferred stock and stock warrants were excluded from dilutive potential common shares as they were antidilutive.

NOTE 9 - FEDERAL INCOME TAXES

Income tax expense (benefit) was as follows (dollars in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|----------------------------|---|---|
| Current | \$ 13 | \$ (2) |
| Deferred (benefit) expense | (13) | 2 |
| | \$ --- | \$ --- |

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NOTE 9 - FEDERAL INCOME TAXES (Continued)

The difference between the financial statement tax expense (benefit) and amount computed by applying the statutory federal tax rate to pretax income was reconciled as follows (dollars in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|---|---|---|
| Statutory rate | 35% | 35% |
| Statutory rate applied to income before taxes | \$ 1,570 | \$ 452 |
| Add (deduct) | | |
| Change in valuation allowance | (1,473) | (355) |
| Tax-exempt interest income | (12) | --- |
| Bank-owned life insurance | (78) | (75) |
| Other, net | (7) | (22) |
| | \$ --- | \$ --- |

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies.

We established an \$18.0 million valuation allowance on deferred tax assets in 2009 based primarily on the Company's net operating losses for 2009 and 2008. As a result of losses incurred in 2010, the Company increased the valuation allowance to \$25.6 million at December 31, 2010. At December 31, 2011 and March 31, 2012, a valuation allowance of \$24.0 million and \$22.6 million, respectively, was maintained as the Company continued to face a challenging economic environment currently confronting banks that could negatively impact future operating results. The valuation allowance may be reversed to income in future periods to the extent that the related deferred tax assets are realized or when the Company returns to consistent, sustained profitability.

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NOTE 9 - FEDERAL INCOME TAXES (Continued)

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

| | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Deferred tax assets | | |
| Allowance for loan losses | \$ 10,308 | \$ 11,074 |
| Nonaccrual loan interest | 880 | 839 |
| Valuation allowance on other real estate owned | 6,108 | 6,029 |
| Net operating loss carryforward | 6,775 | 7,673 |
| Other | 1,147 | 1,137 |
| Gross deferred tax assets | 25,218 | 26,752 |
| Valuation allowance | (22,566) | (24,026) |
| Total net deferred tax assets | 2,652 | 2,726 |
| Deferred tax liabilities | | |
| Depreciation | (1,710) | (1,758) |
| Purchase accounting adjustments | --- | (22) |
| Unrealized gain on securities available for sale | (191) | (204) |
| Prepaid expenses | (407) | (407) |
| Other | (344) | (335) |
| Gross deferred tax liabilities | (2,652) | (2,726) |
| Net deferred tax asset | \$ --- | \$ --- |

At March 31, 2012, we had federal net operating loss carry forwards of \$19.4 million that expire through 2030.

There were no unrecognized tax benefits at March 31, 2012 or December 31, 2011 and the Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2008.

NOTE 10 – CONTINGENCIES

We and our subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business. As of March 31, 2012, there were no material pending legal proceedings to which we or any of our subsidiaries are a party or which any of our properties are the subject.

NOTE 11 – SHAREHOLDERS' EQUITY

Regulatory Capital

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets,

liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

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NOTE 11 – SHAREHOLDERS' EQUITY (Continued)

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

At March 31, 2012 and December 31, 2011, actual capital levels and minimum required levels were (in thousands):

| | Actual | | Minimum Required For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Regulations | | Minimum Required Under MOU/Consent Order (1) | |
|--|------------|-------|--|-------|--|-------|---|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| March 31, 2012 | | | | | | | | |
| Total capital (to risk weighted assets) | | | | | | | | |
| Consolidated | \$ 154,263 | 13.7% | \$ 90,363 | 8.0% | N/A | N/A | N/A | N/A |
| Bank | 147,010 | 13.0 | 90,354 | 8.0 | \$ 112,942 | 10.0% | N/A | N/A |
| Tier 1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 131,046 | 11.6 | 45,182 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 132,684 | 11.8 | 45,177 | 4.0 | 67,765 | 6.0 | N/A | N/A |
| Tier 1 capital (to average assets) | | | | | | | | |
| Consolidated | 131,046 | 8.8 | 59,885 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 132,684 | 8.9 | 59,815 | 4.0 | 74,769 | 5.0 | \$ 119,630 | 8.0 |
| December 31, 2011 | | | | | | | | |
| Total capital (to risk weighted assets) | | | | | | | | |
| Consolidated | \$ 149,905 | 13.2% | \$ 91,201 | 8.0% | N/A | N/A | N/A | N/A |
| Bank | 142,059 | 12.5 | 91,193 | 8.0 | \$ 113,991 | 10.0% | \$ 125,390 | 11.0% |
| Tier 1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 125,028 | 11.0 | 45,601 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 127,576 | 11.2 | 45,596 | 4.0 | 68,394 | 6.0 | N/A | N/A |
| Tier 1 capital (to average assets) | | | | | | | | |
| Consolidated | 125,028 | 8.3 | 60,598 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 127,576 | 8.4 | 60,528 | 4.0 | 75,660 | 5.0 | 121,056 | 8.0 |

(1)

The MOU is applicable to the March 31, 2012 information presented in these columns, and the Consent Order is applicable to the December 31, 2011 information presented in these columns.

Approximately \$32.8 million and \$31.3 million of trust preferred securities outstanding at March 31, 2012 and December 31, 2011, respectively, qualified as Tier 1 capital. Refer to our 2011 Form 10-K for more information on the trust preferred securities.

The Bank was categorized as "well capitalized" at March 31, 2012 and "adequately capitalized" at December 31, 2011. The Bank's regulatory capital ratios exceeded the levels ordinarily required to be categorized as "well capitalized" at December 31, 2011. However, because the Bank was subject to the Consent Order, the Bank could not be categorized as "well capitalized" regardless of actual capital levels. With the termination of the Consent Order on March 2, 2012, the Bank's capital category improved to "well capitalized".

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 11 – SHAREHOLDERS' EQUITY (Continued)

The MOU prohibits the Bank from declaring or paying any cash dividend without the prior written consent of its regulators. The payment of future cash dividends by the Company is largely dependent upon dividends received from the Bank out of its earnings. Under Michigan law, the Bank is also restricted from paying dividends to the Company until its deficit retained earnings has been restored. The Bank had a retained deficit of approximately \$26.7 million at March 31, 2012.

Additional information about the Consent Order and the MOU may be found in Note 1 under the heading "Regulatory Developments".

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements.

At March 31, 2012, we had total assets of \$1.50 billion, total loans of \$1.06 billion, total deposits of \$1.21 billion and shareholders' equity of \$98.9 million. During the first quarter of 2012, we recognized net income of \$4.5 million compared to net income of \$1.3 million in the first quarter of 2011. This represented our eighth consecutive quarter (or two full years) of profitability. As described more fully below, a significant recovery on a previously charged-off loan and continued reductions in net charge-offs and nonperforming loans led to a negative loan loss provision for the most recent quarter.

In response to our losses during 2008, 2009 and the first quarter of 2010, our Board of Directors implemented additional corporate governance practices and disciplined business and banking principles, including more conservative lending principles. The focus of our management team turned from growth in our business to executing these disciplined business and banking procedures and policies designed to limit future losses, preserve capital and improve operational efficiencies. In addition, the Board of Directors added experienced members to provide further oversight and guidance. These and other efforts were reflected in our results of operations for the past two years with lower levels of charge-offs and provision for loan losses, reductions in operating expenses and reduction in balance sheet totals resulting in improvement in our regulatory capital and liquidity ratios. We successfully completed our shareholder rights offering and public offering of common stock in June 2011 resulting in net proceeds of \$20.3 million and contributed \$10.0 million of the proceeds from the stock offering to the Bank retaining the remaining \$10.3 million at the holding company. As of March 31, 2012, the Company's and the Bank's regulatory capital ratios were the highest they have been since December 31, 1999.

On February 22, 2010, Macatawa Bank entered into a Consent Order with the FDIC and OFIR, the primary banking regulators of the Bank. The Company also entered into a Written Agreement with the FRB with an effective date of July 23, 2010. Upon completion of the Bank's 2011 joint examination, the FDIC and OFIR terminated the Bank's Consent Order effective March 2, 2012. As of March 31, 2012, the Bank's capital ratios were at levels comfortably exceeding those required to be categorized as "well capitalized" under applicable regulatory guidance. With the termination of the Bank's Consent Order effective March 2, 2012, the Bank was categorized as "well capitalized" at March 31, 2012.

In connection with the termination of the Consent Order, the Bank reached an understanding with the regulators in the form of a Memorandum of Understanding ("MOU"). As of March 31, 2012, we believe that the Bank was in compliance in all material respects with all of the provisions of the MOU. As of the same date, we believe that the Company was in compliance in all material respects with all of the provisions of the Written Agreement. See Note 1 to the Consolidated Financial Statements for more information.

Additional information further describing changes in our business, including those in response to the Consent Order, MOU and the Written Agreement, are described in detail in our 2011 Annual Report on Form 10-K.

RESULTS OF OPERATIONS

Summary: Net income available to common shares for the quarter ended March 31, 2012 was \$4.5 million, compared to net income of \$1.3 million in the first quarter of 2011. Net income per common share on a diluted basis was \$0.17 for the first quarter of 2012 and \$0.07 for the first quarter of 2011.

The improvement in earnings in the first quarter of 2012 is a continuation of improvement in the past several quarters, led by a significantly lower level of net charge-offs from \$3.6 million in the first quarter of 2011 to a net recovery of \$1.4 million in the first quarter of 2012. This, coupled with a decline in non-performing and impaired loan levels, resulted in a decrease of \$2.1 million in the provision for loan losses. The provision for loan losses was a negative \$3.6 million for the three month period ended March 31, 2012 compared to a negative \$1.5 million for the same period in 2011.

Operating results in recent periods have been significantly impacted by the expense associated with problem loans and nonperforming assets. Apart from the provision for loan losses, expenses associated with nonperforming assets (including administration costs and losses) were \$3.1 million for the first quarter of 2012 compared to \$4.4 million for the first quarter of 2011. Significant valuation writedowns on other real estate owned and higher levels of legal costs associated with nonperforming assets in the first quarter of 2011 are the primary reasons for the change between periods. Lost interest from elevated levels of nonperforming assets was approximately \$1.1 million for the three months ended March 31, 2012 compared to \$1.6 million for the three months ended March 31, 2011. Each of these items is discussed more fully below.

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Net Interest Income: Net interest income totaled \$11.3 million for the first quarter of 2012 compared to \$11.6 million for the first quarter of 2011.

The decrease in net interest income in the first quarter of 2012 was due primarily to an \$87.4 million reduction in our average interest earning assets as a result of our focus on reducing credit exposure within certain segments of our loan portfolio, liquidity improvement and capital preservation. The net interest margin was 3.32% for the first quarter of 2012 compared to 3.22% for the first quarter of 2011. Average interest earning assets decreased from \$1.44 billion for the first quarter of 2011 to \$1.35 billion for the same period in 2012. Our average yield on earning assets for the first quarter of 2012 declined 27 basis points compared to the same period in 2011 from 4.42% to 4.15%. Margin improvement for the most recent quarter was driven by a significant reduction in the cost of average interest bearing liabilities, which more than offset the effect of the decline in yield on earning assets. An increase of \$48.3 million in average taxable securities in the first quarter of 2012 also contributed to the improvement in net interest margin.

The decline in yields on interest earning assets for the three month period ended March 31, 2012 was from decreases in the yield on our commercial, residential and consumer loan portfolios, which have repriced in the generally lower rate environment during this period. Our margin has been negatively impacted by our decision to hold significant balances in liquid and short-term investments during the past two years. As we deploy these balances in building our investment portfolio and booking high quality loans, we expect our margin to be positively impacted.

The cost of funds decreased 39 basis points to 1.03% in the first quarter of 2012 from 1.42% in the same period in 2011. A decrease in the rates paid on our deposit accounts in response to declining market rates and the rollover of time deposits and other borrowings at lower rates within the current rate environment caused the reduction in our cost of funds. Also contributing to the reduction was a shift in our deposit mix from higher costing time deposits to lower costing demand and savings accounts.

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The following table shows an analysis of net interest margin for the three month periods ended March 31, 2012 and 2011.

| | For the three months ended March 31, | | | | | | |
|---|--------------------------------------|-------------------------------|---|--------------------|--------|-------------------------------|-----------------------------|
| | 2012 | Interest Earned or paid | Average Yield or cost (Dollars in thousands) | Average Balance | 2011 | Interest Earned or paid | Average Yield or cost |
| | Average Balance | | | | | | |
| Assets | | | | | | | |
| Taxable securities | \$ 59,895 | 318 | 2.12% | \$ 11,632 | \$ 26 | 0.91% | |
| Tax-exempt securities (1) | 6,194 | 42 | 4.73% | 76 | 1 | 6.95% | |
| Loans (2) | 1,069,052 | 13,526 | 5.02% | 1,184,429 | 15,582 | 5.27% | |
| Federal Home Loan Bank stock | 11,236 | 85 | 2.99% | 11,932 | 76 | 2.56% | |
| Federal funds sold and other short-term investments | 203,905 | 128 | 0.25% | 229,569 | 168 | 0.29% | |
| Total interest earning assets (1) | 1,350,282 | 14,099 | 4.15% | 1,437,638 | 15,853 | 4.42% | |
| Noninterest earning assets: | | | | | | | |
| Cash and due from banks | 21,362 | | | 21,868 | | | |
| Other | 126,371 | | | 106,276 | | | |
| Total assets | \$ 1,498,015 | | | \$ 1,565,782 | | | |
| Liabilities | | | | | | | |
| Deposits: | | | | | | | |
| Interest bearing demand | \$ 210,507 | 97 | 0.18% | \$ 178,942 | 103 | 0.23% | |
| Savings and money market accounts | 395,294 | 509 | 0.52% | 370,640 | 543 | 0.59% | |
| Time deposits | 296,151 | 1,044 | 1.42% | 434,534 | 2,266 | 2.11% | |
| Borrowings: | | | | | | | |
| Other borrowed funds | 149,386 | 778 | 2.06% | 186,340 | 1,000 | 2.15% | |
| Long-term debt | 41,238 | 390 | 3.75% | 41,238 | 343 | 3.34% | |
| Total interest bearing liabilities | 1,092,576 | 2,818 | 1.03% | 1,211,694 | 4,255 | 1.42% | |
| Noninterest bearing liabilities: | | | | | | | |
| Noninterest bearing demand accounts | 303,331 | | | 278,998 | | | |
| | 6,584 | | | 6,166 | | | |

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| | | |
|--|--------------|--------------|
| Other noninterest bearing liabilities | | |
| Shareholders' equity | 95,524 | 68,924 |
| Total liabilities and shareholders' equity | \$ 1,498,015 | \$ 1,565,782 |
| Net interest income | \$ 11,281 | \$ 11,598 |
| Net interest spread | | |
| (1) | 3.12% | 3.00% |
| Net interest margin | | |
| (1) | 3.32% | 3.22% |
| Ratio of average interest earning assets to average interest bearing liabilities | 123.59% | 118.65% |

(1) Yield adjusted to fully tax equivalent.

(2) Includes non-accrual loans of approximately \$31.2 million and \$73.5 million for the three months ended March 31, 2012 and 2011.

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Provision for Loan Losses: The provision for loan losses for the first quarter of 2012 was a negative \$3.6 million compared to a negative \$1.5 million for the first quarter of 2011. The reduction in the provision for loan losses was primarily associated with a \$4.4 million recovery on a previously charged-off loan. This was partially offset by first quarter 2012 charge-offs of \$3.5 million. Provision was also impacted by a reduction in the balance and required reserves on nonperforming loans, stabilizing real estate values on problem credits and continued shrinkage in the overall loan portfolio.

Net recoveries were \$1.4 million for the first quarter of 2012 compared to net charge-offs of \$3.6 million for the first quarter of 2011. Most of the charge-offs taken during the first quarter of 2012 were from impaired loans with previously established reserves. The charge-offs for each period have largely been driven by declines in the value of real estate securing our loans. The pace of the decline in real estate value, however, has been slowing, translating into a decline in charge-offs. We are also experiencing positive results from our collection efforts with recoveries increasing as evidenced by the large recovery collected in the first quarter of 2012. Recoveries increased from \$499,000 for the first quarter of 2011 to \$4.9 million for the same period in 2012. While we expect our collection efforts to produce further recoveries, the amount achieved in the first quarter of 2012 was unusually high and may not recur at this level in future quarters.

We have also experienced a decline in the pace of commercial loans migrating to a lower loan grade, which receive higher allocations in our loan loss reserve, as more fully discussed under the heading "Allowance for Loan Losses" below. In addition to experiencing fewer downgrades of credits, we continue to see an increase in the quality of some credits resulting in an improved loan grade. Over the past six quarters, we have experienced improvements in our weighted average loan grade. We believe efforts that began in late 2009 and in early 2010 to improve loan administration and loan risk management practices have had a significant impact, ultimately allowing for the reduction in the level of the provision for loan losses in 2012.

The amounts of loan loss provision in both the most recent and comparable prior year periods were the result of establishing our allowance for loan losses at levels believed necessary based upon our methodology for determining the adequacy of the allowance. The sustained lower level of quarterly net charge-offs over the past several quarters had a significant effect on the historical loss component of our methodology. More information about our allowance for loan losses and our methodology for establishing its level may be found under the heading "Allowance for Loan Losses" below.

Noninterest Income: Noninterest income for the three month period ended March 31, 2012 was stable at \$3.7 million compared to \$3.7 million for the same period in 2011. The components of noninterest income are shown in the table below (in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|--|---|---|
| Service charges and fees on deposit accounts | \$ 795 | \$ 949 |
| Net gains on mortgage loans | 471 | 435 |
| Trust fees | 609 | 651 |
| ATM and debit card fees | 981 | 918 |
| Bank owned life insurance income | 223 | 215 |
| Investment services fees | 229 | 233 |
| Other income | 403 | 278 |

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| | | | | |
|--------------------------|----|-------|----|-------|
| Total noninterest income | \$ | 3,711 | \$ | 3,679 |
|--------------------------|----|-------|----|-------|

Service charges on deposit accounts decreased for the three month period ended March 31, 2012 as a result of declines in overdraft fee income, consistent with banking industry trends. We recognized increases in gains on sales of mortgage loans for the first quarter of 2012, due in part to increased focus on growth in our residential mortgage loan origination volume. The low interest rate environment has also contributed significantly to this increase in sales volume. Trust income is down for the three month period ended March 31, 2012 due primarily to a decline in trust asset balances and market conditions. Income from ATM and debit card fees was up for the most recent quarter due to increased volume of activity during 2012.

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Noninterest Expense: Noninterest expense decreased to \$14.1 million for the three month period ended March 31, 2012, from \$15.4 million for the same period in 2011. The components of noninterest expense are shown in the table below (in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|--|---|---|
| Salaries and benefits | \$ 5,720 | \$ 5,347 |
| Occupancy of premises | 971 | 1,011 |
| Furniture and equipment | 828 | 817 |
| Legal and professional | 212 | 270 |
| Marketing and promotion | 210 | 224 |
| Data processing | 351 | 304 |
| FDIC assessment | 710 | 978 |
| ATM and debit card processing | 288 | 271 |
| Bond and D&O insurance | 268 | 379 |
| Administration and disposition of problem assets | 3,058 | 4,434 |
| Outside services | 378 | 421 |
| Other noninterest expense | 1,113 | 980 |
| Total noninterest expense | \$ 14,107 | \$ 15,436 |

Several components of noninterest expense experienced a decline due to our ongoing efforts to manage expenses and scale our operations in response to prolonged economic weakness. However, our largest component of noninterest expense, salaries and benefits, increased in the first quarter of 2012 by \$373,000 from the first quarter of 2011. We had 382 full-time equivalent employees at March 31, 2012 compared to 385 at March 31, 2011. The increased expense for the first quarter of 2012 was primarily attributable to increased commissions paid for mortgage origination activity which was 2.6 times greater in the first quarter of 2012 compared to the first quarter of 2011. In March 2012, our board authorized a cost of living increase for the first time in several years, which will result in an increase in compensation expense beginning in the second quarter of 2012. This will be at least partially offset by managed attrition and reductions in certain areas as we adjust for personnel needs with changes in our size and complexity.

The next largest noninterest expense was our cost related to administration and disposition of problem assets. Costs associated with administration and disposition of problem assets include legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense includes survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties include both net losses on the sale of properties and unrealized losses from value declines for outstanding properties.

These costs are itemized in the following table (in thousands):

| | Three Months Ended March 31, 2012 | Three Months Ended March 31, 2011 |
|--|---|---|
|--|---|---|

| | | | | |
|---|----|-------|----|-------|
| Legal and professional – nonperforming assets | \$ | 441 | \$ | 825 |
| Reposessed and foreclosed property administration | | 1,021 | | 1,116 |
| Losses on reposessed and foreclosed properties | | 1,596 | | 2,493 |
| Total | \$ | 3,058 | \$ | 4,434 |

Losses on reposessed assets and foreclosed properties decreased significantly for the three month period ended March 31, 2012, decreasing \$897,000 from the same period in 2011. The overall level of losses on reposessed and foreclosed properties remains elevated due to the level of other real estate owned.

Costs associated with administration and disposition of problem assets remained elevated. As loans work through the collection process to resolution or foreclosure these costs tend to increase. As our level of problem loans and other real estate owned decreases, we believe we will experience meaningful reductions in these costs.

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FDIC assessments decreased by \$268,000 to \$710,000 for the first quarter of 2012 compared to \$978,000 for the first quarter of 2011 as a result of our reduced level of deposits, changes to the assessment base implemented by the FDIC and due to a change in our assessment category resulting from the termination of our Consent Order effective March 2, 2012. We expect savings to be even more for the second quarter of 2012 as the Bank will be assessed at the lower rate for the full quarter. We estimate an annual FDIC assessment cost savings of \$1.2 million related to the Consent Order termination. Because the Consent Order was not terminated until March 2, 2012, we will not realize the full amount of annual savings in 2012.

We realized a \$111,000 reduction in our bond and D&O insurance costs in the first quarter of 2012 compared to the first quarter 2011 as a result of our improving financial condition and the decreased risk perceived by our insurance carriers.

Federal Income Tax Expense/Benefit: We recorded no federal income tax expense for the three month periods ended March 31, 2012 and 2011. Since June 30, 2009, we have concluded that a full valuation allowance must be maintained for all of our net deferred tax assets based primarily on our net operating losses in recent years and the continued challenging environment confronting banks that could negatively impact future operating results. At March 31, 2012, the valuation allowance on our net deferred tax assets totaled \$22.6 million. Under certain conditions according to accounting standards, the valuation allowance may be reversed to income in future periods to the extent that the related deferred tax assets are realized or when we return to consistent, sustained profitability.

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FINANCIAL CONDITION

Summary: Due to the Consent Order and the continuing soft economic conditions, in recent periods we had been focused on reducing our loan portfolio, including reducing exposure in higher loan concentration types, to improve our financial condition through increased liquidity, diversification of credit risk, improved capital ratios, and reduced reliance on non-core funding. With the successful capital raise in the second quarter of 2011, our improving financial condition and the termination of the Consent Order, we are beginning to focus on high quality, measured growth in our investment and loan portfolios.

Total assets were \$1.50 billion at March 31, 2012, a decrease of \$4.7 million from \$1.51 billion at December 31, 2011. This change reflected increases of \$34.0 million in securities available for sale, offset by declines of \$11.0 million in our loan portfolio and \$27.7 million in short-term investments. Total deposits were stable (\$818,000 decrease) and other borrowed funds were paid down by \$11.1 million during the first quarter of 2012.

Federal Funds Sold and Other Short Term Investments: The \$27.7 million decrease in federal funds sold and other short-term investments to \$184.4 million at March 31, 2012 was used to fund the increase in securities available for sale and pay down other borrowed funds. We expect these balances to decrease further in 2012 as we continue to rebuild our investment portfolio.

Securities Available for Sale: Securities available for sale were \$88.7 million at March 31, 2012 compared to \$54.7 million at December 31, 2011. We began rebuilding our investment portfolio during the second quarter of 2011. The balance at March 31, 2012 primarily consisted of U.S. agency securities and various municipal investments. We expect to continue to reinvest excess liquidity and selectively rebuild our investment portfolio to continue our diversification of asset quality throughout the remainder of 2012.

Portfolio Loans and Asset Quality: Total portfolio loans declined by \$11.0 million to \$1.06 billion at March 31, 2012 compared to \$1.07 billion at December 31, 2011. During the first quarter of 2012, our commercial and consumer loan portfolios (excluding residential mortgages) decreased by \$22.2 million and \$1.5 million, respectively, while our residential mortgage portfolio increased by \$12.6 million as a result of our initiative to increase this portfolio segment to further diversify our credit risk.

We also saw an increase in the volume of residential mortgage loans originated for sale in the first quarter of 2012 compared to the same period in 2011. Residential mortgage loans originated for sale were \$26.5 million in the first quarter of 2012 compared to \$16.7 million for the same period in 2011. This increase was primarily due to market conditions and our focus on increasing our residential mortgage lending volume.

The decline in the commercial loan portfolio balances in recent quarters reflected the continuing weak economic conditions in West Michigan and our interest in improving the quality of our loan portfolio through reducing our exposure to these generally higher credit risk assets. We have focused our efforts on reducing our exposure to residential land development loans, diversifying our commercial loan portfolio and improving asset quality. As discussed earlier, we believe our loan portfolio has stabilized and we expect to begin measured high quality loan portfolio growth.

Commercial and commercial real estate loans still remained our largest loan segment and accounted for approximately 73% of the total loan portfolio at March 31, 2012 and 74% at December 31, 2011. Residential mortgage and consumer loans comprised approximately 27% and 26% of total loans at March 31, 2012 and December 31, 2011, respectively.

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A further breakdown of the composition of the commercial loan portfolio is shown in the table below (in thousands):

| | March 31, 2012 | Percent of Total Loans | December 31, 2011 | Percent of Total Loans |
|-------------------------------------|-------------------|---------------------------|----------------------|---------------------------|
| Commercial real estate:(1) | | | | |
| Residential developed | \$ 31,553 | 3.0% | \$ 33,829 | 3.2% |
| Unsecured to residential developers | 5,995 | 0.5 | 5,937 | 0.5 |
| Vacant and unimproved | 58,448 | 5.5 | 66,046 | 6.2 |
| Commercial development | 5,239 | 0.5 | 4,586 | 0.4 |
| Residential improved | 81,570 | 7.7 | 82,337 | 7.7 |
| Commercial improved | 291,014 | 27.4 | 304,070 | 28.4 |
| Manufacturing and industrial | 70,556 | 6.7 | 71,462 | 6.7 |
| Total commercial real estate loans | 544,375 | 51.3 | 568,267 | 53.1 |
| Commercial and industrial | 228,771 | 21.6 | 227,051 | 21.2 |
| Total commercial loans | \$ 773,146 | 72.9% | \$ 795,318 | 74.3% |

(1) Includes both owner occupied and non-owner occupied commercial real estate.

Commercial real estate accounted for approximately 51% of the total loan portfolio at March 31, 2012 and consisted primarily of loans to business owners and developers of owner and non-owner occupied commercial properties and loans to developers of single and multi-family residential properties. In the table above, we show our commercial real estate portfolio by loans secured by residential and commercial real estate, and by stage of development. Improved loans are generally secured by properties that are under construction or completed and placed in use. Development loans are secured by properties that are in the process of development or fully developed. Vacant land loans are secured by raw land for which development has not yet begun and agricultural land.

Total commercial real estate loans declined \$23.9 million since December 31, 2011 as we continued to focus on reducing our real estate loan concentrations and balances. Commercial loans secured by residential real estate, the portfolio that has created the majority of stress within our loan portfolio, declined \$5.1 million. The balance of loans secured by nonresidential real estate declined \$18.8 million since December 31, 2011.

The following table shows our loan origination activity for portfolio loans during the first quarter of 2012, broken out by loan type and also shows average originated loan size (dollars in thousands):

| | Portfolio Originations 2012 | Percent of Total Originations | Average Loan Size |
|-------------------------------------|-----------------------------------|-------------------------------------|-------------------------|
| Commercial real estate: | | | |
| Residential developed | \$ 336 | 0.3% | \$ 336 |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 3,644 | 3.7 | 729 |
| Commercial development | --- | --- | --- |
| Residential improved | 12,585 | 12.8 | 252 |
| Commercial improved | 6,813 | 7.0 | 296 |
| Manufacturing and industrial | 3,079 | 3.1 | 440 |
| Total commercial real estate | 26,457 | 26.9 | 308 |
| Commercial and industrial | 45,745 | 46.6 | 30 |
| Total commercial | 72,202 | 73.5 | 45 |

| | | | |
|-----------------------------------|-----------|-------|-----|
| Consumer: | | | |
| Residential mortgage | 20,341 | 20.8 | 155 |
| Unsecured | 120 | 0.1 | 24 |
| Home equity | 4,630 | 4.7 | 68 |
| Other secured | 896 | 0.9 | 16 |
| Total consumer | 25,987 | 26.5 | 100 |
| Total portfolio loan originations | \$ 98,189 | 100 % | 53 |

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Our loan portfolio is reviewed regularly by our senior management, our loan officers, and an internal loan review team that is independent of our loan originators and credit administration. An administrative loan committee consisting of senior management and seasoned lending and collections personnel meets monthly to manage our internal watch list and proactively manage high risk loans.

When reasonable doubt exists concerning collectability of interest or principal of one of our loans, that loan is placed in non-accrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. At March 31, 2012, nonperforming assets totaled \$89.7 million compared to \$95.4 million at December 31, 2011. Significant progress has been made to accelerate workout strategies with problem assets, leading to several properties moving to other real estate owned, which increased by \$8.5 million in 2011. Additions to other real estate owned in the first quarter of 2012 were \$5.8 million. Proceeds from sales of foreclosed properties were \$4.4 million in the first quarter of 2012 resulting in a net gain of \$94,000. This is a small decrease from the volume of sales in the first quarter of 2011, when we experienced proceeds of \$5.0 million and realized a net gain of \$212,000.

Nonperforming loans include loans on non-accrual status and loans delinquent more than 90 days but still accruing. As of March 31, 2012, nonperforming loans totaled \$23.5 million, or 2.22% of total portfolio loans, compared to \$28.9 million, or 2.70% of total portfolio loans, at December 31, 2011.

Loans for development or sale of 1-4 family residential properties comprised a large portion of non-performing loans. They were approximately \$8.2 million, or 34.8% of total non-performing loans, at March 31, 2012 compared to \$8.5 million, or 29.4% of total non-performing loans, at December 31, 2011. The remaining balance of non-performing loans at March 31, 2012 consisted of \$4.2 million of commercial real estate loans secured by various types of non-residential real estate, \$9.2 million of commercial and industrial loans, and \$1.9 million of consumer and residential mortgage loans.

Foreclosed and repossessed assets include assets acquired in settlement of loans. Foreclosed assets totaled \$66.2 million at March 31, 2012 compared to \$66.4 million at December 31, 2011. Of this balance, there were 137 commercial real estate properties totaling approximately \$61.1 million. The remaining balance was comprised of 60 residential properties totaling approximately \$5.1 million. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less estimated costs to sell and then evaluated for impairment after transfer using a lower of cost or market approach. Updated property valuations are obtained at least annually on all foreclosed assets to ensure proper carrying values are maintained.

At March 31, 2012, our foreclosed asset portfolio had a weighted average age held in portfolio of 1.4 years. Below is a breakout of our foreclosed asset portfolio at March 31, 2012 by property type and the percentages the property has been written down since taken into our possession and the combined writedown percentage, including losses taken when the property was loan collateral (dollars in thousands):

| Foreclosed Asset Property type | Carrying Value at March 31, 2012 | Foreclosed Asset Writedown | Combined Writedown (Loan and Foreclosed Asset) |
|--------------------------------|----------------------------------|----------------------------|--|
| Single Family | \$ 3,780 | 13.9% | 35.6% |
| Residential Lot | 1,376 | 34.1% | 59.4% |

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| | | | |
|-------------------------|-----------|-------|-------|
| Multi-Family | 388 | 15.5% | 41.3% |
| Vacant Land | 7,723 | 28.8% | 48.9% |
| Residential Development | 19,880 | 28.9% | 60.6% |
| Commercial Office | 7,482 | 19.5% | 51.9% |
| Commercial Industrial | 2,241 | 7.8% | 30.6% |
| Commercial Improved | 23,366 | 10.5% | 27.3% |
| | \$ 66,236 | 20.8% | 47.6% |

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The following table shows the composition and amount of our nonperforming assets (dollars in thousands):

| | March 31, 2012 | December 31, 2011 |
|---|-------------------|----------------------|
| Nonaccrual loans | \$ 23,468 | \$ 26,876 |
| Loans 90 days past due and still accruing | 26 | 2,070 |
| Total nonperforming loans (NPLs) | 23,494 | 28,946 |
| Foreclosed assets | 66,236 | 66,438 |
| Reposessed assets | 9 | --- |
| Total nonperforming assets (NPAs) | 89,739 | 95,384 |
| Accruing restructured loans (ARLs) (1) | 64,152 | 55,679 |
| Total NPAs and ARLs | \$ 153,891 | \$ 151,063 |
| NPLs to total loans | 2.22% | 2.70% |
| NPAs to total assets | 5.97% | 6.33% |

(1) Comprised of approximately \$48.5 million and \$40.9 million of commercial loans and \$15.7 million and \$14.8 million of consumer loans whose terms have been restructured at March 31, 2012 and December 31, 2011, respectively. Interest is being accrued on these loans under their restructured terms as they are less than 90 days past due.

Allowance for loan losses: The allowance for loan losses at March 31, 2012 was \$29.4 million, a decrease of \$2.2 million, compared to \$31.6 million at December 31, 2011. The balance of the allowance for loan losses represented 2.78% of total portfolio loans compared to 2.95% of total portfolio loans at December 31, 2011. While this ratio decreased, the allowance for loan losses to nonperforming loan coverage ratio continued to increase, from 109.31% at December 31, 2011 to 125.36% at March 31, 2012.

The continued reduction in net charge-offs over the past several quarters had a significant effect on the historical loss component of our allowance for loan loss computation as did the improvements in our credit quality metrics. The table below shows the changes in these metrics over the past five quarters:

| (in millions) | Quarter Ended March 31, 2012 | Quarter Ended December 31, 2011 | Quarter Ended September 30, 2011 | Quarter Ended June 30, 2011 | Quarter Ended March 31, 2011 |
|---|---------------------------------------|--|---|--------------------------------------|---------------------------------------|
| Commercial loans | \$ 773.1 | \$ 795.3 | \$ 819.6 | \$ 836.6 | \$ 886.4 |
| Nonperforming loans | 23.5 | 28.9 | 35.0 | 40.4 | 56.1 |
| Other real estate owned and repo assets | 66.2 | 66.4 | 66.5 | 65.4 | 65.0 |
| Total nonperforming assets | 89.7 | 95.4 | 101.5 | 105.9 | 121.1 |
| Net charge-offs (recoveries) | (1.4) | 3.2 | 1.4 | 2.9 | 3.6 |
| Total delinquencies | 8.9 | 13.1 | 20.7 | 30.4 | 41.2 |

Nonperforming loans have continually declined since the first quarter of 2010 to \$23.5 million at March 31, 2012, which was our lowest level of nonperforming loans since the second quarter of 2007. As discussed earlier, we had net recoveries for the first quarter 2012 of \$1.4 million, compared to the first quarter of 2011 when we incurred \$3.6 million in net charge-offs. Our total delinquencies have continued to decline, from \$41.2 million at March 31, 2011 to just \$8.9 million at March 31, 2012.

As discussed earlier, the sustained reduced level of quarterly net charge-offs has a significant effect on our 18 month historical loss ratios, which are the base for our allowance for loan loss computation. The change in the 18 month historical loss ratios from December 31, 2011 to March 31, 2012 reduced the historical loss allocations in our allowance computation by \$680,000.

These factors all provide for a reduction in our provision for loan losses. The provision for loan losses decreased \$2.1 million to a negative \$3.6 million for the three months ended March 31, 2012 compared to a negative \$1.5 million for the same period of 2011. Net recoveries were \$1.4 million for the three months ended March 31, 2012 compared to net charge-offs of \$3.6 million for the same period in 2011. The ratio of net charge-offs to average loans was -0.53% on an annualized basis for the first quarter of 2012, compared to 1.19% for the fourth quarter of 2011 and 1.23% for the first quarter of 2011.

We are encouraged by the reduced level of charge-offs over recent quarters. We do, however, recognize that future chargeoffs and resulting provisions for loan losses are expected to be impacted by the timing and extent of changes in the overall economy and the real estate markets. We believe we have seen some stabilization in the pace of decline in economic conditions and real estate markets. However, we expect it to take additional time for sustained improvement in the economy and real estate markets in order for us to reduce our non-performing and impaired loans to acceptable levels.

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Our allowance for loan losses is maintained at a level believed appropriate based upon our monthly assessment of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance and related provision for loan losses relies on several key elements, which include specific allowances for loans considered impaired, general allowance for commercial loans not considered impaired based upon applying our loan rating system, and general allocations based on historical trends for homogeneous loan groups with similar risk characteristics.

Overall, impaired loans increased to \$86.6 million at March 31, 2012, from \$84.6 million at December 31, 2011. The specific allowance for impaired loans increased \$824,000 to \$10.4 million, or 12.0% of total impaired loans, at March 31, 2012 compared to \$9.6 million, or 11.3% of total impaired loans, at December 31, 2011. The increase in impaired loans was primarily attributable to new loans moving into an impaired status more than offsetting loans migrating to other real estate owned, loan payoffs and upgrades. Charge-offs totaling \$2.7 million had previously been taken on these impaired loans, bringing the balance to \$86.6 million as of March 31, 2012. Combined with the \$10.4 million of specific reserves at March 31, 2012, these loans have been written down 14%.

The general allowance allocated to commercial loans that were not considered to be impaired was based upon the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are stratified between real estate secured and non real estate secured. The real estate secured portfolio is further stratified by the type of real estate. Each stratified portfolio is assigned a loss allocation factor. A lower grade assigned to a loan category generally results in a greater allocation percentage. Changes in risk grade of loans affect the amount of the allowance allocation.

The determination of our loss factors is based upon our actual loss history by loan grade and adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the analysis date. We use a rolling 18 month actual net chargeoff history as the base for our computation. The 18 month period ended March 31, 2012 reflected a sizeable decrease in net chargeoff experience. We addressed this volatility in the qualitative factor considerations applied in our allowance computation. Adjustments to the qualitative factors also involved consideration of different loss periods for the Bank, including 12 and 24 month periods. Considering the change in our qualitative factors and the decrease in our commercial loan portfolio balances, the general commercial loan allowance decreased to \$16.6 million at March 31, 2012 compared to \$18.9 million at December 31, 2011. This resulted in a general reserve percentage allocated at March 31, 2012 of 2.36% of commercial loans, a decrease from 2.61% at December 31, 2011. The qualitative component of our allowance allocated to commercial loans decreased from \$14.3 million at December 31, 2011 to \$13.0 million at March 31, 2012.

Groups of homogeneous loans, such as residential real estate and open- and closed-end consumer loans, receive allowance allocations based on loan type. As with commercial loans that are not considered impaired, the determination of the allowance allocation percentage is based principally on our historical loss experience. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans. The homogeneous loan allowance was \$2.4 million at March 31, 2012 compared to \$3.1 million at December 31, 2011. The decrease was related to significant improvements in delinquencies in both residential mortgage and consumer loan portfolios.

The allowance allocations are not intended to imply limitations on usage of the allowance. The entire allowance is available for any loan losses without regard to loan type.

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Deposits and Other Borrowings: Total deposits decreased slightly (\$818,000) to \$1.21 billion at March 31, 2012 compared to \$1.22 billion at December 31, 2011. While the balance remained consistent, we did experience some shifting between product types. During the first quarter of 2012, we had a \$23.6 million decrease in noninterest checking, a \$14.3 million increase in interest bearing checking, and a \$31.6 million increase in savings and money market deposits. Partially offsetting this was a \$23.1 million decrease in higher costing certificates of deposit which is our most rate sensitive category of deposits. Some of this decline in certificates of deposit was intentional and encouraged through our rate setting process in response to our high on-balance sheet liquidity.

The overall stability of in-market deposits is particularly noteworthy considering the financial challenges we have experienced, the lack of economic expansion in western Michigan and the intense competition for core deposit growth in our markets. We believe the stability in balances of personal and business checking and savings accounts was primarily attributable to our focus on quality customer service, the desire of customers to deal with a local bank, the convenience of our maturing branch network and the breadth and depth of our product line. A provision of the Dodd-Frank Act went into effect on July 21, 2011 eliminating the prohibition of payment of interest on commercial checking accounts. This change may impact the shift of noninterest bearing checking accounts in future periods.

Other borrowed funds, consisting of Federal Home Loan Bank advances, decreased \$11.1 million during the first quarter of 2012 as a result of scheduled maturities.

CAPITAL RESOURCES

Total shareholders' equity of \$98.9 million at March 31, 2012 increased \$4.5 million from \$94.4 million at December 31, 2011. The increase was a result of net income of \$4.5 million earned in the first quarter of 2012.

Our regulatory capital ratios improved again in the first quarter of 2012 and the Bank was categorized as "well capitalized" at March 31, 2012. The following table shows our regulatory capital ratios (on a consolidated basis) for the past several quarters:

| | March 31, 2012 | Dec 31, 2011 | Sept 30, 2011 | June 30, 2011 | March 31, 2011 | Dec 31, 2010 | Sept 30, 2010 |
|---------------------------------------|-------------------|-----------------|------------------|------------------|-------------------|-----------------|------------------|
| Total capital to risk weighted assets | 13.7% | 13.2% | 12.9% | 12.7% | 10.3% | 9.7% | 9.3% |
| Tier 1 capital to average assets | 8.8% | 8.3% | 8.1% | 8.1% | 5.8% | 5.8% | 5.4% |

Approximately \$32.8 million of the \$40.0 million of trust preferred securities outstanding at March 31, 2012 qualified as Tier 1 capital. The remaining \$7.2 million qualified as Tier II capital, a component of total risk-based capital. The ratios have increased each quarter since March 31, 2010 due to declines in risk weighted assets, positive earnings for each quarter and the stock offering completed in the second quarter of 2011.

We continued to suspend payments of cash dividends on our preferred stock during the quarter and until further action by the Board of Directors. During any period that we do not declare and pay cash dividends on our preferred stock, we may not declare and pay cash dividends on our common stock. During the quarter, we also continued to exercise our right to defer interest payments on our trust preferred securities for 20 consecutive quarters or until such earlier time as is determined by further action of the Board of Directors. During any deferral period, we may not declare or pay any dividends on our common stock or preferred stock or make any payment on any outstanding debt obligations that

rank equally with or junior to the trust preferred securities.

LIQUIDITY

Liquidity of Macatawa Bank: The liquidity of a financial institution reflects its ability to manage a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the FRB's discount window, the Federal Home Loan Bank, federal funds purchased lines of credit and other secured borrowing sources with our correspondent banks, loan payments by our borrowers, maturity and sales of our securities available for sale, growth of our deposits and deposit equivalents, federal funds sold, and the various capital resources discussed above.

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Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. Our liquidity management involves periodic monitoring of our assets considered to be liquid and illiquid, and our funding sources considered to be core and non-core and short-term (less than 12 months) and long-term. We have established parameters that monitor, among other items, our level of liquid assets to short-term liabilities, our level of non-core funding reliance and our level of available borrowing capacity. We maintain a diversified wholesale funding structure and actively manage our maturing wholesale sources to reduce the risk to liquidity shortages. We have also developed a contingency funding plan to stress test our liquidity requirements arising from certain events that may trigger liquidity shortages, such as rapid loan growth in excess of normal growth levels or the loss of deposits and other funding sources under extreme circumstances.

The Bank continued to make significant progress during 2010 and 2011 to intentionally reduce its reliance on non-core funding sources, including brokered deposits, and remains focused on maintaining a non-core funding dependency ratio below its peer group average. During 2010, we reduced our brokered deposits by \$158.4 million and other borrowed funds by \$92.7 million. During 2011, we paid off \$48.2 million in brokered deposits and had no such deposits outstanding at December 31, 2011 or March 31, 2012. Since December 31, 2008, we reduced our brokered deposits by \$337.8 million. We also reduced other borrowed funds by \$36.7 million in 2011 and an additional \$11.1 million in the first quarter of 2012.

The Bank also held \$184.4 million of short-term investments and had available borrowing capacity from correspondent banks of approximately \$76.5 million as of March 31, 2012 to provide additional liquidity as needed.

Liquidity of Holding Company: The primary sources of liquidity for the Company are dividends from the Bank, existing cash resources and the various capital resources discussed above. Banking regulations and the laws of the State of Michigan in which our Bank is chartered limit the amount of dividends the Bank may declare to the Company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Company until its deficit retained earnings has been restored. At March 31, 2012, the retained earnings deficit of the Bank was approximately \$26.7 million. Throughout 2009, 2010, 2011 and the first quarter of 2012, the Company has not received dividends from the Bank and we have not paid any dividends to our common shareholders. Under the MOU and the Written Agreement, the Bank and the Company may not pay any dividends without prior regulatory approval.

The Company continued to suspend payments of cash dividends on its preferred stock during 2010, 2011 and the first quarter of 2012 until further action is taken by the Board of Directors. During the period that the Company does not declare and pay cash dividends on its preferred stock, it may not declare and pay cash dividends on its common stock.

During 2010, 2011 and the first quarter of 2012, the Company also continued to exercise its right to defer interest payments on its trust preferred securities for 20 consecutive quarters or until such earlier time as is determined by further action of the Board of Directors. During the deferral period, the Company may not declare or pay any dividends on its common stock or preferred stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities.

In June 2011, the Company closed its shareholder rights and public offerings and conversion of our 2% Subordinated Note due 2018, resulting in the issuance of 9,404,202 shares of common stock and net proceeds of \$20.4 million. The Company contributed \$10.0 million of the proceeds to the Bank in 2011 and retained the remaining \$10.3 million at the holding company level. The Company's cash balance at March 31, 2012 was \$10.3 million. The Company believes it has sufficient liquidity to meet its cash flow requirements for the remainder of 2012.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES:

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and future results could differ. The allowance for loan losses, other real estate owned valuation, loss contingencies and income taxes are deemed critical due to the required level of management judgment and the use of estimates, making them particularly subject to change.

Our methodology for determining the allowance for loan losses and the related provision for loan losses is described above in the "Allowance for Loan Losses" discussion. This area of accounting requires significant judgment due to the number of factors which can influence the collectability of a loan. Unanticipated changes in these factors could significantly change the level of the allowance for loan losses and the related provision for loan losses. Although, based upon our internal analysis, and in our judgment, we believe that we have provided an adequate allowance for loan losses, there can be no assurance that our analysis has properly identified all of the probable losses in our loan portfolio. As a result, we could record future provisions for loan losses that may be significantly different than the levels that we recorded in the periods presented in the consolidated financial statements that are a part of this report.

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Assets acquired through or instead of foreclosure, primarily other real estate owned, are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. New real estate appraisals are generally obtained at the time of foreclosure and are used to establish fair value. If fair value declines, a valuation allowance is recorded through expense. Estimating the initial and ongoing fair value of these properties involves a number of factors and judgments including holding time, costs to complete, holding costs, discount rate, absorption and other factors.

Loss contingencies are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. This, too, is an accounting area that involves significant judgment. Although, based upon our judgment, internal analysis, and consultations with legal counsel we believe that we have properly accounted for loss contingencies, future changes in the status of such contingencies could result in a significant change in the level of contingent liabilities and a related impact to operating earnings.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. At March 31, 2012, we had gross deferred tax assets of \$25.2 million, gross deferred tax liabilities of \$2.6 million and a valuation allowance of \$22.6 million for the entire amount of net deferred tax assets. Accounting standards require that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. Based upon a number of factors, including our net operating losses in recent years and the challenging environment currently confronting banks that could negatively impact future operating results, we concluded that we needed to continue to maintain a valuation allowance during the first quarter of 2012 for our net deferred tax assets. Changes in tax laws, changes in tax rates, changes in ownership and our future level of earnings can impact the ultimate realization of our net deferred tax asset as well as the valuation allowance that we established.

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Item 4: CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), as of March 31, 2012, the end of the period covered by this report.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as the Company's are designed to do, and management necessarily was required to apply its judgment in evaluating whether the benefits of the controls and procedures that the Company adopts outweigh their costs.

Our CEO and CFO, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report, have concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

(b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

As of the date hereof, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking, to which we or any of our subsidiaries are a party or of which any of our properties are the subject.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

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Item 6. Exhibits.

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| 3.1 | Restated Articles of Incorporation. Previously filed with the Commission on April 28, 2011 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 3.1. Here incorporated by reference. |
| 3.2 | Bylaws. Previously filed with the Commission on November 24, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 3.1. Here incorporated by reference. |
| 3.3 | Certificate of Designation of Series A Noncumulative Convertible Perpetual Preferred Stock. Previously filed with the Commission on November 5, 2008 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference. |
| 3.4 | Certificate of Designation of Series B Noncumulative Convertible Perpetual Preferred Stock. Previously filed with the Commission on July 2, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference. |
| 4.1 | Restated Articles of Incorporation. Exhibit 3.1 is here incorporated by reference. |
| 4.2 | Bylaws. Exhibit 3.2 is here incorporated by reference. |
| 4.3 | Certificate of Designation of Series A Noncumulative Convertible Perpetual Preferred Stock. Exhibit 3.3 is here incorporated by reference. |
| 4.4 | Certificate of Designation of Series B Noncumulative Convertible Perpetual Preferred Stock. Exhibit 3.4 is here incorporated by reference. |
| 4.5 | First Amended Settlement and Release and Warrant Issuance Agreement dated January 30, 2009. Previously filed with the Commission on January 30, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 10.1. Here incorporated by reference. |
| 4.6 | Second Amendment to Settlement and Release and Warrant Issuance Agreement dated April 30, 2009. Previously filed with the Commission on May 8, 2009 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 10. Here incorporated by reference. |
| 4.7 | Warrant Agreement between the Company and Registrar and Transfer Company dated June 16, 2009. Previously filed with the Commission on June 19, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference. |
| 4.8 | Warrant Agreement Addendum between the Company and Registrar and Transfer Company dated July 27, 2009. Previously filed with the Commission on July 31, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference. |
| 4.9 | Form of Warrant Certificate (first series). Previously filed with the Commission on June 19, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here incorporated by reference. |
| 4.10 | Form of Warrant Certificate (second series). Previously filed with the Commission on July 31, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here |

incorporated by reference.

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|-------------|--|
| 4.11 | Form of 11% Subordinated Note Due 2017. Previously filed with the Commission on July 2, 2009 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.2. Here incorporated by reference. |
| 4.12 | Form of Subscription Rights Certificate. Previously filed with the Commission on May 11, 2011 in Macatawa Bank Corporation's Amendment No. 2 to Form S-1 registration statement, Exhibit 4.13. Here incorporated by reference. |
| 4.13 | Form of 2% Subordinated Note Due 2018. Previously filed with the Commission on April 22, 2011 in Macatawa Bank Corporation's Current Report on Form 8-K, Exhibit 4.1. Here incorporated by reference. |
| 4.14 | Long-Term Debt. The registrant has outstanding long-term debt which at the time of this report does not exceed 10% of the registrant's total consolidated assets. The registrant agrees to furnish copies of the agreements defining the rights of holders of such long-term debt to the SEC upon request. |
| <u>31.1</u> | Certification of Chief Executive Officer. |
| <u>31.2</u> | Certification of Chief Financial Officer. |
| <u>32.1</u> | Certification pursuant to 18 U.S.C. Section 1350. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MACATAWA BANK CORPORATION

/s/ Ronald L. Haan
Ronald L. Haan
Chief Executive Officer
(Principal Executive Officer)

/s/ Jon W. Swets
Jon W. Swets
Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

Dated: April 26, 2012