MACATAWA BANK CORP
Form 10-K
February 16, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016
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	38-3391345
(State or other jurisdiction of incorporation or organization)	(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
Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained in this form and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10 K.

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

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

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, as of June 30, 2016, was $233,288,000 based on the closing sale price of $7.42 as reported on the Nasdaq Stock Market. There were 33,940,788 outstanding shares of the Company's common stock as of February 16, 2017.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held May 2, 2017 are incorporated by reference into Part III of this report.

MACATAWA BANK CORPORATION
FORM 10-K ANNUAL REPORT
TABLE OF CONTENTS

Table of Contents

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 or that the Company or its management “anticipates”, “believes”, “estimates”, “plans”, “forecasts”, “intends”, “predicts”, “proj “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”, “conce forward”, “focus”, “starting”, “initiative,” “trend” 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, future levels of earning assets, statements related to stabilization of our loan portfolio, trends in credit quality metrics, future capital levels and capital needs, including the impact of Basel III, real estate valuation, future levels of repossessed and foreclosed properties and nonperforming assets, future levels of losses and costs associated with the administration and disposition of repossessed and foreclosed properties and nonperforming assets, future levels of loan charge-offs, future levels of other real estate owned, future levels of provisions for loan losses and reserve recoveries, the rate of asset dispositions, future dividends, future growth and funding sources, future cost of funds, future liquidity levels, future profitability levels, future FDIC assessment levels, future net interest margin levels, building and improving our investment portfolio, diversifying our credit risk, the effects on earnings of changes in interest rates, future economic conditions, future effects of new or changed accounting standards, future loss recoveries, future balances of short-term investments, future loan demand and loan growth, future levels of mortgage banking revenue 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 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, 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, continue 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 this report. 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.

Table of Contents

PART I

ITEM 1: Business.

As used in this report, the terms "we," "us," "our" and "Company" mean Macatawa Bank Corporation and its subsidiaries, unless the context indicates another meaning. The term "Bank" means Macatawa Bank.

Overview

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. The Company was incorporated in 1997. Our business is concentrated in a single industry segment - commercial banking. Through our wholly-owned subsidiary, Macatawa Bank, we offer a full range of commercial and personal banking services, including checking, savings and certificates of deposit accounts, cash management, safe deposit boxes, trust services and commercial, mortgage and consumer loans through our twenty-six branch offices and a lending and operation service facility in Ottawa County, Kent County and northern Allegan County, Michigan. Other services we offer include ATMs, internet banking, telephone banking and debit cards. The Bank provides various brokerage services, including discount brokerage through Infinex, personal financial planning and consultation regarding mutual funds.

At December 31, 2016, we had total assets of $1.74 billion, total loans of $1.28 billion, total deposits of $1.45 billion and shareholders' equity of $162.2 million. We recognized net income of $16.0 million in 2016 compared to net income of $12.8 million in 2015. Earnings in 2016 and 2015 improved over their respective previous years through growth in total revenue, primarily net interest income, while holding noninterest expenses flat. As of December 31, 2016, the Company's and the Bank's risk-based regulatory capital ratios were significantly above those required under the regulatory standards and the Bank continued to be categorized as "well capitalized" at December 31, 2016.

During 2013, the Company improved its capital structure by prepaying and redeeming its $1.7 million of 11% unsecured subordinated debt, resuming interest payments on its trust preferred securities and completing an exchange of all of the Company's Series A and Series B Preferred Stock for Company common stock and cash, at the election of the holder. Each of these transactions are discussed in detail in Item 7.

This paved the way for the Company to resume payment of quarterly cash dividends to common shareholders. Beginning with the first quarter of 2014, the Company paid a cash dividend of $0.02 per share in each quarter of 2014, after a hiatus of over five years. In the second quarter of 2015, the Company increased this cash dividend by 50%, to $0.03 per share and continued to pay at this level for the third and fourth quarters of 2015 and for each quarter in 2016.

Over the past several years, much progress has been made at reducing our nonperforming assets. The following table reflects period end balances of these nonperforming assets as well as total loan delinquencies.

(dollars in thousands)	December 31,				
	2016	2015	2014	2013	2012
Nonperforming loans	$300	$756	$8,426	$12,335	$16,003
Other repossessed assets	---	---	38	40	6
Other real estate owned	12,253	17,572	28,242	36,796	51,582
Total nonperforming assets	$12,553	$18,328	$36,706	$49,171	$67,591
Total delinquencies 30 days or greater past due	$1,447	$1,371	$2,841	$5,520	$7,887

Earnings in recent years have been impacted by high costs associated with administration and disposition of nonperforming assets. These costs, including losses on repossessed and foreclosed properties, were $1.3 million, $3.0 million and $3.1 million for the years ended December 31, 2016, 2015 and 2014, respectively. Going forward, as further reductions in nonperforming assets are accomplished, we expect the costs associated with these assets to continue to decline thereby allowing for improved earnings in future periods.

Our earnings in 2016, 2015 and 2014 were favorably impacted by a negative provision for loan losses of $1.35 million, $3.5 million and $3.35 million, respectively. As discussed in detail later in Item 7 of this report under the heading "Allowance for Loan Losses", the large negative provision in 2015 was primarily a result of the reversal of a portion of a specific reserve on an individual credit that was upgraded to accruing status in the fourth quarter of 2015 as well as net loan recoveries for the year. The negative provision in each period was also impacted by other recoveries from our collection efforts and a continual decline in our historical charge-off levels from prior years.

Table of Contents

The following table reflects the provision for loan losses for the past five years along with certain metrics that impact the determination of the level of the provision for loan losses.

(dollars in thousands)	For the Year Ended December 31,				
	2016	2015	2014	2013	2012
Provision for loan losses	$(1,350)	$(3,500)	$(3,350)	$(4,250)	$(7,100)
Net charge-offs (recoveries)	(1,231)	(1,619)	(1,514)	(1,309)	802
Net charge-offs (recoveries) to average loans	(0.10)%	(0.14)%	(0.14)%	(0.13)%	0.08 %
Nonperforming loans to total loans	0.02 %	0.06 %	0.75 %	1.18 %	1.52 %
Loans transferred to ORE to average loans	0.03 %	0.22 %	0.47 %	0.34 %	0.88 %
Performing troubled debt restructurings ("TDRs") to average loans	2.45 %	3.34 %	4.47 %	5.61 %	6.24 %

Economic conditions in our market areas of Grand Rapids and Holland have improved during the past several years. The state’s unemployment rate at the end of 2016 was 4.5%. The Grand Rapids and Holland area unemployment rate was 3.1% at the end of 2016. Residential housing values and commercial real estate property values decreased significantly during the recession, but have stabilized and shown signs of improvement, with some of our newer appraisals tending to reflect values at or above prior year values.

It also appears that the housing market in our primary market area is improving. In the Grand Rapids market during 2016, there were 65% more living unit starts than in 2015. Similarly, in the Holland-Grand Haven/Lakeshore region, there were 27% more living unit starts in 2016 than in 2015. These improvements are on top of improved results in 2015 over 2014. Also, these markets are now also seeing significant activity in duplex, condominium and apartment starts after years of virtually no activity.

Beginning in 2014, with our improved financial condition, and earnings growth, our primary focus was on high quality loan portfolio growth. We experienced strong commercial loan growth in the fourth quarter of 2014 and throughout 2015 and 2016. Most of our emphasis has been on growing commercial and industrial loans. These loans have increased from $274.1 million at December 31, 2013 to $327.7 million at December 31, 2014, $377.3 million at December 31, 2015 and $449.3 million at December 31, 2016. Commercial real estate loans have increased from $472.3 million at December 31, 2013 to $490.5 million at December 31, 2014, $508.7 million at December 31, 2015 and $518.0 million at December 31, 2016. Consumer loans have increased from $295.9 million at December 31, 2013 to $300.3 million at December 31, 2014, $312.0 million at December 31, 2015 and $313.5 million at December 31, 2016. We believe we are positioned for continued growth in 2017.

We have no material foreign loans, assets or activities. No material part of our business is dependent on a single customer or very few customers. Our loan portfolio is not concentrated in any one industry.

Our headquarters and administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424, and our telephone number is (616) 820-1444. Our internet website address is www.macatawabank.com. We make available free of charge through this website our annual report on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after filing or furnishing such reports with the Securities and Exchange Commission. The information on our website address is not incorporated by reference into this report, and the information on the website is not part of this report.

Table of Contents
Products and Services

Loan Portfolio

We have historically offered a broad range of loan products to business customers, including commercial and industrial and commercial real estate loans, and to retail customers, including residential mortgage and consumer loans. Select, well-managed loan renewal activity is taking place and we are seeing growth in our commercial and consumer loan portfolios and pipelines. Following is a discussion of our various types of lending activities.

Commercial and Industrial Loans

Our commercial and industrial lending portfolio contains loans with a variety of purposes and security, including loans to finance operations and equipment. Generally, our commercial and industrial lending has been limited to borrowers headquartered, or doing business, in our primary market area. These credit relationships typically require the satisfaction of appropriate loan covenants and debt formulas, and generally require that the Bank be the primary depository bank of the business. These loan covenants and debt formulas are monitored through periodic, required reporting of accounts receivable aging schedules and financial statements, and in the case of larger business operations, reviews or audits by independent professional firms.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself and economic conditions. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial Real Estate Loans

Our commercial real estate loans consist primarily of construction and development loans and multi-family and other non-residential real estate loans.

Construction and Development Loans. These consist of construction loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments.

This portfolio can be affected by job losses, declines in real estate value, declines in home sale volumes, and declines in new home building. During the past several years, we made a significant effort to reduce exposure to residential land development and other construction and development loans.

Multi-Family and Other Non-Residential Real Estate Loans. These are permanent loans secured by multi-family and other non-residential real estate and include loans secured by apartment buildings, condominiums, small office buildings, small business facilities, medical facilities and other non-residential building properties, substantially all of which are located within our primary market area.

Multi-family and other non-residential real estate loans generally present a higher level of risk than loans secured by owner occupied one- to four-family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of these loans is typically dependent upon the successful operation of the related real estate project. For example, if leases are not obtained or renewed, or a bankruptcy court modifies a lease term, or a major tenant is unable to fulfill its lease obligations, cash flow from the project will be reduced. If cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Retail Loans

Our retail loans are loans to consumers and consist primarily of residential mortgage loans and consumer loans.

Residential Mortgage Loans. We originate construction loans to individuals for the construction of their residences and owner-occupied residential mortgage loans, which are generally long-term with either fixed or adjustable interest rates. Our general policy is to sell the majority of our fixed rate residential mortgage loans in the secondary market due primarily to the interest rate risk associated with these loans. For 2016, we retained loans representing 43% of the total dollar volume originated, compared to 46% in 2015.

Table of Contents

Our borrowers generally qualify and are underwritten using industry standards for quality residential mortgage loans. We do not originate loans that are considered "sub-prime". Residential mortgage loan originations derive from a number of sources, including advertising, direct solicitation, real estate broker referrals, existing borrowers and depositors, builders and walk-in customers. Loan applications are accepted at most of our offices and online. The substantial majority of these loans are secured by one-to-four family properties in our market area.

Consumer Loans. We originate a variety of different types of consumer loans, including automobile loans, home equity lines of credit and installment loans, home improvement loans, deposit account loans and other loans for household and personal purposes. We also originate home equity lines of credit utilizing the same underwriting standards as for home equity installment loans. Home equity lines of credit are revolving line of credit loans. The majority of our existing home equity line of credit portfolio has variable rates with floors and ceilings, interest only payments and a maximum maturity of ten years.

The underwriting standards that we employ for consumer loans include a determination of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes a comparison of the value of the security, if any, in relation to the proposed loan amount. Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Loan Portfolio Composition

The following table reflects the composition of our loan portfolio and the corresponding percentage of our total loans represented by each class of loans as of the dates indicated.

(Dollars in thousands)	December 31									
	2016		2015		2014		2013		2012	
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
Real estate - construction (1)	$64,968	5 %	$90,039	8 %	$77,564	7 %	$86,413	8 %	$89,631	9 %
Real estate - mortgage	453,013	35	418,633	35	412,967	37	385,927	37	413,328	39
Commercial and industrial	449,342	35	377,298	31	327,674	29	274,099	27	259,700	25
Total commercial	967,323	75	885,970	74	818,205	73	746,439	72	762,659	73
Residential mortgage	217,614	17	209,972	18	190,249	17	188,648	18	182,625	17
Consumer	95,875	8	101,990	8	110,029	10	107,290	10	107,064	10
Total loans	1,280,812	100 %	1,197,932	100 %	1,118,483	100 %	1,042,377	100 %	1,052,348	100 %

Less: allowance for loan losses	(16,962)	(17,081)	(18,962)	(20,798)	(23,739)
Total loans receivable, net	$1,263,850	$1,180,851	$1,099,521	$1,021,579	$1,028,609

(1) Consists of construction and development loans.

At December 31, 2016, there was no concentration of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the table above.

Table of Contents

Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table shows the amount of total loans outstanding at December 31, 2016 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

(Dollars in thousands)	Maturing Within One Year	After One, But Within Five Years	After Five Years	Total
Real estate - construction (1)	$29,136	$ 20,307	$ 15,525	$64,968
Real estate - mortgage	65,687	299,526	87,800	453,013
Commercial and industrial	250,670	164,317	34,355	449,342
Total Commercial	345,493	484,150	137,680	967,323
Residential mortgage	329	1,124	216,161	217,614
Consumer	5,025	27,668	63,182	95,875
Total Loans	$350,847	$ 512,942	$ 417,023	$1,280,812
	Maturing or Repricing			
Loans above:				
With predetermined interest rates	$94,170	$ 370,666	$ 117,637	$582,473
With floating or adjustable rates	594,202	52,493	51,344	698,039
Total (excluding nonaccrual loans)	$688,372	$ 423,159	$ 168,981	1,280,512
Nonaccrual loans				300
Total Loans				$1,280,812

(1) Consists of construction and development loans.

Nonperforming Assets

Interest income totaling $1.5 million was recorded in 2016 on loans that were on a non-accrual status or classified as restructured as of December 31, 2016. Additional interest income of $374,000 would have been recorded during 2016 on these loans had they been current in accordance with their original terms. More information about the levels of nonperforming loan balances in 2012 through 2016 and our policy for placing loans on non-accrual status may be found in Item 7 of this report under the heading "Portfolio Loans and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Loans at December 31, 2016 that were classified as substandard or worse per our internal risk rating system that would cause management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms are discussed in Item 7 of this report under the heading "Portfolio Loans and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition." At December 31, 2016, there were no other interest-bearing assets that would be required to be disclosed under Industry Guide 3, Item III, C. 1. or 2. if such assets were loans.

Loan Loss Experience

A summary of our loan balances at the end of 2012 through 2016 and the daily average balances of these loans as well as changes in the allowance for loan losses arising from loans charged-off and recoveries on loans previously charged-off, and additions to the allowance which we have expensed is shown in Item 7 of this report under the heading "Loan Portfolio and Asset Quality" included in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Additional information about our allowance for loan losses, including a table showing the allocation of the allowance for loan losses at the end of 2012 through 2016 and the factors which influenced management's judgment in determining the amount of the additions to the allowance charged to operating expense, may be found in Item 7 of this report under the heading "Allowance for Loan Losses" in "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Table of Contents

Deposit Portfolio

We offer a broad range of deposit services, including checking accounts, savings accounts and time deposits of various types. Transaction accounts and savings and time certificates are tailored to the principal market area at rates competitive with those offered in the area. All deposit accounts are insured by the FDIC up to the maximum amount permitted by law.

We solicit deposit services from individuals, businesses, associations, churches, nonprofit organizations, financial institutions and government authorities. Deposits are gathered primarily from the communities we serve through our network of 26 branches. We offer business and consumer checking accounts, regular and money market savings accounts, and certificates of deposit with many term options. We operate in a competitive environment, competing with other local banks similar in size and with significantly larger regional banks. We monitor rates at other financial institutions in the area to ascertain that our rates are competitive with the market. We also attempt to offer a wide variety of products to meet the needs of our customers. We set our deposit pricing to be competitive with other banks in our market area.

We may utilize alternative funding sources as needed, including short-term borrowings, advances from the Federal Home Loan Bank of Indianapolis or the Federal Reserve Bank of Chicago, securities sold under agreements to repurchase ("repo borrowings") and brokered deposits. We had no brokered deposits or repo borrowings at December 31, 2016 or 2015.

Deposit Portfolio Composition

The following table sets forth the average deposit balances and the weighted average rates paid.

(Dollars in thousands)	December 31									
	2016		2015		2014		2013		2012	
	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate
Noninterest bearing demand	$445,046	--- %	$395,814	--- %	$359,384	--- %	$317,332	--- %	$323,368	--- %
Interest bearing demand	321,825	0.1	339,698	0.1	274,100	0.1	272,689	0.1	225,250	0.2
Savings and money market accounts	521,857	0.2	487,087	0.2	449,623	0.2	472,920	0.4	420,553	0.5
Time	84,170	0.6	106,746	0.9	138,300	1.0	171,657	0.9	254,796	1.3
Total deposits	$1,372,898	0.1 %	$1,329,345	0.2 %	$1,221,407	0.2 %	$1,234,598	0.3 %	$1,223,967	0.5 %

The following table summarizes time deposits in amounts of $100,000 or more by time remaining until maturity as of December 31, 2016 (dollars in thousands).

Three months or less	$6,341
Over 3 months through 6 months	4,078
Over 6 months through 1 year	7,604

Over 1 year	11,021
	$29,044

As of the date of this report, the Bank had no material foreign deposits.

Securities Portfolio

Our securities portfolio is classified as either "available for sale" or "held to maturity." Securities classified as "available for sale" may be sold prior to maturity due to changes in interest rates, prepayment risks, and availability of alternative investments, or to meet our liquidity needs.

The primary objective of our investing activities is to provide for the safety of the principal invested. Our secondary considerations include the maximization of earnings, liquidity and to help decrease our overall exposure to changes in interest rates. We have generally invested in bonds with lower credit risk, primarily those secured by government agencies or insured municipalities, to assist in the diversification of credit risk within our asset base. We have not experienced any credit losses within our investment portfolio.

Table of Contents

The following table reflects the composition of our securities portfolio as of the dates indicated.

(Dollars in thousands)	December 31,				
	2016	2015	2014	2013	2012
U.S. Treasury and federal agency securities	$84,350	$74,392	$67,164	$54,439	$42,564
U.S. Agency MBS and CMOs	11,817	13,755	16,688	19,365	23,761
Tax-exempt state and municipal bonds	108,565	85,454	69,046	46,097	25,093
Taxable state and municipal bonds	33,883	28,763	25,293	26,328	27,296
Corporate bonds	13,726	14,813	13,766	11,212	7,526
Other equity securities	1,470	1,494	1,502	1,466	1,557
Total	$253,811	$218,671	$193,459	$158,907	$127,797

At December 31, 2016, other than our holdings in U.S. Treasury and U.S. Government Agency Securities, we had no investments in securities of any one issuer with an aggregate book value in excess of 10% of shareholders' equity. At December 31, 2016, we had no investment in securities of issuers outside of the United States.

Schedule of Maturities of Investment Securities and Weighted Average Yields

The following is a schedule of investment securities maturities and their weighted average yield by category at December 31, 2016.

(Dollars in thousands)	Due Within One Year		One to Five Years		Five to Ten Years		After Ten Years		No Contractual Maturity	
	Amount	Average Yield	Amount	Average Yield	Amount	Average Yield	Amount	Average Yield	Amount	Average Yield
U.S. Treasury and federal agency securities	$6,484	1.22 %	$60,805	1.41 %	$17,062	1.79 %	$---	--- %	$---	--- %
U.S. Agency MBS and CMOs	---	---	---	---	1,115	2.48	10,702	2.05	---	---
Tax-exempt state and municipal bonds (1)	25,247	1.23	9,522	2.80	68,551	2.83	5,245	3.54	---	---
Taxable state and municipal bonds	3,872	3.31	21,377	2.15	7,452	2.18	1,181	2.25	---	---
Corporate bonds	5,929	1.39	7,797	1.82	---	---	---	---	---	---
Other equity securities	---	---	---	---	---	---	---	---	1,470	2.23
Total (1)	$41,532	1.44 %	$99,501	1.73 %	$94,180	2.58 %	$17,128	2.37 %	$1,470	2.23 %

(1) Yields on tax-exempt securities are computed on a fully taxable-equivalent basis.

Trust Services

We offer trust services to further provide for the financial needs of our customers. As of December 31, 2016, the Trust Department managed assets of approximately $649.2 million. Our types of service include both personal trust and retirement plan services.

Our personal trust services include financial planning, investment management services, trust and estate administration and custodial services. As of December 31, 2016, personal trust assets under management totaled approximately $395.2 million. Our retirement plan services encompass all types of qualified retirement plans, including profit sharing, 401(k) and pension plans. As of December 31, 2016, retirement plan assets under management totaled approximately $254.0 million.

Table of Contents

Market Area

Our primary market area includes Ottawa, Kent and northern Allegan Counties, all located in western Michigan. This area includes two mid-sized cities, Grand Rapids and Holland, and rural areas. Grand Rapids is the second largest city in Michigan. Holland is the largest city in Ottawa County. Both cities and surrounding areas have a solid and diverse economic base, which includes health and life sciences, tourism, office and home furniture, automotive components and assemblies, pharmaceutical, transportation, equipment, food and construction supplies. Grand Valley State University, a 25,000-student regional university with nearly 2,000 employees, has its three main campuses in our market area. GVSU and several smaller colleges and university affiliates located in our market area help stabilize the local economy because they are not as sensitive to the fluctuations of the broader economy. Companies operating in the market area include the Van Andel Institute, Steelcase, Herman Miller, Alticor, Gentex, Spectrum Health, Haworth, Wolverine World Wide, Johnson Controls, General Motors, Gerber, Magna, SpartanNash and Meijer.

Competition

There are many bank, thrift, credit union and other financial institution offices located within our market area. Most are branches of larger financial institutions. We also face competition from finance companies, insurance companies, mortgage companies, securities brokerage firms, money market funds and other providers of financial services. Many of our competitors have been in business a number of years, have established customer bases, are larger and have higher lending limits than we do. We compete for loans, deposits and other financial services based on our ability to communicate effectively with our customers, to understand and meet their needs and to provide high quality customer service. Our management believes that our personal service philosophy, our local decision-making and diverse delivery channels enhances our ability to compete favorably in attracting individuals and small businesses. We actively solicit customers by offering our customers personal attention, professional service, and competitive interest rates.

Employees

As of December 31, 2016, we had 342 full-time equivalent employees consisting of 292 full-time and 82 part-time employees. We have assembled a staff of experienced, dedicated and qualified professionals whose goal is to meet the financial needs of our customers while providing outstanding service. The majority of our management team has at least 10 years of banking experience, and several key personnel have more than 20 years of banking experience. None of our employees are represented by collective bargaining agreements with us.

Table of Contents

SUPERVISION AND REGULATION

The following is a summary of statutes and regulations affecting Macatawa Bank Corporation and Macatawa Bank. A change in applicable laws or regulations may have a material effect on us and our business.

General

Financial institutions and their holding companies are extensively regulated under federal and state law. Consequently, our growth and earnings performance can be affected not only by management decisions and general economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. Those authorities include, but are not limited to, the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the FDIC, the State of Michigan's Department of Financial and Insurance Services ("DIFS"), the Internal Revenue Service, and state taxing authorities. The effect of such statutes, regulations and policies can be significant, and cannot be predicted with a high degree of certainty.

Federal and state laws and regulations generally applicable to financial institutions and their holding companies regulate, among other things, the scope of business, investments, reserves against deposits, capital levels relative to operations, lending activities and practices, the nature and amount of collateral for loans, the establishment of branches, mergers, consolidations and declaration and payment of dividends. The system of supervision and regulation applicable to us and our bank establishes a comprehensive framework for our respective operations and is intended primarily for the protection of the FDIC's deposit insurance fund, our depositors, and the public, rather than our shareholders.

Federal law and regulations establish supervisory standards applicable to our lending activities, including internal controls, credit underwriting, loan documentation and loan-to-value ratios for loans secured by real property.

Recent Developments

Dodd-Frank Act: The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States, established the Consumer Financial Protection Bureau ("CFPB"), and requires the CFPB and other federal agencies to implement many new and significant rules and regulations. The CFPB has issued significant new regulations that impact consumer mortgage lending and servicing. Those regulations became effective in January 2014. In addition, the CFPB issued new regulations that changed the disclosure requirements and forms used under the Truth in Lending Act and Real Estate Settlement and Procedures Act effective October 3, 2015. Compliance with these new laws and regulations and other regulations under consideration by the CFPB will likely result in additional costs, which could be significant and could adversely impact the Company's results of operations, financial condition or liquidity.

BASEL III: On July 3, 2013, the FDIC Board of Directors approved the Regulatory Capital Interim Final Rule, implementing Basel III. This rule redefines Tier 1 capital as two components (Common Equity Tier 1 and Additional Tier 1), creates a new capital ratio (Common Equity Tier 1 Risk-based Capital Ratio) and implements a capital conservation buffer. It also revises the prompt corrective action thresholds and makes changes to risk weights for certain assets and off-balance-sheet exposures. Banks were required to transition into the new rule beginning on January 1, 2015.

Macatawa Bank Corporation

General. Macatawa Bank Corporation is registered with, and subject to regulation by, the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended (the "BHCA"). Under the BHCA, Macatawa Bank Corporation is subject to periodic examination by the Federal Reserve Board, and is required to file with the Federal

Reserve Board periodic reports of our operations and such additional information as the Federal Reserve Board may require.

In accordance with Federal Reserve Board policy, Macatawa Bank Corporation is expected to act as a source of financial strength to the Bank and to commit resources to support the Bank. In addition, if the DIFS deems the Bank's capital to be impaired, the DIFS may require the Bank to restore its capital by a special assessment upon Macatawa Bank Corporation as the Bank's sole shareholder. If Macatawa Bank Corporation were to fail to pay any such assessment, the directors of the Bank would be required, under Michigan law, to sell the shares of the Bank's stock owned by Macatawa Bank Corporation to the highest bidder at either a public or private auction and use the proceeds of the sale to restore the Bank's capital.

Investments and Activities. In general, any direct or indirect acquisition by us of any voting shares of any bank which would result in our direct or indirect ownership or control of more than 5% of any class of voting shares of such bank, and any merger or consolidation between us and another financial holding company or bank holding company, will require the prior written approval of the Federal Reserve Board under the BHCA.

Table of Contents

The merger or consolidation of the Bank with another bank, or the acquisition by the Bank of assets of another bank, or the assumption of liability by the Bank to pay any deposits of another bank, will require the prior written approval of the responsible federal depository institution regulatory agency under the Bank Merger Act. In addition, in certain such cases, an application to, and the prior approval of, the Federal Reserve Board under the BHCA or the DIFS under the Michigan Banking Code, may be required.

Capital Requirements. The Federal Reserve Board uses capital adequacy guidelines in its examination and regulation of bank holding companies. If capital falls below minimum guidelines, a bank holding company may, among other things, be denied approval to acquire or establish additional banks or non-bank businesses.

Additional information on our capital ratios may be found in Item 7 of this report under the heading "Capital Resources" included in "Management’s Discussion and Analysis of Results of Operations and Financial Condition" and in Item 8 of this report in the Notes to the Consolidated Financial Statements, and is here incorporated by reference.

Dividends. Macatawa Bank Corporation is a corporation separate and distinct from the Bank. Most of our revenues are dividends paid by the Bank. Thus, Macatawa Bank Corporation's ability to pay dividends to our shareholders is indirectly limited by restrictions on the Bank's ability to pay dividends described below. Further, in a policy statement, the Federal Reserve Board has expressed its view that a bank holding company should not pay cash dividends if its net income available to shareholders for the past four quarters, net of dividends paid during that period, is not sufficient to fully fund the dividends, its prospective rate of earnings retention is not consistent with capital needs and overall current and prospective financial condition, or it will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve Board also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies. Similar enforcement powers over our bank are possessed by the FDIC. The "prompt corrective action" provisions of federal law and regulation authorizes the FDIC to restrict the payment of dividends to Macatawa Bank Corporation by our bank if it fails to meet specified capital levels.

In addition, the Michigan Business Corporation Act provides that dividends may be legally declared or paid only if after the distribution a corporation can pay its debts as they come due in the usual course of business and its total assets equal or exceed the sum of its liabilities plus the amount that would be needed to satisfy the preferential rights upon dissolution of any holders of preferred stock whose preferential rights are superior to those receiving the distribution.

Additional information about restrictions on the payment of dividends by the Bank may be found in Item 8 of this report in Notes 1 and 17 to the Consolidated Financial Statements and is here incorporated by reference.

Federal Securities Regulation. Our common stock is registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We are subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act. We are subject to the Sarbanes-Oxley Act, which imposes numerous reporting, accounting, corporate governance and business practices on companies, as well as financial and other professionals who have involvement with the U.S. public markets. We are generally subject to these requirements and applicable SEC rules and regulations.

Macatawa Bank

General. Macatawa Bank is a Michigan banking corporation, and its deposit accounts are insured by the Deposit Insurance Fund (the "DIF") of the FDIC. As a DIF-insured Michigan-chartered bank, the Bank is subject to the examination, supervision, reporting and enforcement requirements of the DIFS, as the chartering authority for Michigan banks, and the FDIC, as administrator of the DIF. These agencies, and the federal and state laws applicable to the Bank and its operations, extensively regulate various aspects of the banking business, including, among other things, permissible types and amounts of loans, investments and other activities, capital adequacy, branching, interest rates on loans and on deposits, the maintenance of noninterest bearing reserves on deposit accounts, and the safety and soundness of banking practices.

Deposit Insurance. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC has adopted a risk-based assessment system under which all insured depository institutions are placed into one of four categories and assessed insurance premiums, based upon their respective levels of capital and results of supervisory evaluation. Institutions categorized as well-capitalized (as defined by the FDIC) and considered healthy pay the lowest premium, while institutions that are categorized as less than adequately capitalized (as defined by the FDIC) and considered of substantial supervisory concern pay the highest premium. Risk classification of all insured institutions is made by the FDIC for each semi-annual assessment period.

Table of Contents

The FDIC’s deposit insurance assessment base methodology uses average consolidated total assets less average tangible equity as the assessment base. Under this calculation, most well capitalized banks will pay 5 to 9 basis points annually, increasing up to 35 basis points for banks that pose significant supervisory concerns. This base rate may be adjusted for the level of unsecured debt and brokered deposits, resulting in adjusted rates ranging from 2.5 to 9 basis points annually for most well capitalized banks to 30 to 45 basis points for banks that pose significant supervisory concerns. We estimate our annual assessment rate to be 3 basis points in 2017.

FICO Assessments. The Bank, as a member of the DIF, is subject to assessments to cover the payments on outstanding obligations of the Financing Corporation ("FICO"). From now until the maturity of the outstanding FICO obligations in 2019, DIF members will share the cost of the interest on the FICO bonds on a pro rata basis. It is estimated that FICO assessments during this period will be less than 0.025% of deposits.

Capital Requirements. The FDIC has established the following minimum capital standards for FDIC insured banks: a leverage requirement consisting of a ratio of Tier 1 capital to total average assets and risk-based capital requirements consisting of a ratio of total capital to total risk-weighted assets, a ratio of Tier 1 capital to total risk-weighted assets, and a ratio of common equity Tier 1 (CET1) capital to risk weighted assets. Tier 1 capital consists principally of shareholders' equity. Common equity Tier 1 capital excludes forms of stock that are not common stock.

Federal regulations define these capital categories as follows:

	CET1 Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Leverage Ratio
Well capitalized	6.5% or above	6% or above	10% or above	5% or above
Adequately capitalized	4.5% or above	4% or above	8% or above	4% or above
Undercapitalized	Less than 4.5%	Less than 4%	Less than 8%	Less than 4%
Significantly undercapitalized	Less than 3%	Less than 3%	Less than 6%	Less than 3%
Critically undercapitalized	--	--	--	Ratio of tangible equity to total assets of 2% or less

Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: requiring the submission of a capital restoration plan; placing limits on asset growth and restrictions on activities; requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; restricting transactions with affiliates; restricting the interest rate the institution may pay on deposits; ordering a new election of directors of the institution; requiring that senior executive officers or directors be dismissed; prohibiting the institution from accepting deposits from correspondent banks; requiring the institution to divest certain subsidiaries; prohibiting the payment of principal or interest on subordinated debt; and ultimately, appointing a receiver for the institution.

In general, a depository institution may be reclassified to a lower category than is indicated by its capital levels if the appropriate federal depository institution regulatory agency determines the institution to be otherwise in an unsafe or unsound condition or to be engaged in an unsafe or unsound practice. This could include a failure by the institution, following receipt of a less-than-satisfactory rating on its most recent examination report, to correct the deficiency.

As of December 31, 2016, the Bank was categorized as “well capitalized”. Additional information on our capital ratios may be found in Item 8 of this report in the Notes to the Consolidated Financial Statements, and is here incorporated by reference.

Dividends. Under Michigan law, the Bank is restricted as to the maximum amount of dividends it may pay on its common stock. The Bank may not pay dividends except out of net income after deducting its losses and bad debts. A Michigan state bank may not declare or pay a dividend unless the bank will have surplus amounting to at least 20% of its capital after the payment of the dividend.

Federal law generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. The FDIC may prevent an insured bank from paying dividends if the bank is in default of payment of any assessment due to the FDIC. In addition, the FDIC may prohibit the payment of dividends by our bank, if such payment is determined to be an unsafe and unsound banking practice.

Additional information about restrictions on payment of dividends by the Bank may be found in Item 8 of this report in Notes 1 and 17 to the Consolidated Financial Statements, and is here incorporated by reference.

Table of Contents

Insider Transactions. The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to Macatawa or any subsidiary of Macatawa, on investments in the stock or other securities of Macatawa or any subsidiary of Macatawa and the acceptance of the stock or other securities of Macatawa or any subsidiary of Macatawa as collateral for loans. Certain limitations and reporting requirements are also placed on extensions of credit by our bank to its directors and officers, to Macatawa's directors and officers, to our principal shareholders and to "related interests" of such directors, officers and principal shareholders. In addition, federal law and regulations may affect the terms upon which any person becoming a director or officer of our company or any subsidiary or a principal shareholder in our company may obtain credit from banks with which our bank maintains a correspondent relationship.

Safety and Soundness Standards. The federal banking agencies have adopted guidelines to promote the safety and soundness of federally insured depository institutions. These guidelines establish standards for, among other things, internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

Investments and Other Activities. Under federal law and FDIC regulations, FDIC insured state banks are prohibited, subject to certain exceptions, from making or retaining equity investments of a type, or in an amount, that are not permissible for a national bank. Federal law, as implemented by FDIC regulations, also prohibits FDIC insured state banks and their subsidiaries, subject to certain exceptions, from engaging as principal in any activity that is not permitted for a national bank or its subsidiary, respectively, unless the bank meets, and continues to meet, its minimum regulatory capital requirements and the FDIC determines the activity would not pose a significant risk to the DIF. Impermissible investments and activities must be divested or discontinued within certain time frames set by the FDIC in accordance with federal law.

Consumer Protection Laws. The Bank's business includes making a variety of types of loans to individuals. In making these loans, we are subject to state usury and regulatory laws and to various federal laws and regulations, including the privacy of consumer financial information provisions of the Gramm-Leach-Bliley Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Servicemembers Civil Relief Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act, which prohibit discrimination, specify disclosures to be made to borrowers regarding credit and settlement costs, and regulate the mortgage loan servicing activities of the Bank, including the maintenance and operation of escrow accounts and the transfer of mortgage loan servicing. In receiving deposits, the Bank is subject to extensive regulation under state and federal law and regulations, including the Truth in Savings Act, the Expedited Funds Availability Act, the Electronic Funds Transfer Act, and the Federal Deposit Insurance Act. Violation of these laws could result in the imposition of significant damages and fines upon the Bank and its directors and officers.

Anti-Money Laundering and OFAC Regulation. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The Bank Secrecy Act of 1970 (“BSA”) and subsequent laws and regulations require the Bank to take steps to prevent the use of the Bank or its systems from facilitating the flow of illegal or illicit money or terrorist funds. Those requirements include ensuring effective Board and management oversight, establishing policies and procedures, performing comprehensive risk assessments, developing effective monitoring and reporting capabilities, ensuring adequate training and establishing a comprehensive independent audit of BSA compliance activities.

The USA PATRIOT Act of 2001 ("Patriot Act") significantly expanded the anti-money laundering ("AML") and financial transparency laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Regulations promulgated under the Patriot Act impose various requirements on financial institutions, such as standards for verifying client identification at account opening and maintaining expanded records (including "Know Your Customer" and "Enhanced Due Diligence" practices) and other obligations to maintain appropriate policies, procedures and controls to aid the process of preventing, detecting, and reporting money laundering and terrorist financing. An institution subject to the Patriot Act must provide AML training to employees, designate an AML compliance officer and annually audit the AML program to assess its effectiveness. The FDIC continues to issue regulations and additional guidance with respect to the application and requirements of BSA and AML.

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. Based on their administration by the United States Department of the Treasury's Office of Foreign Assets Control ("OFAC"), these are typically known as the "OFAC" rules. The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements:
(i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "United States persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to United States jurisdiction (including property in the possession or control of United States persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC.

Table of Contents

Failure of a financial institution to maintain and implement adequate BSA, AML and OFAC programs, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution and result in material fines and sanctions.

Branching Authority. Michigan banks have the authority under Michigan law to establish branches anywhere in the State of Michigan, subject to receipt of all required regulatory approvals. Banks may establish interstate branch networks through acquisitions of other banks. The establishment of de novo interstate branches or the acquisition of individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) is allowed only if specifically authorized by state law.

Michigan law permits both U.S. and non-U.S. banks to establish branch offices in Michigan. The Michigan Banking Code permits, in appropriate circumstances and with the approval of the DIFS, (1) acquisition of Michigan banks by FDIC-insured banks, savings banks or savings and loan associations located in other states, (2) sale by a Michigan bank of branches to an FDIC-insured bank, savings bank or savings and loan association located in a state in which a Michigan bank could purchase branches of the purchasing entity, (3) consolidation of Michigan banks and FDIC-insured banks, savings banks or savings and loan associations located in other states having laws permitting such consolidation, (4) establishment of branches in Michigan by FDIC-insured banks located in other states, the District of Columbia or U.S. territories or protectorates having laws permitting a Michigan bank to establish a branch in such jurisdiction, and (5) establishment by foreign banks of branches located in Michigan. A Michigan bank holding company may acquire a non-Michigan bank and a non-Michigan bank holding company may acquire a Michigan bank.

ITEM 1A: Risk Factors.

Risks related to the our Business

Earnings in recent years were supported, in part, by negative provisions for loan losses and non-recurring events, which will not necessarily be available in future years.

We were profitable in years 2012 through 2016. Earnings in these years were supported, in part, by negative provisions for loan losses and non-recurring events. We have recorded negative provisions for loan losses of $1.35 million, $3.5 million, $3.35 million, $4.3 million and $7.1 million for the years ended December 31, 2016, 2015, 2014, 2013 and 2012, respectively. Earnings in 2012 were significantly impacted by the reversal of an $18.9 million valuation allowance on our deferred tax assets, the receipt of a large prepayment fee of $2.8 million, and large recoveries of previously charged-off loans. We do not expect a similar level of negative provisions for loan losses in 2017, and non-recurring events with similar levels of positive impact on earnings are not likely to occur in 2017.

Our elevated level of nonperforming assets and other problem loans could continue to have an adverse effect on the Company's results of operations and financial condition.

Our nonperforming assets (which includes non-accrual loans, foreclosed properties and other accruing loans past due 90 days or more) were approximately $12.6 million at December 31, 2016. These elevated levels could continue to negatively impact operating results through higher loan losses, lost interest and higher costs to administer problem assets.

National, state and local economic conditions could have a material adverse effect on the Company's results of operations and financial condition.

The results of operations for financial institutions, including our Bank, may be materially and adversely affected by changes in prevailing national, state and local economic conditions. Our profitability is heavily influenced by the quality of the Company's loan portfolio and the stability of the Company's deposits. Unlike larger national or regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in Ottawa, Kent and Allegan Counties of western Michigan. The local economic conditions in these areas have a significant impact on the demand for the Company's products and services, and the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities, financial, capital or credit markets or other factors, could impact national and local economic conditions and have a material adverse effect on the Company's results of operations and financial condition.

Table of Contents

Our credit losses could increase and our allowance for loan losses may not be adequate to cover actual loan losses.

The risk of nonpayment of loans is inherent in all lending activities and nonpayment of loans may have a material adverse effect on our earnings and overall financial condition, and the value of our common stock. We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for potential losses based on a number of factors. If our assumptions are wrong, our allowance for loan losses may not be sufficient to cover our losses, which could have an adverse effect on our operating results, and may cause us to increase the allowance in the future. The actual amount of future provisions for loan losses cannot now be determined and may exceed the amounts of past provisions for loan losses. Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to increase our provision for loan losses or to recognize further loan charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses could have a negative effect on our regulatory capital ratios, net income, financial condition and results of operations.

We are subject to liquidity risk in our operations, which could adversely affect our ability to fund various obligations.

Liquidity risk is the possibility of being unable to meet obligations as they come due, pay deposits when withdrawn, and fund loan and investment opportunities as they arise because of an inability to liquidate assets or obtain adequate funding on a timely basis, at a reasonable cost and within acceptable risk tolerances. Liquidity is required to fund various obligations, including credit obligations to borrowers, mortgage originations, withdrawals by depositors, repayment of debt, operating expenses and capital expenditures. Liquidity of the Bank is derived primarily from retail deposit growth and retention, principal and interest payments on loans and investment securities, net cash provided from operations and access to other funding sources. Liquidity is essential to our business. We must maintain sufficient funds to respond to the needs of depositors and borrowers. An inability to raise funds through deposits, borrowings, the sale or pledging as collateral of loans and other assets could have a material adverse effect on our liquidity. An inability to retain the current level of deposits, including the loss of one or more of the Bank's larger deposit relationships, could have a material adverse effect on the Bank's liquidity. Our access to funding sources in amounts adequate to finance activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of the business activity due to a market down turn or regulatory action that limits or eliminates access to alternate funding sources, including brokered deposits discussed above. Our ability to borrow could also be impaired by factors that are nonspecific to the Company, such as severe disruption of the financial markets or negative expectations about the prospects for the financial services industry as a whole.

Our construction and development lending exposes us to significant risks.

Construction and development loans consist of loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments. This portfolio may be particularly adversely affected by job losses, declines in real estate values, declines in home sale volumes, and declines in new home building. Declining real estate values may result in sharp increases in losses, particularly in the land development and construction loan portfolios to residential developers. This type of lending is generally considered to have more complex credit risks than traditional single-family residential lending because the principal is concentrated in a limited number of loans with repayment dependent on the successful completion and sales of the related real estate project. Consequently, these loans are often more sensitive to adverse conditions in the real estate market or the general economy than other real estate loans. These loans are generally less predictable and more difficult to evaluate and monitor and collateral may be difficult to dispose of in a market decline. Additionally, we may experience significant construction loan losses if independent appraisers or project engineers inaccurately estimate the cost and value of construction loan projects.

We have significant exposure to risks associated with commercial and residential real estate.

A substantial portion of our loan portfolio consists of commercial and residential real estate-related loans, including real estate development, construction and residential and commercial mortgage loans. As of December 31, 2016, we had approximately $518.0 million of commercial real estate loans outstanding, which represented approximately 40% of our loan portfolio. As of that same date, we had approximately $305.7 million in residential real estate loans outstanding, or approximately 24% of our loan portfolio. Consequently, real estate-related credit risks are a significant concern for us. The adverse consequences from real estate-related credit risks tend to be cyclical and are often driven by national economic developments that are not controllable or entirely foreseeable by us or our borrowers.

Table of Contents

Commercial loans may expose us to greater financial and credit risk than other loans.

Our commercial loan portfolio, including commercial mortgages, was approximately $967.3 million at December 31, 2016, comprising approximately 75% of our total loan portfolio. Commercial loans generally carry larger loan balances and can involve a greater degree of financial and credit risk than other loans. Any significant failure to pay on time by our customers would hurt our earnings. The increased financial and credit risk associated with these types of loans are a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the size of loan balances, the effects of general economic conditions on income-producing properties and the increased difficulty of evaluating and monitoring these types of loans. In addition, when underwriting a commercial or industrial loan, we may take a security interest in commercial real estate, and, in some instances upon a default by the borrower, we may foreclose on and take title to the property, which may lead to potential financial risks for us under applicable environmental laws. If hazardous substances were discovered on any of these properties, we may be liable to governmental agencies or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination.

Our loan portfolio has and will continue to be affected by the housing market.

Loans to residential developers involved in the development or sale of 1-4 family residential properties were approximately $26.0 million, $30.1 million, $29.8 million, $35.2 million and $48.9 million at December 31, 2016, 2015, 2014, 2013 and 2012, respectively. While improving, we expect the home builder market to continue to be soft and anticipate continued pressure on the home builder segment. As we continue our on-going portfolio monitoring, we will make credit and reserve decisions based on the current conditions of the borrower or project combined with our expectations for the future. If the housing market deteriorates, we could experience higher charge-offs and delinquencies in this portfolio.

We may face pressure from historical purchasers of our residential mortgage loans to repurchase those loans or reimburse purchasers for losses related to those loans.

We generally sell the fixed rate long-term residential mortgage loans we originate on the secondary market and retain adjustable rate mortgage loans for our portfolios. In response to the financial crisis, purchasers of residential mortgage loans, such as government sponsored entities, have increased their efforts to seek to require sellers of residential mortgage loans to either repurchase loans previously sold or reimburse purchasers for losses related to loans previously sold when losses are incurred on a loan previously sold due to actual or alleged failure to strictly conform to the purchaser's purchase criteria. As a result, we may face increasing pressure from historical purchasers of our residential mortgage loans to repurchase those loans or reimburse purchasers for losses related to those loans and we may face increasing expenses to defend against such claims. If we are required in the future to repurchase loans previously sold, reimburse purchasers for losses related to loans previously sold, or if we incur increasing expenses to defend against such claims, our financial condition and results of operations would be negatively affected, and would lower our capital ratios as a result of increasing assets and lowering income through expenses and any loss incurred.

For the five-year period ended December 31, 2016, the Company has sold an aggregate of $537.2 million of residential mortgage loans on the secondary market. During the year ended December 31, 2016, the Company settled claims on loans having an aggregate of $857,000 in principal amount for loans originated and sold during 2006 through 2008, realizing a nominal loss. This settlement closes all potential claims related to loans sold to Countrywide Mortgage. As of December 31, 2016, the Company had no other repurchase demands or claims related to residential mortgage loans sold on the secondary market during the five-year period ended December 31, 2016.

Changes in interest rates may negatively affect our earnings and the value of our assets.

Our earnings and cash flows depend substantially upon our net interest income. Net interest income is the difference between interest income earned on interest-earning assets, such as loans and investment securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are sensitive to many factors that are beyond our control, including general economic conditions, competition and policies of various governmental and regulatory agencies and, in particular, the policies of the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investment securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect: (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities, including our securities portfolio; and (iii) the average duration of our interest-earning assets. This also includes the risk that interest-earning assets may be more responsive to changes in interest rates than interest-bearing liabilities, or vice versa (repricing risk), the risk that the individual interest rates or rates indices underlying various interest-earning assets and interest-bearing liabilities may not change in the same degree over a given time period (basis risk), and the risk of changing interest rate relationships across the spectrum of interest-earning asset and interest-bearing liability maturities (yield curve risk), including a prolonged flat or inverted yield curve environment. Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations.

Table of Contents

For the last several years and through November 2015, the Federal Open Market Committee (“FOMC”) kept the target federal funds between 0% and 0.25%. In December 2015, the FOMC increased the target federal funds rate by 25 basis points, representing the first increase in nearly a decade. In December 2016, the FOMC increased the target federal funds by another 25 basis points. Based on comments made by the FOMC, we expect gradual increases during 2017, but the overall low interest rate environment is expected to continue in 2017. The extended low interest rate environment has compressed our net interest spread and reduced our spread-based revenues, which has had an adverse impact on our revenue and results of operations.

The Dodd-Frank Act may adversely impact the Company's results of operations, financial condition or liquidity.

The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States, established the Consumer Financial Protection Bureau (the "CFPB"), and requires the CFPB and other federal agencies to implement many new and significant rules and regulations. The CFPB has issued significant new regulations that impact consumer mortgage lending and servicing. Those regulations became effective in January 2014. In addition, the CFPB issued new regulations that changed the disclosure requirements and forms used under the Truth in Lending Act and Real Estate Settlement and Procedures Act. Compliance with these new laws and regulations and other regulations under consideration by the CFPB will likely result in additional costs, which could be significant, and could adversely impact the Company's results of operations, financial condition or liquidity.

We are subject to significant government regulation, and any regulatory changes may adversely affect us.

The banking industry is heavily regulated under both federal and state law. These regulations are primarily intended to protect customers and the Deposit Insurance Fund, not our creditors or shareholders. We are subject to extensive regulation by the Federal Reserve, the FDIC and the DIFS, in addition to other regulatory and self-regulatory organizations. Future regulatory changes or accounting pronouncements may increase our regulatory capital requirements or adversely affect our regulatory capital levels. Regulations affecting banks and financial services companies undergo continuous change, and we cannot predict the ultimate effect of such changes, which could have a material adverse effect on our profitability or financial condition.

The Company could be adversely affected by the soundness of other financial institutions, including defaults by larger financial institutions.

The Company's ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of credit, trading, clearing, counterparty or other relationships between financial institutions. The Company has exposure to multiple counterparties, and the Company routinely executes transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, could lead to market-wide liquidity problems and losses or defaults by the Company or by other institutions. This is sometimes referred to as "systemic risk" and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges, with which the Company interacts on a daily basis, and therefore could adversely affect the Company.

We rely heavily on our management and other key personnel, and the loss of any of them may adversely affect our operations.

We are and will continue to be dependent upon the services of our management team and other key personnel. Losing the services of one or more key members of our management team could adversely affect our operations.

Our controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. If we fail to identify and remediate control deficiencies, it is possible that a material misstatement of interim or annual financial statements will not be prevented or detected on a timely basis. In addition, any failure or circumvention of our other controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

Table of Contents

The Bank may be required to pay additional insurance premiums to the FDIC, which could negatively impact earnings.

Depending upon any future losses that the FDIC insurance fund may suffer, there can be no assurance that there will not be additional premium increases in order to replenish the fund. The FDIC may need to set a higher base rate schedule or impose special assessments due to future financial institution failures and updated failure and loss projections. Increased FDIC assessment rates could have an adverse impact on our results of operations.

If we cannot raise additional capital when needed, our ability to further expand our operations through organic growth and acquisitions could be materially impaired.

We are required by federal and state regulatory authorities to maintain specified levels of capital to support our operations. We may need to raise additional capital to support our current level of assets or our growth. Our ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. We cannot assure that we will be able to raise additional capital in the future on terms acceptable to us or at all. If we cannot raise additional capital when needed, our ability to expand our operations through organic growth or acquisitions could be materially limited. Additional information on the capital requirements applicable to the Bank may be found under the heading "Regulatory Capital" in Note 17 in Item 8.

We may be a defendant in a variety of litigation and other actions, which may have a material adverse effect on our financial condition and results of operations.

We may be involved from time to time in a variety of litigation arising out of our business. Our insurance may not cover all claims that may be asserted against us, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation or cause us to incur unexpected expenses, which could be material in amount. Should the ultimate expenses, judgments or settlements in any litigation exceed our insurance coverage, they could have a material adverse effect on our financial condition and results of operations. In addition, we may not be able to obtain appropriate types or levels of insurance in the future, and we may not be able to obtain adequate replacement of our existing policies with acceptable terms, if at all.

Our future success is dependent on our ability to compete effectively in the highly competitive banking industry.

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and out-of-state banks, thrifts, credit unions and other financial institutions as well as other entities which provide financial services. Some of the financial institutions and financial services organizations with which we compete are not subject to the same degree of regulation as we are. Most of our competitors have been in business for many years, have established customer bases, are larger, and have substantially higher lending limits than we do. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. Competition for limited, high-quality lending opportunities and core deposits in an increasingly competitive marketplace may adversely affect our results of operations.

Evaluation of investment securities for other-than-temporary impairment involves subjective determinations and could materially impact our results of operations and financial condition.

The evaluation of impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of investments should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition or future recovery prospects, the effects of changes in interest rates or credit spreads and the expected recovery period.

Estimating future cash flows involves incorporating information received from third-party sources and making internal assumptions and judgments regarding the future performance of the underlying collateral and assessing the probability that an adverse change in future cash flows has occurred. The determination of the amount of other-than-temporary impairments is based upon our periodic evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. Our management considers a wide range of factors about the security issuer and uses reasonable judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Impairments to the carrying value of our investment securities may need to be taken in the future, which could have a material adverse effect on our results of operations and financial condition.

Table of Contents

We depend upon the accuracy and completeness of information about customers.

In deciding whether to extend credit to customers, we rely on information provided to us by our customers, including financial statements and other financial information. We also rely on representations of customers as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. Our financial condition and results of operations could be negatively impacted to the extent that we extend credit in reliance on financial statements or other information provided by customers that is false, misleading or incomplete.

Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of computer systems or otherwise, or failure or interruption of the Company's communication or information systems, could severely harm the Company’s business.

As part of its business, the Company collects, processes and retains sensitive and confidential client and customer information on behalf of the Company and other third parties. Despite the security measures the Company has in place for its facilities and systems, and the security measures of its third party service providers, the Company may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming and/or human errors or other similar events.

The Company relies heavily on communications and information systems to conduct its business. Any failure or interruption of these systems could result in failures or disruptions in the Company’s customer relationship management, general ledger, deposit, loan and other systems. In addition, customers could lose access to their accounts and be unable to conduct financial transactions during a period of failure or interruption of these systems.

Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether by the Company or by its vendors, or failure or interruption of the Company's communication or information systems, could severely damage the Company’s reputation, expose it to risks of regulatory scrutiny, litigation and liability, disrupt the Company’s operations, or result in a loss of customer business, the occurrence of any of which could have a material adverse effect on the Company’s business.

Cybersecurity incidents could disrupt business operations, result in the loss of critical and confidential information, and adversely impact our reputation and results of operations.

Global cybersecurity threats and incidents can range from uncoordinated individual attempts to gain unauthorized access to information technology (IT) systems to sophisticated and targeted measures known as advanced persistent threats, directed at the Company and/or its third party service providers. While we have experienced, and expect to continue to experience, these types of threats and incidents, none of them to date have been material to the Company. Although we employ comprehensive measures to prevent, detect, address and mitigate these threats (including access controls, data encryption, vulnerability assessments, continuous monitoring of our IT networks and systems and maintenance of backup and protective systems), cybersecurity incidents, depending on their nature and scope, could potentially result in the misappropriation, destruction, corruption or unavailability of critical data and confidential or proprietary information (our own or that of third parties) and the disruption of business operations. The potential consequences of a material cybersecurity incident include reputational damage, litigation with third parties and increased cybersecurity protection and remediation costs, which in turn could adversely affect our results of operations.

We continually encounter technological change, and we may have fewer resources than our competitors to continue to invest in technological improvements.

The banking industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. There can be no assurance that we will be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to our customers.

Table of Contents

An "ownership change" for purposes of Section 382 of the Internal Revenue Code could materially impair our ability to use our deferred tax assets.

At December 31, 2016, our gross deferred tax asset was $11.3 million. Our ability to use our deferred tax assets to offset future taxable income will be limited if we experience an "ownership change" as defined in Section 382 of the Internal Revenue Code. In general, an ownership change will occur if there is a cumulative increase in our ownership by "5-percent shareholders" (as defined in the Code) that exceeds 50 percentage points over a rolling three-year period. A corporation that experiences an ownership change will generally be subject to an annual limitation on the use of its pre-ownership change deferred tax assets equal to the equity value of the corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate.

If an "ownership change" occurs, we could lose certain built-in losses that have not been recognized for tax purposes. The amount of the permanent loss would depend on the size of the annual limitation (which is in part a function of our market capitalization at the time of an "ownership change") and the remaining carry forward period (U.S. federal net operating losses generally may be carried forward for a period of 20 years).

Risks Associated With the Company's Stock

The market price of our common stock can be volatile, which may make it more difficult to resell our common stock at a desired time and price.

Stock price volatility may make it more difficult for a shareholder to resell our common stock when a shareholder wants to and at prices a shareholder finds attractive or at all. Our stock price can fluctuate significantly in response to a variety of factors, regardless of operating results. These factors include, among other things:

- Variations in our anticipated or actual operating results or the results of our competitors;
- Changes in investors' or analysts' perceptions of the risks and conditions of our business;
- The size of the public float of our common stock;
- Regulatory developments, including changes to regulatory capital levels, components of regulatory capital and how regulatory capital is calculated;
- Interest rate changes or credit loss trends;
- Trading volume in our common stock;
- Market conditions; and
- General economic conditions.

The Company may issue additional shares of its common stock in the future, which could dilute a shareholder's ownership of common stock.

The Company's articles of incorporation authorize its Board of Directors, without shareholder approval, to, among other things, issue additional shares of common or preferred stock. The issuance of any additional shares of common or preferred stock could be dilutive to a shareholder's ownership of Company common stock.

To the extent that the Company issues options or warrants to purchase common stock in the future and the options or warrants are exercised, the Company's shareholders may experience further dilution. Holders of shares of Company common stock have no preemptive rights that entitle holders to purchase their pro rata share of any offering of shares of any class or series and, therefore, shareholders may not be permitted to invest in future issuances of Company common or preferred stock.

Although publicly traded, our common stock has substantially less liquidity than the average liquidity of stocks listed on The Nasdaq Global Select Market.

Although our common stock is listed for trading on The Nasdaq Global Select Market, our common stock has substantially less liquidity than the average liquidity for companies listed on The Nasdaq Global Select Market. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This marketplace depends on the individual decisions of investors and general economic and market conditions over which we have no control. This limited market may affect a shareholder’s ability to sell their shares on short notice, and the sale of a large number of shares at one time could temporarily depress the market price of our common stock. For these reasons, our common stock should not be viewed as a short-term investment.

Table of Contents

The Company's common stock is not insured by any governmental entity.

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity. Investment in Company common stock is subject to risk, including possible loss.

The Company may issue debt and equity securities that are senior to Company common stock as to distributions and in liquidation, which could negatively affect the value of Company common stock.

The Company has in the past and may in the future increase its capital by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of the Company's liquidation, its lenders and holders of its debt securities would receive a distribution of the Company's available assets before distributions to the holders of Company common stock. The Company's decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond its control. The Company cannot predict or estimate the amount, timing or nature of its future offerings and debt financings. Future offerings could reduce the value of shares of Company common stock and dilute a shareholder's interest in the Company.

Our articles of incorporation and bylaws and Michigan laws contain certain provisions that could make a takeover more difficult.

Our articles of incorporation and bylaws, and the laws of Michigan, include provisions which are designed to provide our Board of Directors with time to consider whether a hostile takeover offer is in our best interest and the best interests of our shareholders. These provisions could discourage potential acquisition proposals and could delay or prevent a change in control. The provisions also could diminish the opportunities for a holder of our common stock to participate in tender offers, including tender offers at a price above the then-current price for our common stock. These provisions could also prevent transactions in which our shareholders might otherwise receive a premium for their shares over then current market prices, and may limit the ability of our shareholders to approve transactions that they may deem to be in their best interests.

The Michigan Business Corporation Act contains provisions intended to protect shareholders and prohibit or discourage certain types of hostile takeover activities. In addition to these provisions and the provisions of our articles of incorporation and bylaws, federal law requires the Federal Reserve Board's approval prior to acquisition of "control" of a bank holding company. All of these provisions may have the effect of delaying or preventing a change in control of the Company without action by our shareholders, and therefore, could adversely affect the price of our common stock.

If an entity holds as little as a 5% interest in our outstanding securities, that entity could, under certain circumstances, be subject to regulation as a "bank holding company."

Any entity, including a "group" composed of natural persons, owning or controlling with the power to vote 25% or more of our outstanding securities, or 5% or more if the holder otherwise exercises a "controlling influence" over us, may be subject to regulation as a "bank holding company" in accordance with the Bank Holding Company Act of 1956, as amended (the "BHC Act"). In addition, any bank holding company or foreign bank with a U.S. presence may be required to obtain the approval of the Federal Reserve Board under the BHC Act to acquire or retain 5% or more of our outstanding securities. Becoming a bank holding company imposes statutory and regulatory restrictions and obligations, such as providing managerial and financial strength for its bank subsidiaries. Regulation as a bank holding company could require the holder to divest all or a portion of the holder's investment in our securities or those nonbanking investments that may be deemed impermissible or incompatible with bank holding company status, such as a material investment in a company unrelated to banking.

Any person not defined as a company by the BHC Act may be required to obtain the approval of the Federal Reserve Board under the Change in Bank Control Act of 1978, as amended, to acquire or retain 10% or more of our outstanding securities.

Any person not otherwise defined as a company by the BHC Act and its implementing regulations may be required to obtain the approval of the Federal Reserve Board under the Change in Bank Control Act of 1978, as amended, to acquire or retain 10% or more of our outstanding securities. Applying to obtain this approval could result in a person incurring substantial costs and time delays. There can be no assurance that regulatory approval will be obtained.

Table of Contents

ITEM 1B: Unresolved Staff Comments.

None.

ITEM 2: Properties.

We own or lease facilities located in Ottawa County, Allegan County and Kent County, Michigan. Our administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424. Our administrative offices are approximately 49,000 square feet and contain our administration, human resources, trust, loan underwriting and processing, and deposit operations. We believe our facilities are well-maintained and adequately insured. We own each of the facilities except those identified in the "Use" column as "(Leased facility)". Our facilities as of February 16, 2017, were as follows:

Location of Facility	Use
10753 Macatawa Drive, Holland	Main Branch, Administrative, and Loan Processing Offices
815 E. Main Street, Zeeland	Branch Office
116 Ottawa Avenue N.W., Grand Rapids	Branch Office (Leased facility, lease expires August 2020)
126 Ottawa Avenue N.W., Grand Rapids	Loan Center (Leased facility, lease expires August 2020)
141 E. 8th Street, Holland	Branch Office
489 Butternut Dr., Holland	Branch Office
701 Maple Avenue, Holland	Branch Office
699 E. 16th Street, Holland	Branch Office
41 N. State Street, Zeeland	Branch Office
2020 Baldwin Street, Jenison	Branch Office
6299 Lake Michigan Dr., Allendale	Branch Office
132 South Washington, Douglas	Branch Office
4758 – 136th Street, Hamilton	Branch Office (Leased facility, lease expires December 2019)
3526 Chicago Drive, Hudsonville	Branch Office
20 E. Lakewood Blvd., Holland	Branch Office
3191 – 44th Street, S.W., Grandville	Branch Office
2261 Byron Center Avenue S.W., Byron Center	Branch Office
5271 Clyde Park Avenue, S.W., Wyoming	Branch Office and Loan Center
4590 Cascade Road, Grand Rapids	Branch Office
3177 Knapp Street, N.E., Grand Rapids	Branch Office and Loan Center
15135 Whittaker Way, Grand Haven	Branch Office
12415 Riley Street, Holland	Branch Office
2750 Walker N.W., Walker	Branch Office
1575 – 68th Street S.E., Grand Rapids	Branch Office
2820 – 10 Mile Road, Rockford	Branch Office
520 Baldwin Street, Jenison	Branch Office
2440 Burton Street, S.E., Grand Rapids	Branch Office
6330 28th Street, S.E., Grand Rapids	Branch Office

ITEM 3: Legal Proceedings.

As of the date of this report, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking, to which Macatawa Bank Corporation or the Bank are a party or of which any of our properties are the subject.

ITEM 4: Mine Safety Disclosures.

Not applicable.

Table of Contents
PART II

ITEM 5: Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our common stock is quoted on The Nasdaq Global Select Market under the symbol MCBC. High and low closing prices (as reported on The Nasdaq Global Select Market) of our common stock for each quarter for the years ended December 31, 2016 and 2015 are set forth in the table below.

	2016			2015		
			Dividends			Dividends
Quarter	High	Low	Declared	High	Low	Declared
First Quarter	$6.24	$5.43	$ 0.03	$6.10	$5.10	$ 0.02
Second Quarter	7.38	6.29	0.03	5.57	5.04	0.03
Third Quarter	8.08	7.25	0.03	5.35	5.05	0.03
Fourth Quarter	10.57	7.83	0.03	5.49	5.19	0.03

Information on restrictions on payments of dividends by us may be found in Item 1 of this report under the heading “Supervision and Regulation” and is here incorporated by reference. Information regarding our equity compensation plans may be found in Item 12 of this report and is here incorporated by reference.

On February 16, 2017, there were approximately 657 owners of record and approximately 5.442 beneficial owners of our common stock.

Shareholder Return Performance Graph

The following graph shows the cumulative total shareholder return on an investment in the Company’s common stock compared to the Russell 2000 Index and the SNL Bank NASDAQ Index. The comparison assumes a $100 investment on December 31, 2011 at the initial price of $2.28 per share (adjusted for all stock dividends and splits) and assumes that dividends are reinvested. The comparisons in this table are set forth in response to Securities and Exchange Commission (SEC) disclosure requirements and therefore are not intended to forecast or be indicative of future performance of the common stock.

	Period Ending					
Index	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Macatawa Bank Corporation	100.00	126.75	219.30	242.36	275.20	481.56
Russell 2000	100.00	116.35	161.52	169.43	161.95	196.45
SNL Bank NASDAQ	100.00	119.19	171.31	177.42	191.53	265.56

Table of Contents

Issuer Purchases of Equity Securities

The following table provides information regarding the Company's purchase of its own common stock during the fourth quarter of 2016. All employee transactions are under stock compensation plans. These include shares of Macatawa Bank Corporation common stock submitted for cancellation to satisfy tax withholding obligations that occur upon the vesting of restricted shares. The value of the shares withheld is determined based on the closing price of Macatawa Bank Corporation common stock at the date of vesting. The Company has no publicly announced repurchase plans or programs.

Macatawa Bank Corporation Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid Per Share
October 1 - October 31, 2016		
Employee Transactions	---	---
November 1 - November 30, 2016		
Employee Transactions	25,977	$ 9.18
December 1 - December 31, 2016		
Employee Transactions	---	---
Total for Fourth Quarter ended December 31, 2016		
Employee Transactions	25,977	$ 9.18

Table of Contents

ITEM 6: Selected Financial Data.

The following unaudited table sets forth selected historical consolidated financial information as of and for the years ended December 31, 2016, 2015, 2014, 2013 and 2012, which is derived from our audited consolidated financial statements. You should read this information in conjunction with our consolidated financial statements and related notes and "Management's Discussion and Analysis of Results of Operations and Financial Condition" included elsewhere in this report.

(Dollars in thousands, except per share data)	As of and for the Year Ended December 31,				
	2016	2015	2014	2013	2012
Financial Condition					
Total assets	$1,741,013	$1,729,643	$1,583,846	$1,517,405	$1,560,718
Securities	253,811	218,671	193,459	158,907	127,797
Loans	1,280,812	1,197,932	1,118,483	1,042,377	1,052,348
Deposits	1,448,724	1,435,512	1,306,325	1,249,734	1,286,261
Long-term debt	41,238	41,238	41,238	41,238	42,888
Other borrowed funds	84,173	96,169	88,107	89,991	91,822
Shareholders' equity	162,239	151,977	142,519	132,522	130,507
Share Information*					
Basic earnings (loss) per common share	$0.47	$0.38	$0.31	$(0.29)	$1.31
Diluted earnings (loss) per common share	0.47	0.38	0.31	(0.29)	1.31
Book value per common share	4.78	4.48	4.21	3.92	3.59
Tangible book value per common share	4.78	4.48	4.21	3.92	3.59
Dividends per common share	0.12	0.11	0.08	---	---
Dividend payout ratio	25.53%	28.95%	25.81%	---%	---%
Average dilutive common shares outstanding	33,922,548	33,891,429	33,803,030	27,161,888	27,086,792
Common shares outstanding at period end	33,940,788	33,925,113	33,866,789	33,801,097	27,203,825
Operations					
Interest income	$52,499	$49,386	$46,988	$48,620	$57,276
Interest expense	4,959	5,306	5,596	7,337	9,814
Net interest income	47,540	44,080	41,392	41,283	47,462
Provision for loan losses	(1,350)	(3,500)	(3,350)	(4,250)	(7,100)
Net interest income after provision for loan losses	48,890	47,580	44,742	45,533	54,562
Total noninterest income	19,074	17,793	16,214	16,141	15,628
Total noninterest expense	45,782	46,953	45,910	47,855	53,283
Income before income tax	22,182	18,420	15,046	13,819	16,907
Federal income tax (benefit)	6,231	5,626	4,573	4,270	(18,583)
Net income	15,951	12,794	10,473	9,549	35,490
Dividend declared on preferred shares**	---	---	---	(17,575)	---
Net income (loss) attributable to common shares	15,951	12,794	10,473	(8,026)	35,490
Performance Ratios					

Return on average equity	10.06	%	8.68	%	7.58	%	7.11	%	34.39	%
Return on average assets	0.95		0.79		0.70		0.63		2.37	
Yield on average interest-earning assets	3.42		3.36		3.48		3.58		4.21	
Cost on average interest-bearing liabilities	0.46		0.49		0.56		0.69		0.92	
Average net interest spread	2.96		2.87		2.92		2.89		3.29	
Average net interest margin	3.11		3.01		3.07		3.05		3.49	
Efficiency ratio	68.73		75.89		79.70		83.34		84.46	
Capital Ratios										
Period-end equity to total assets	9.32	%	8.79	%	9.00	%	8.73	%	8.36	%
Average equity to average assets	9.47		9.10		9.25		8.90		6.89	
Total risk-based capital ratio (consolidated)	14.88		14.80		15.55		15.69		14.98	
Credit Quality Ratios										
Allowance for loan losses to total loans	1.32	%	1.43	%	1.70	%	2.00	%	2.26	%
Nonperforming assets to total assets	0.72		1.06		2.32		3.24		4.33	
Net charge-offs to average loans	(0.10	)	(0.14	)	(0.14	)	(0.13	)	0.08	

*Retroactively adjusted to reflect the effect of all stock splits and dividends
**2013 reflects effect of induced exchange of preferred stock to common stock

Table of Contents

Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition.

Management's discussion and analysis of results of operations and financial condition contains forward-looking statements. Please refer to the discussion of forward-looking statements at the beginning of this report.

The following section presents additional information to assess our results of operations and financial condition. This section should be read in conjunction with the consolidated financial statements and the supplemental financial data contained elsewhere in this report.

OVERVIEW

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 have 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 December 31, 2016, we had total assets of $1.74 billion, total loans of $1.28 billion, total deposits of $1.45 billion and shareholders' equity of $162.2 million. We recognized net income of $16.0 million in 2016 compared to net income of $12.8 million in 2015. Earnings in 2016 and 2015 improved over their respective previous years through growth in total revenue, primarily net interest income, while holding noninterest expenses flat. As of December 31, 2016, the Company's and the Bank's risk-based regulatory capital ratios were significantly above those required under the regulatory standards and the Bank continued to be categorized as "well capitalized" at December 31, 2016.

During 2013, the Company improved its capital structure by prepaying and redeeming its $1.7 million of 11% unsecured subordinated debt, resuming interest payments on its trust preferred securities and completing an exchange of all of the Company's Series A and Series B Preferred Stock for Company common stock and cash, at the election of the holder. Each of these transactions are discussed in detail in Item 7.

Beginning with the first quarter of 2014, the Company paid a cash dividend of $0.02 per share in each quarter of 2014, after a hiatus of over five years. In the second quarter of 2015, the Company increased this cash dividend by 50%, to $0.03 per share and continued to pay at this level for the third and fourth quarters of 2015 and for each quarter in 2016.

Over the past several years, much progress has been made at reducing our nonperforming assets. The following table reflects period end balances of these nonperforming assets as well as total loan delinquencies.

(Dollars in thousands)	December 31, 2016	December 31, 2015	December 31, 2014	December 31, 2013	December 31, 2012
Nonperforming loans	$ 300	$ 756	$ 8,426	$ 12,335	$ 16,003
Other repossessed assets	---	---	38	40	6
Other real estate owned	12,253	17,572	28,242	36,796	51,582
Total nonperforming assets	$ 12,553	$ 18,328	$ 36,706	$ 49,171	$ 67,591
Total loan delinquencies 30 days or greater past due	$ 1,447	$ 1,371	$ 2,841	$ 5,520	$ 7,887

Earnings in recent years have been impacted by high costs associated with administration and disposition of nonperforming assets. These costs, including losses on repossessed and foreclosed properties, were $1.3 million, $3.0 million and $3.1 million for the years ended December 31, 2016, 2015 and 2014, respectively. Going forward, as further reductions in nonperforming assets are accomplished, we expect the costs associated with these assets to continue to decline thereby allowing for improved earnings in future periods.

Table of Contents
Our earnings in 2016, 2015 and 2014 were favorably impacted by negative provision for loan losses of $1.35 million, $3.5 million and $3.35 million, respectively. As discussed in detail later in Item 7 of this report under the heading "Allowance for Loan Losses", the large negative provision in 2015 was the result of the reversal of a portion of a specific reserve on an individual credit that was upgraded to accruing status in the fourth quarter of 2015 as well as the net loan recoveries for the year. The negative provision in each period was also impacted by other recoveries from our collection efforts and a continual decline in our historical charge-off levels from prior years.

We had our fourth consecutive full year of net recoveries in 2016. The following table reflects the provision for loan losses for the past five years along with certain metrics that impact the determination of the level of the provision for loan losses.

	For the year ended December 31,				
(Dollars in thousands)	2016	2015	2014	2013	2012
Provision for loan losses	$(1,350)	$(3,500)	$(3,350)	$(4,250)	$(7,100)
Net charge-offs (recoveries)	(1,231)	(1,619)	(1,514)	(1,309)	802
Net charge-offs to average loans	(0.10)%	(0.14)%	(0.14)%	(0.13)%	0.08 %
Nonperforming loans to total loans	0.02 %	0.06 %	0.75 %	1.18 %	1.52 %
Loans transferred to ORE to average loans	0.03 %	0.22 %	0.47 %	0.34 %	0.88 %
Performing troubled debt restructurings to average loans	2.45 %	3.34 %	4.47 %	5.61 %	6.24 %

Economic conditions in our market areas of Grand Rapids and Holland have improved during the past several years. The state’s unemployment rate at the end of 2016 was 4.5%. The Grand Rapids and Holland area unemployment rate was 3.1% at the end of 2016. Residential housing values and commercial real estate property values have shown signs of improvement, with some of our newer appraisals tending to reflect values at or above prior year values.

It also appears that the housing market in our primary market area is improving. In the Grand Rapids market during 2016, there were 65% more living unit starts than in 2015. Similarly, in the Holland-Grand Haven/Lakeshore region, there were 27% more living unit starts in 2016 than in 2015. These improvements are on top of improved results in 2015 over 2014. Also, these markets are now also seeing significant activity in duplex, condominium and apartment starts after years of virtually no activity.

Beginning in 2014, with our improved financial condition, and earnings growth, our primary focus was on high quality loan portfolio growth. We experienced strong commercial loan growth in the fourth quarter of 2014 and throughout 2015 and 2016. Most of our emphasis has been on growing commercial and industrial loans. These loans have increased from $274.1 million at December 31, 2013 to $327.7 million at December 31, 2014, $377.3 million at December 31, 2015 and $449.3 million at December 31, 2016. Commercial real estate loans have increased from $472.3 million at December 31, 2013 to $490.5 million at December 31, 2014, $508.7 million at December 31, 2015 and $518.0 million at December 31, 2016. Consumer loans have increased from $295.9 million at December 31, 2013 to $300.3 million at December 31, 2014, $312.0 million at December 31, 2015 and $313.5 million at December 31, 2016. We believe we are positioned for continued growth in 2017.

RESULTS OF OPERATIONS

Summary: Net income was $16.0 million ($22.2 million on a pretax basis) for 2016, compared to $12.8 million ($18.4 million on a pretax basis) and $10.5 million ($15.0 million on a pretax basis) for 2014. Earnings per common share on a diluted basis was $0.47 for 2016, $0.38 for 2015 and $0.31 for 2014.

Generally, the improvement in Company earnings was the result of growth in revenue while expenses have been held flat. The increase in earnings in 2016 compared to 2015 and 2014 was due primarily to increased net interest income and noninterest income, along with a reduction in noninterest expense. Net interest income increased to $47.5 million in 2016 compared to $44.1 million in 2015 and $41.4 million in 2014. We realized a higher level of income from gains on sales of residential mortgages in 2016 and 2015 compared to 2014 due to the extended low interest rate environment. Total noninterest expense was $45.8 million in 2016 compared to $47.0 million in 2015 and $45.9 million in 2014.

Earnings in each period were positively impacted by negative provisions for loan losses ($1.35 million in 2016, $3.5 million in 2015 and $3.35 million in 2014). These negative provisions resulted from reduced levels of nonperforming loans, improved asset quality and net loan recoveries realized in each of these periods. These items are discussed more fully below.

Table of Contents

We continued our improvement in nonperforming asset expenses in 2016. Costs associated with nonperforming assets were $1.3 million in 2016, compared to $3.0 million in 2015 and $3.1 million in 2014. Lost interest from nonperforming assets decreased to approximately $572,000 for 2016, compared to $1.4 million for 2015 and $1.9 million for 2014. Each of these items are discussed more fully below.

Net Interest Income: Net interest income totaled $47.5 million during 2016, compared to $44.1 million during 2015 and $41.4 million in 2014.

The increase in net interest income during 2016 compared to 2015 marked our second consecutive year with an increase in net interest income, following several years of declining net interest income. This increase was primarily due to an increase in average earning assets of $63.9 million from $1.48 billion in 2015 to $1.55 billion in 2016. Average yield on securities, interest earning assets and net interest margin are presented on a fully taxable equivalent basis. Our net interest income as a percentage of average interest-earning assets (i.e. "net interest margin" or "margin") increased by 10 basis points compared to 2015.

The increase in net interest income during 2015 compared to 2014 was due to an increase in average earning assets of $129.4 million from $1.35 billion in 2014 to $1.48 billion in 2015. Our net interest margin decreased by 6 basis points in 2015 compared to 2014.

The yield on earning assets increased 6 basis points from 3.36% for 2015 to 3.42% for 2016 and decreased 12 basis points from 3.48% for 2014 to 3.36% for 2015. The increase from 2015 to 2016 was generally due to increases in average balances of loans and securities along with a reduction in average balances in low-yielding short-term investments as we deployed our excess liquidity. These were also positively impacted by the 25 basis point increase in the federal funds rate at the end of 2015. The decreases in 2015 compared to 2014 were due to decreases in the yield on our commercial, residential and consumer loan portfolios, which repriced downward in the generally lower rate environment during those years. Our margin in recent years has been negatively impacted by our decision to hold significant balances in liquid and short-term investments in the past three years. In 2014 through 2016, we began to see the positive impact on our net interest margin from deploying some of these balances into higher yielding assets, including investment securities and portfolio loans. Also, the Federal Reserve Board increased the target federal funds rate by 25 basis points in December 2015 and another 25 basis points in December 2016 and is expected to follow a systematic process of slowly increasing this target rate in 2017 and beyond. With these developments, we expect our net interest margin to be positively impacted in 2017.

Our net interest margin for 2016 benefitted from a 3 basis point decrease in our cost of funds from 0.49% for 2015 to 0.46% for 2016. Average interest bearing liabilities decreased from $1.07 billion in 2015 to $1.06 billion in 2016. Decreases 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 for each period. With the recent increases in the federal funds rate, we anticipate some increase in our funding costs, but with a lesser impact than on our interest earning assets.

Net interest margin continued to be dampened by the impact of our elevated levels of nonperforming assets, particularly other real estate owned. However, as we work to further reduce these levels, our net interest margin is expected to continue to benefit. The estimated negative impact of these nonperforming assets on net interest margin decreased from 14 basis points in 2014 to 9 basis points in 2015 and 4 basis points in 2016.

We are encouraged by the increase in higher yielding average earning assets in 2016 and expect these balances to continue to increase in 2017, which should positively affect net interest income.

Table of Contents

The following table shows an analysis of net interest margin for the years ended December 31, 2016, 2015 and 2014 (dollars in thousands).

	For the years ended December 31,								
	2016			2015			2014		
	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost
Assets									
Taxable securities	$136,051	$2,322	1.71 %	$123,126	$2,065	1.67 %	$120,980	$2,006	1.66 %
Tax-exempt securities (1)	89,442	1,819	3.25	77,418	1,557	3.26	57,445	1,161	3.16
Commercial loans (2)	906,506	35,946	3.90	845,070	33,449	3.90	751,419	31,511	4.14
Residential mortgage loans	217,776	7,647	3.51	202,845	7,305	3.60	191,922	7,045	3.67
Consumer loans	96,616	3,806	3.94	105,350	4,103	3.89	106,759	4,355	4.08
Federal Home Loan Bank stock	11,558	491	4.18	11,430	472	4.07	11,319	471	4.10
Federal funds sold and other short-term investments	90,243	468	0.51	119,036	435	0.36	115,021	439	0.38
Total interest earning assets (1)	1,548,192	52,499	3.42	1,484,275	49,386	3.36	1,354,865	46,988	3.48
Noninterest earning assets:									
Cash and due from banks	26,593			25,956			26,108		
Other	98,799			108,544			113,113		
Total assets	$1,673,584			$1,618,775			$1,494,086		
Liabilities									
Deposits:									
Interest bearing demand	$321,825	$293	0.09 %	$339,698	$381	0.12 %	$274,100	$308	0.11 %
Savings and money market accounts	521,857	961	0.19	487,087	893	0.19	449,623	936	0.21
Time deposits	84,170	517	0.62	106,746	936	0.87	138,300	1,332	0.96
Borrowings:									

Other borrowed funds	94,264	1,685	1.76	94,893	1,765	1.83	88,714	1,709	1.90
Long-term debt	41,238	1,503	3.59	41,238	1,331	3.18	41,238	1,311	3.14
Total interest bearing liabilities	1,063,354	4,959	0.46	1,069,662	5,306	0.49	991,975	5,596	0.56
Noninterest bearing liabilities:									
Noninterest bearing demand accounts	445,046			395,814			359,384		
Other noninterest bearing liabilities	6,618			5,963			4,585		
Shareholders' equity	158,566			147,336			138,142		
Total liabilities and shareholders' equity	$1,673,584			$1,618,775			$1,494,086		
Net interest income		$47,540			$44,080			$41,392	
Net interest spread (1)			2.96 %			2.87 %			2.92 %
Net interest margin (1)			3.11 %			3.01 %			3.07 %
Ratio of average interest earning assets to average interest bearing liabilities	145.60 %			138.76 %			136.58 %		

(1) Yields are presented on a tax equivalent basis using a 35% tax rate.

(2) Loan fees of $883,000, $550,000 and $583,000 for 2016, 2015 and 2014 are included in interest income. Includes average nonaccrual loans of approximately $372,000 million, $5.5 million and $10.3 million for 2016, 2015 and 2014.

Table of Contents

The following table presents the dollar amount of changes in net interest income due to changes in volume and rate.

	For the years ended December 31,					
	2016 vs 2015			2015 vs 2014		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
(Dollars in thousands)	Volume	Rate	Total	Volume	Rate	Total
Interest income						
Taxable securities	$220	$37	$257	$36	$23	$59
Tax-exempt securities	244	18	262	408	(12)	396
Commercial loans	2,436	61	2,497	3,742	(1,804)	1,938
Residential mortgage loans	524	(182)	342	393	(133)	260
Consumer loans	(342)	45	(297)	(57)	(195)	(252)
Federal Home Loan Bank stock	5	14	19	5	(4)	1
Federal funds sold and other short-term investments	(120)	153	33	15	(19)	(4)
Total interest income	2,967	146	3,113	4,542	(2,144)	2,398
Interest expense						
Interest bearing demand	$(19)	$(69)	$(88)	$74	$(1)	$73
Savings and money market accounts	64	4	68	74	(117)	(43)
Time deposits	(173)	(246)	(419)	(284)	(112)	(396)
Other borrowed funds	(12)	(68)	(80)	115	(59)	56
Long-term debt	---	172	172	---	20	20
Total interest expense	(140)	(207)	(347)	(21)	(269)	(290)
Net interest income	$3,107	$353	$3,460	$4,563	$(1,875)	$2,688

Provision for Loan Losses: The provision for loan losses for 2016 was a negative $1.35 million compared to a negative $3.5 million for 2015 and a negative $3.35 million for 2014. The negative provisions in each period were the result of continued realization of net recoveries in each of these years, reduction in the balances and required reserves on nonperforming loans, and stabilizing real estate values on problem credits. Of the $3.5 million negative provision for loan losses in 2015, $2.0 million was attributable to a reduction in specific reserve on our largest individual impaired loan relationship. This loan relationship was upgraded to accruing status in the fourth quarter of 2015 upon the sale of the company and multiple years of profitable operations and positive cash flows. As such, with the upgrade, we changed our method of estimating the specific reserve from one based on liquidation value to one based on expected cash flow from operations. This resulted in the $2.0 million reduction in the required reserve discussed above. Net charge-offs were $58.0 million in 2009, $29.7 million in 2010, $11.1 million in 2011, and $802,000 in 2012, turning to net recoveries of $1.3 million in 2013, $1.5 million in 2014, $1.6 million in 2015 and $1.2 million in 2016. Net recoveries in recent years were attributable to positive results from our aggressive collection recovery efforts.

We continue to see an increase in the quality of some credits within our loan portfolio resulting in an improved loan grade. Over the past three years, we have experienced improvements in our weighted average loan grade. Our weighted average commercial loan grade was 3.73 at December 31, 2016 reflecting improvement compared to 3.77 at December 31, 2015, 3.78 at December 31, 2014, 3.88 at December 31, 2013 and 4.01 at December 31, 2012. This loan grade improvement has also been a contributing factor to allowing for the reduction in the level of the allowance for loan losses since then.

The amounts of loan loss provision in each period 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 level of net recoveries over the past three years has 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 in this Item 7 of the report under the heading “Allowance for Loan Losses” below and in Item 8 of this report in Note 3 of the Consolidated Financial Statements.

Table of Contents

Noninterest Income: Noninterest income totaled $19.1 million in 2016, compared to $17.8 million in 2015 and $16.2 million in 2014. The components of noninterest income are shown in the table below (in thousands):

	2016	2015	2014
Service charges and fees on deposit accounts	$4,425	$4,377	$4,334
Net gains on mortgage loans	3,024	2,925	1,939
Trust fees	3,096	2,927	2,701
Gain as sales of securities	124	129	75
ATM and debit card fees	4,980	4,750	4,654
Bank owned life insurance (“BOLI”) income	977	663	678
Investment services fees	1,044	1,068	1,002
Other income	1,404	954	831
Total noninterest income	$19,074	$17,793	$16,214

Revenue from deposit services was $4.4 million in 2016, compared to $4.4 million in 2015 and $4.3 million in 2014. The increase from 2015 to 2016 and from 2014 to 2015 was due primarily to better penetration into our business customer base in providing fee-based services.

Net gains on mortgage loans included gains on the sale of real estate mortgage loans in the secondary market. We sell the majority of the fixed-rate mortgage loans we originate. We do not retain the servicing rights for the loans we sell.

A summary of gain on sales of loans and related loan volume was as follows (in thousands):

	For the Year Ended December 31,		
	2016	2015	2014
Gain on sales of loans	$3,024	$2,925	$1,939
Real estate mortgage loans originated for sale	$103,385	$99,998	$73,516
Real estate mortgage loans sold	107,003	102,494	75,023
Net gain on the sale of mortgage loans as a percent of real estate mortgage loans sold ("Loan sale margin")	2.83 %	2.85 %	2.58 %

As demonstrated in the table above, mortgage volume was slightly higher in 2016 compared to 2015 and was up significantly compared to 2014. Mortgage rates increased in the second half of 2013, reducing the residential mortgage volume and thus reducing gains on mortgage loans in the latter half of 2013 and into 2014. Volume increased again in 2015 as a result of the continued low mortgage rate environment, our focus on increasing originations from purchase activity and the addition of a couple of residential mortgage lenders in 2015. Rates increased again in late 2016, reducing volume in the fourth quarter of 2016. During the past two years, we have seen a shift in our mortgage production from refinance activity to purchase activity.

Trust service revenue increased $169,000 in 2016 after having increased $226,000 in 2015. These increases were due to growth in our trust service customer base and improvements in general market conditions.

ATM and debit card processing income increased $230,000 in 2016 to $5.0 million, following an increase of $96,000 in 2015 over 2014. These increases reflected a continued increase in usage from current customers and overall growth in the number of debit and ATM card customers. Promotional efforts to increase volume in these low cost transaction alternatives continued to be successful. Our recent rollout of our uChoose Rewards program also had a positive impact on this income in 2015 and 2016.

We sold securities resulting in net gains of $124,000 in 2016, $129,000 in 2015 and $75,000 in 2014. The sales in each year were done to reposition certain holdings in our investment portfolio in response to changes in market rates during the years. We continually review our securities portfolio and will dispose of securities that pose higher than desired credit or market risk.

Table of Contents

Other categories of noninterest income totaled $3.4 million in 2016, $2.7 million in 2015 and $2.5 million in 2014. Earnings from bank owned life insurance increased by $314,000 in 2016 compared to 2015 due to a distribution of a death claim on a covered former employee, a $10 million increase in BOLI holdings late in the third quarter of 2016 and general improvement in the performance of the underlying investments. This followed a reduction in bank owned life insurance earnings of $15,000 from 2014 to 2015, due to the performance of the underlying investments. Investment service fees were down $24,000 in 2016 and up $66,000 in 2015. ORE rental income was $611,000 in 2016, compared to $176,000 in 2015 and $195,000 in 2014. The year over year changes were a result of changes in rental arrangements on some of these properties.

Noninterest Expense: Noninterest expense was $45.8 million in 2016, $47.0 million in 2015 and $45.9 million in 2014. Our noninterest expense areas reflected our active management of controllable costs to offset the high level of nonperforming assets costs. These costs have decreased during the periods presented as well. The components of noninterest expense are shown in the table below (in thousands):

	2016	2015	2014
Salaries and benefits	$24,867	$24,668	$23,137
Occupancy of premises	3,789	3,714	3,840
Furniture and equipment	3,256	3,237	3,190
Legal and professional	863	833	846
Marketing and promotion	1,000	951	1,056
Data processing	2,787	2,483	2,423
FDIC assessment	778	1,137	1,218
Interchange and other card expense	1,286	1,151	1,109
Bond and D&O insurance	527	584	659
Net (gains) losses on repossessed and foreclosed properties	318	1,651	999
Administration and disposition of problem assets	977	1,381	2,072
Outside services	1,639	1,469	1,597
Other noninterest expense	3,695	3,694	3,764
Total noninterest expense	$45,782	$46,953	$45,910

Salaries and benefit expense was the largest component of noninterest expense and was $24.9 million in 2016, $24.7 million in 2015 and $23.1 million in 2014. The slight increase in 2016 was primarily due to increases in medical insurance costs exceeding the positive effect of managed attrition in staffing levels. The increase in 2015 was primarily driven by salary and wage performance adjustments, higher commissions to mortgage loan officers due to their higher origination volumes in 2015, and an increase in medical insurance costs driven by higher claims experience in 2015.

Costs associated with nonperforming assets remained elevated, but have decreased in each of the past three years, totaling $1.3 million in 2016 compared to $3.0 million in 2015 and $3.1 million in 2014. These costs included legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Of the $3.0 million in nonperforming asset costs in 2015, $1.1 million represented a loss on the sale of our largest individual other real estate owned property in December 2015. This sale alone reduced the carrying value of our other real estate portfolio by $7.6 million. Repossessed and foreclosed property administration expense included survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties included both net gains and 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):

	2016	2015	2014

Legal and professional – nonperforming assets	$152	$278	$362
Repossessed and foreclosed property administration	825	1,103	1,710
Net (gains) losses on repossessed and foreclosed properties	318	1,651	999
Total	$1,295	$3,032	$3,071

As problems loans move through the collection process, the costs associated with nonperforming assets have remained elevated, yet have decreased significantly during each of the past three years. During 2016, we added $339,000 in other real estate and sold $5.3 million, allowing for a meaningful reduction in our year end balance. This compares to 2015, when we added $2.5 million in other real estate and sold $11.5 million and 2014 when we added $4.9 million in other real estate and sold $12.5 million. Looking forward to 2017, we expect this trend to continue and should see meaningful reductions in the balances of other real estate owned and the related nonperforming asset carry costs.

Table of Contents
FDIC assessments decreased to $778,000 in 2016 compared to $1.1 million in 2015 and $1.2 million in 2014 primarily due to our assessment category and changes to the FDIC insurance assessment methodology. Further discussion regarding the determination of FDIC assessments for the Bank may be found in Item 1 of this report under the heading "Supervision and Regulation."

Insurance costs for bond and directors and officers (“D&O”) insurance decreased from $659,000 in 2014 to $584,000 in 2015 and $527,000 in 2016. The reductions experienced in 2015 and 2016 were a result of the improvement in our regulatory status and financial condition, which demonstrated to the insurance carriers our lower risk and resulted in a reduction in premiums charged.

Occupancy expense increased $75,000 in 2016 following a decrease of $126,000 in 2015. Furniture and equipment expense was up $19,000 in 2016 following an increase of $47,000 in 2015 and a decrease of $34,000 in 2014. Both occupancy and furniture and equipment expenses were stable over these years due to our continued efforts to manage facility costs.

Data processing expenses were $2.8 million in 2016, compared to $2.5 million in 2015 and $2.4 million in 2014. The increase in these expenses in each period were due to increases in customer usage of certain e-banking channels, such as online banking, mobile banking and electronic bill pay services.

Other noninterest expenses not discussed above were $8.5 million in 2016, compared to $8.1 million in 2015 and $8.4 million in 2014. On February 10, 2015, we entered into a settlement agreement with our former Chairman and Chief Executive Officer to resolve litigation he brought against the Bank in early 2014 for payment under an employment agreement. The settlement totaled $516,000, net of insurance proceeds, and was included in other noninterest expense in 2014. This accounts for the higher level of other noninterest expense in 2014.

Federal Income Tax Expense: We recorded federal income tax expense of $6.2 million in 2016, $5.6 million in 2015 and $4.6 million in 2014. Our effective tax rate was 28% for 2016, 31% for 2015 and 30% for 2014. Federal income tax expense and related effective tax rate decreased in the third quarter of 2016 due to tax credits and other adjustments recognized in our 2015 federal tax return which we filed in the third quarter of 2016. The effective tax rate also decreased for 2016 due to earnings on bank owned life insurance resulting from payment of a death benefit in the first quarter of 2016.

FINANCIAL CONDITION

Summary: Over the past several years, we focused on improving our financial condition through diversification of credit risk, improved capital ratios, and reduced reliance on non-core funding. We experienced positive results in each of these areas. With the success in strengthening our financial condition, we also turned our focus in 2014 to achieving high quality loan portfolio growth, and have experienced this growth since then.

Total assets were $1.741 billion at December 31, 2016, an increase of $11.4 million from $1.730 billion at December 31, 2015. This change reflected increases of $17.6 million in securities available for sale, $17.5 million in securities held to maturity, $82.9 million in our loan portfolio and $10.4 million in bank owned life insurance, partially offset by decreases of $91.2 million in cash and cash equivalents and $5.3 million in other real estate owned. Total deposits increased by $13.2 million and other borrowed funds were down by $12.0 million at December 31, 2016 compared to December 31, 2015.

Total shareholders’ equity increased by $10.3 million from December 31, 2015 to December 31, 2016. Shareholders’ equity was increased by $16.0 million of net income in 2016, partially offset by cash dividends of $4.0 million, or $0.12 per share. Shareholders’ equity also decreased by $1.8 million in 2016 as a result of a swing in accumulated other comprehensive income due to the effect of interest rate movement on the fair value of our available for sale securities portfolio. As of December 31, 2016, the Bank was categorized as “well capitalized” under applicable regulatory guidelines.

Cash and Cash Equivalents: Our cash and cash equivalents, which include federal funds sold and short-term investments, were $89.8 million at December 31, 2016 compared to $181.5 million at December 31, 2015. This $91.7 million decrease was caused by our efforts to grow loans and investments resulting in the deployment of excess liquidity.

Interest-bearing Time Deposits with Other Financial Institutions: We opened a $20.0 million time deposit account with our primary correspondent bank in the first quarter of 2014. This time deposit matured in February 2016.

Table of Contents

Securities: Securities available for sale were $184.4 million at December 31, 2016 compared to $166.8 million at December 31, 2015. The balance at December 31, 2016 primarily consisted of U.S. agency securities, agency mortgage backed securities and various municipal investments. Our held to maturity portfolio increased from $51.9 million at December 31, 2015 to $69.4 million at December 31, 2016. Our held to maturity portfolio is comprised of state and municipal bonds.

Portfolio Loans and Asset Quality: Total portfolio loans increased by $82.9 million to $1.28 billion at December 31, 2016 compared to $1.20 billion at December 31, 2015. During 2016, our commercial portfolio increased by $81.4 million, while our residential portfolio increased by $7.6 million and our consumer portfolio decreased by $6.1 million.

The volume of residential mortgage loans originated for sale in 2016 increased slightly compared to 2015 due to the mortgage rate environment and our increase in the number of residential mortgage lenders. Residential mortgage loans originated for sale were $103.4 million in 2016 compared to $100.0 million in 2015 and $73.5 million in 2014.

We experienced year over year growth in commercial loan balances for the first time in many years in 2014, increasing $71.8 million from December 31, 2013 and increasing another $67.8 million in 2015 and $81.4 million in 2016. We plan to continue measured, high quality loan portfolio growth in 2017.

Commercial and commercial real estate loans remained our largest loan segment and accounted for approximately 76% of the total loan portfolio at December 31, 2016 and 74% at December 31, 2015. Residential mortgage and consumer loans comprised approximately 24% of total loans at December 31, 2016 and 26% at December 31, 2015.

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

	December 31, 2016			December 31, 2015		
	Balance	Percent of Total Loans		Balance	Percent of Total Loans	
Commercial real estate: (1)						
Residential developed	$ 11,970	0.9	%	$ 10,448	0.9	%
Unsecured to residential developers	4,734	0.4		7,372	0.6	
Vacant and unimproved	40,286	3.1		42,881	3.6	
Commercial development	378	---		559	---	
Residential improved	75,348	5.9		67,922	5.7	
Commercial improved	289,478	22.6		289,651	24.2	
Manufacturing and industrial	95,787	7.5		89,839	7.5	
Total commercial real estate	517,981	40.4		508,672	42.5	
Commercial and industrial	449,342	35.1		377,298	31.5	
Total commercial	967,323	75.5		885,970	74.0	
Consumer						
Residential mortgage	217,614	17.0		209,972	17.5	
Unsecured	396	---		637	0.1	
Home equity	88,113	6.9		92,716	7.7	
Other secured	7,366	0.6		8,637	0.7	
Total consumer	313,489	24.5		311,962	26.0	
Total loans	$ 1,280,812	100.0	%	$ 1,197,932	100.0	%

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

Commercial real estate loans accounted for approximately 40% of the total loan portfolio at December 31, 2016 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 and unimproved loans are secured by raw land for which development has not yet begun and agricultural land.

Table of Contents

Total commercial real estate loans increased $9.3 million since December 31, 2015. Our commercial and industrial loan portfolio increased by $72.0 million to $449.3 million at December 31, 2016 and represented 35% of our commercial portfolio.

Our consumer residential mortgage loan portfolio, which also includes residential construction loans made to individual homeowners, comprised approximately 17% of portfolio loans at December 31, 2016 and 18% at December 31, 2015. We expect to continue to retain in our loan portfolio certain types of residential mortgage loans (primarily high quality, low loan to value, adjustable rate loans) in an effort to continue to diversify our credit risk and deploy our excess liquidity. A large portion of our residential mortgage loan production continues to be sold on the secondary market with servicing released.

The volume of residential mortgage loans originated for sale during 2016 increased slightly from 2015 as interest rates remained low throughout 2015 and 2016 and there was a shift in production to financing new home purchases versus refinancings. During the year ended December 31, 2016, we settled claims on loans having an aggregate of $857,000 in principal amount for loans originated and sold during 2006 through 2008, realizing a nominal loss. This settlement closes all potential claims related to loans sold to Countrywide Mortgage dating back to June 14, 1999. As of December 31, 2016, the Company had no other repurchase demands or claims related to residential mortgage loans sold on the secondary market during the five-year period ended December 31, 2016.

Our portfolio of other consumer loans includes loans secured by personal property and home equity fixed term and line of credit loans. Consumer loans decreased by $6.1 million to $95.9 million at December 31, 2016 from $102.0 million at December 31, 2015 primarily due to a decrease in home equity loans. Consumer loans comprised approximately 8% of our portfolio loans at December 31, 2016 and 9% at December 31, 2015.

The following table shows our loan origination activity for portfolio loans during 2016 and 2015, broken out by loan type and also shows average originated loan size (dollars in thousands):

	Year ended December 31, 2016			Year ended December 31, 2015		
	Portfolio Originations	Percent of Total Originations	Average Loan Size	Portfolio Originations	Percent of Total Originations	Average Loan Size
Commercial real estate:						
Residential developed	$ 5,626	1.6 %	$ 625	$ 6,219	1.6 %	$ 327
Unsecured to residential developers	---	---	---	107	---	54
Vacant and unimproved	947	0.3	158	4,733	1.2	263
Commercial development	2,342	0.7	1,171	1,622	0.4	541
Residential improved	68,149	19.2	364	76,672	19.2	326
Commercial improved	45,176	12.7	1,189	45,995	11.6	648
Manufacturing and industrial	25,903	7.3	1,233	35,080	8.8	1,096
Total commercial real estate	148,143	41.8	563	170,428	42.8	448
Commercial and industrial	86,615	24.4	516	97,863	24.5	655
Total commercial	234,758	66.2	545	268,291	67.3	530
Consumer						
Residential mortgage	75,847	21.4	226	82,200	20.6	217
Unsecured	14	---	7	179	---	13
Home equity	41,313	11.7	82	44,888	11.3	79
Other secured	2,464	0.7	16	3,318	0.8	20
Total consumer	119,638	33.8	96	130,585	32.7	116
Total loans	$ 354,396	100.0 %	211	$ 398,876	100.0 %	265

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, the loan is placed in nonaccrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Table of Contents

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. At December 31, 2016, nonperforming assets totaled $12.6 million compared to $18.3 million at December 31, 2015. Additions to other real estate owned in 2016 were $339,000, compared to $2.5 million in 2015. Based on the loans currently in their redemption period, we expect there to be few additions to other real estate owned in 2017. Proceeds from sales of foreclosed properties were $5.3 million in 2016, resulting in a net realized gain on sale of $645,000. Proceeds from sales of foreclosed properties were $11.5 million in 2015 resulting in a net realized loss on sale of $926,000. We expect the level of sales of foreclosed properties in 2017 to be similar to the levels experienced in 2016.

Nonperforming loans include loans on nonaccrual status and loans delinquent more than 90 days but still accruing. As of December 31, 2016, nonperforming loans totaled $300,000, or 0.04% of total portfolio loans, compared to $756,000, or 0.06% of total portfolio loans, at December 31, 2015.

There were no nonperforming loans for development or sale of 1-4 family residential properties at December 31, 2016 compared to $195,000, or 25.8% of total nonperforming loans, at December 31, 2015. The remaining balance of nonperforming loans at December 31, 2016 consisted of $183,000 of commercial real estate loans secured by various types of non-residential real estate, $36,000 of commercial and industrial loans, and $81,000 of consumer and residential mortgage loans.

Foreclosed and repossessed assets include assets acquired in settlement of loans. Foreclosed assets totaled $12.3 million at December 31, 2016 and $17.6 million at December 31, 2015. Of this balance at December 31, 2016, there were 34 commercial real estate properties totaling approximately $11.7 million. The remaining balance was comprised of 7 residential properties totaling approximately $564,000. One commercial real estate property comprised $3.4 million, or 28%, of total other real estate owned at December 31, 2016. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less estimated costs to sell and then evaluated monthly for impairment after transfer using a lower of cost or market approach. Updated property valuations are obtained at least annually on all foreclosed assets.

At December 31, 2016, our foreclosed asset portfolio had a weighted average age held in portfolio of 5.35 years. Below is a breakout of our foreclosed asset portfolio at December 31, 2016 and 2015 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):

	December 31, 2016			December 31, 2015		
Foreclosed Asset Property Type	Carrying Value	Foreclosed Asset Writedown	Combined Writedown (Loan and Foreclosed Asset)	Carrying Value at Carrying Value	Foreclosed Asset Writedown	Combined Writedown (Loan and Foreclosed Asset)
Single Family	$136	--- %	20.3 %	$736	--- %	13.2 %
Residential Lot	438	30.1	48.0	277	34.0	59.4
Multi-Family	---	---	---	---	---	---
Vacant Land	3,096	47.2	58.3	3,887	44.0	55.4
Residential Development	2,570	36.2	74.2	3,859	28.7	68.7
Commercial Office	240	49.3	51.1	1,002	25.4	44.1
Commercial Industrial	---	---	---	---	---	---
Commercial Improved	5,773	48.7	51.2	7,811	40.1	44.1
	$12,253	45.2	60.1	$17,572	37.0	54.2

Table of Contents

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

	December 31,				
	2016	2015	2014	2013	2012
Nonaccrual loans	$300	$739	$8,292	$12,182	$15,385
Loans 90 days or more delinquent and still accruing	---	17	134	153	618
Total nonperforming loans (NPLs)	300	756	8,426	12,335	16,003
Foreclosed assets	12,253	17,572	28,242	36,796	51,582
Repossessed assets	---	---	38	40	6
Total nonperforming assets (NPAs)	12,553	18,328	36,706	49,171	67,591
NPLs to total loans	0.02 %	0.06 %	0.75 %	1.18 %	1.52 %
NPAs to total assets	0.73 %	1.06 %	2.32 %	3.24 %	4.33 %

The following table shows the composition and amount of our troubled debt restructurings (“TDRs”) at December 31, 2016 and 2015 (dollars in thousands):

	December 31, 2016			December 31, 2015		
	Commercial	Consumer	Total	Commercial	Consumer	Total
Performing TDRs	$17,786	$ 12,051	$29,837	$24,932	$ 13,543	$38,475
Nonperforming TDRs (1)	141	8	149	550	27	577
Total TDRs	$17,927	$ 12,059	$29,986	$25,482	$ 13,570	$39,052

(1) Included in nonperforming asset table above

We had a total of $30.0 million and $39.1 million of loans whose terms have been modified in TDRs as of December 31, 2016 and 2015, respectively. These loans may have 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. 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. In situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired designations may be removed.

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, less estimated costs to sell. 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.

- 36 -

Table of Contents

Allowance for loan losses: Determining the appropriate level of the allowance for loan losses is highly subjective. Timely identification of risk rating changes within the commercial loan portfolio is key to our process of establishing an appropriate allowance balance. The internal risk rating system is discussed below.

The allowance for loan losses at December 31, 2016 was $17.0 million, a decrease of $119,000, compared to $17.1 million at December 31, 2015. The balance of the allowance for loan losses was 1.32% of total portfolio loans at December 31, 2016 compared to 1.43% of total portfolio loans at December 31, 2015. While this ratio decreased, the allowance for loan losses to nonperforming loan coverage ratio continued to increase, from 2,259.39% at December 31, 2015 to 5,654.00% at December 31, 2016.

The following is a summary of our portfolio loan balances at the end of each period and the daily average balance of these loans. It also includes changes in the allowance for loan losses arising from loans charged-off, recoveries on loans previously charged-off, and provisions for loan losses.

	December 31				
(Dollars in thousands)	2016	2015	2014	2013	2012
Portfolio loans:					
Average daily balance of loans for the year	$1,218,901	$1,151,101	$1,048,496	$1,030,766	$1,041,833
Amount of loans outstanding at end of period	1,280,812	1,197,932	1,118,483	1,042,377	1,052,348
Allowance for loan losses:					
Balance at beginning of year	17,081	18,962	20,798	23,739	31,641
Provision for loan losses	(1,350)	(3,500)	(3,350)	(4,250)	(7,100)
Loans charged-off:					
Real estate - construction	---	---	---	(55)	(1,455)
Real estate - mortgage	---	(218)	(133)	(1,010)	(1,751)
Commercial and industrial	---	(172)	(43)	(317)	(1,245)
Total Commercial	---	(390)	(176)	(1,382)	(4,451)
Residential mortgage	(10)	(158)	(9)	(433)	(2,257)
Consumer	(195)	(154)	(491)	(389)	(788)
	(205)	(702)	(676)	(2,204)	(7,496)
Recoveries:					
Real estate - construction	426	699	869	1,568	5,521
Real estate - mortgage	664	565	510	573	319
Commercial and industrial	162	406	522	1,134	547
Total Commercial	1,252	1,670	1,901	3,275	6,387
Residential mortgage	33	415	142	65	142
Consumer	151	236	147	173	165
	1,436	2,321	2,190	3,513	6,694
Net (charge-offs) recoveries	1,231	1,619	1,514	1,309	(802)
Balance at end of year	$16,962	$17,081	$18,962	$20,798	$23,739
Ratios:					
Net charge-offs (recoveries) to average loans outstanding	(0.10)%	(0.14)%	(0.14)%	(0.13)%	0.08%
Allowance for loan losses to loans outstanding at year-end	1.32%	1.43%	1.70%	2.00%	2.26%
	5,654.00%	2,259.39%	225.04%	168.61%	148.34%

Allowance for loan losses to
nonperforming loans at year-end

The continued reduction in net charge-offs over the last several years has had a significant effect on the historical loss component of our allowance for loan losses computation as have the improvements in our credit quality metrics.

Table of Contents

The table below shows the changes in these metrics over the past five years:

(Dollars in millions)	2016	2015	2014	2013	2012
Commercial loans	$967.3	$886.0	$818.2	$746.4	$762.7
Nonperforming loans	0.3	0.8	8.4	12.3	16.0
Other real estate owned and repo assets	12.3	17.6	28.3	36.8	51.6
Total nonperforming assets	12.6	18.3	36.7	49.2	67.6
Net charge-offs (recoveries)	(1.2)	(1.6)	(1.5)	(1.3)	0.8
Total delinquencies	1.4	1.4	2.8	5.5	7.9

Nonperforming loans have continually declined since 2012 to $300,000 at December 31, 2016. At December 31, 2016, we have had net loan recoveries in 14 of the past 16 quarters and for the full years of 2013 through 2016. Perhaps even more importantly, our total delinquencies have continued to decrease, and were just $1.4 million at December 31, 2016.

These factors all provide for a reduction in our allowance for loan losses, and thus impact our provision for loan losses. The provision for loan losses was a negative $1.35 million for 2016 compared to a negative $3.5 million for 2015 and a negative $3.35 million for 2014. The negative provision in each period was partially due to decreases in nonperforming loans and favorable net charge-off/recovery expense. Also impacting the negative provision in 2015 was a $2.0 million reduction in a specific reserve on an impaired loan that was upgraded in the fourth quarter of 2015. We had net recoveries in 2016 totaling $1.2 million compared to net recoveries of $1.6 million in 2015 and $1.5 million in 2014. The ratio of net charge-offs (recoveries) to average loans was (0.10)% for 2016, compared to (0.14)% for 2015 and (0.14)% for 2014.

We are encouraged by the reduced level of charge-offs over the past five years. We do, however, recognize that future charge-offs 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.

Our allowance for loan losses is maintained at a level believed appropriate based upon our 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.

Impaired loans declined $9.1 million, or 23%, to $29.7 million at December 31, 2016 compared to $38.8 million at December 31, 2015. This follows a decline of $14.5 million from December 31, 2014 to December 31, 2015. The specific allowance for impaired loans declined $242,000 to $1.7 million, or 5.7% of total impaired loans, at December 31, 2016 compared to $1.9 million, or 5.0% of total impaired loans, at December 31, 2015. The overall balance of impaired loans remained elevated due to an accounting rule (ASU 2011-02) adopted in 2011 that requires us to identify classified loans that renew at existing contractual rates as troubled debt restructurings ("TDRs") if the contractual rate is less than market rates for similar loans at the time of renewal.

Specific allowances are established on individually impaired credits where we believe it is probable that a loss may be incurred. Specific allowances are determined based on discounting estimated cash flows over the life of the loan or based on the fair value of collateral supporting the loan. For commercial real estate loans, generally appraisals are used to estimate the fair value of the collateral and determine the appropriate specific allowance. Estimated selling costs are also considered in the estimate. When it becomes apparent that liquidation of the collateral is the only source of repayment, the collateral shortfall is charged off rather than carried as a specific allowance.

The general allowance (referred to as “formula 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. Generally, a worse grade assigned to a loan category 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 (6 quarter) actual net charge-off history as the base for our computation for commercial loans. The 18 month period ended December 31, 2016 reflected net recoveries. 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, 24, 36, 48 and 60 month periods.

Table of Contents
We also considered the extended period of improved asset quality in assessing the overall qualitative component. Considering the change in our qualitative factors and changes in our commercial loan portfolio balances, the general commercial loan allowance decreased $99,000 to $12.1 million at December 31, 2016 compared to $12.2 million at December 31, 2015. This resulted in a general reserve percentage allocated at December 31, 2016 of 1.27% of commercial loans, a decrease from 1.41% at December 31, 2015. The qualitative component of our allowance allocated to commercial loans was $12.4 million at December 31, 2016 (up from $12.2 million at December 31, 2015).

Groups of homogeneous loans, such as residential real estate and open- and closed-end consumer loans, receive allowance allocations based on loan type. A rolling 12 month (4 quarter) historical loss experience period was applied to residential mortgage and consumer loan portfolios. 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 $3.1 million at December 31, 2016 compared to $2.9 million at December 31, 2015. The increase was related to an increase in consumer loans 30-89 days past due, which receive a larger allocation and mortgage portfolio growth.

As noted above, the formula allowance allocated to commercial loans that are not considered to be impaired is calculated by applying historical loss factors to outstanding loans based on the internal risk rating of such loans. We use a loan rating method based upon an eight point system. Loans rated a 4 or better are considered of acceptable risk. Loans rated a 5 exhibit above-normal risk to the Company and warrant a greater level of attention by management. These loans are subject to on-going review and assessment by our Administrative Loan Committee. Loans rated a 6 or worse are considered substandard, doubtful or loss, exhibit a greater relative risk of loss to the Company based upon the rating and warrant an active workout plan administered by our Special Asset Group.

The qualitative factors assessed and used to adjust historical loss experience reflect our assessment of the impact of economic trends, delinquency and other problem loan trends, trends in valuations supporting underlying collateral, changes in loan portfolio concentrations, effect of changes in interest rates on loan collectibility, competition and changes in internal credit administration practices have on probable losses inherent in our loan portfolio. Qualitative adjustments are inherently subjective and there can be no assurance that these adjustments have properly identified probable losses in our loan portfolio. More information regarding the subjectivity involved in determining the estimate of the allowance for loan losses may be found in this Item 7 of the report under the heading "Critical Accounting Policies and Estimates."

The following table shows the allocation of the allowance for loan losses by portfolio type at the dates indicated.

(Dollars in thousands)	December 31									
	2016		2015		2014		2013		2012	
	Allowance Amount	% of Each Category to total Loans	Allowance Amount	% of Each Category to total Loans	Allowance Amount	% of Each Category to total Loans	Amount	% of Each Category to total Loans	Amount	% of Each Category to total Loans
Commercial and commercial real estate	$13,092	76 %	$13,320	75 %	$14,916	73 %	$17,095	72 %	$19,952	73 %
Residential mortgage	2,646	17	2,557	17	2,689	17	2,368	18	2,544	17

Consumer	1,224	7	1,204	8	1,357	10	1,335	10	1,243	10
Total	$16,962	100 %	$17,081	100 %	$18,962	100 %	$20,798	100 %	$23,739	100 %

Table of Contents

The components of the allowance for loan losses were as follows:

(Dollars in thousands)	December 31, 2016 Balance of Loans	2016 Allowance Amount	2015 Balance of Loans	2015 Allowance Amount
Commercial and commercial real estate:				
Impaired with allowance recorded	$15,253	$ 973	$22,340	$ 1,109
Impaired with no allowance recorded	2,675	---	2,947	---
Loss allocation factor on non-impaired loans	949,395	12,118	860,683	12,211
	967,323	13,091	885,970	13,320
Residential mortgage and consumer:				
Reserves on troubled debt restructurings	11,726	723	13,463	829
Loss allocation factor	301,763	3,148	298,499	2,932
Total	$1,280,812	$ 16,962	$1,197,932	$ 17,081

With the exception of certain TDRs, impaired commercial loans at December 31, 2016 were classified as substandard or worse per our internal risk rating system. $4.2 million of residential mortgage troubled debt restructurings were associated with programs approved by the U.S. government during 2009 to minimize the number of consumer foreclosures. These loans involved the restructuring of terms on consumer mortgages to allow customers to mitigate foreclosure by meeting a lower loan payment requirement based upon their current cash flow. Also included in this category are certain consumer home equity loans that were restructured maturing home equity lines of credit that did not qualify for traditional term financing. We have been actively working with our customers to reduce the risk of foreclosure using these programs. Additional information regarding impaired loans at December 31, 2016 and 2015 may be found in Item 8 of this report in Note 3 to the Consolidated Financial Statements.

The decrease in the level of the allowance for 2016 was due to decreases in gross charge-offs from commercial loans, a reduction in the level of impaired loans and nonperforming loans, reduction in specific reserves allocated to impaired loans, an improvement in the loan grades and a reduction in qualitative factor allocations for commercial loans, which provided a lower allocation. Our weighted average loan grade improved from 4.01 at December 31, 2012 to 3.88 at December 31, 2013, 3.78 at December 31, 2014, 3.77 at December 31, 2015 and 3.73 at December 31, 2016. The decrease of $234,000 in reserves on commercial loans for 2016 was due to a $135,000 decrease in specific reserves on impaired loans and a $99,000 decrease in the loss allocation factor on non-impaired loans.

The general allowance for residential real estate and consumer loans was $3.1 million at December 31, 2016, compared to $2.9 million at December 31, 2015.

Of the $17.0 million allowance at December 31, 2016, 10% related to specific allocations on impaired loans, 71% related to formula allowance on commercial loans and 19% related to general allocations for homogeneous loans. Of the $17.1 million allowance at December 31, 2015, 11% related to specific allocations on impaired loans, 71% related to formula allowance on commercial loans and 18% related to general allocations for homogeneous loans. Of the $15.2 million total formula based allowance for loan loss allocations at December 31, 2016, $15.7 million is from general/environmental allocations with ($505,000) driven from historical experience. Of the $15.1 million total formula based allowance for loan loss allocations at December 31, 2015, $15.3 million is from general/environmental allocations with ($119,000) driven from historical experience. The above 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.

More information regarding steps to address the elevated levels of substandard, impaired and nonperforming loans may be found in this Item 7 of the report under the heading "Portfolio Loans and Asset Quality" above and in Item 8 of this report in Note 3 to the Consolidated Financial Statements.

Although we believe our allowance for loan losses has captured the losses that are probable in our portfolio as of December 31, 2016, there can be no assurance that all losses have been identified or that the allowance is sufficient. The additional efforts by management to accelerate the identification and disposition of problem assets discussed above, and the impact of the lasting economic slowdown, may result in additional losses in 2017.

Table of Contents

Premises and Equipment: Premises and equipment totaled $50.0 million at December 31, 2016 compared to $51.5 million at December 31, 2015 as capital additions were offset by depreciation of current facilities during 2016.

Bank owned life insurance (BOLI): The Bank has purchased life insurance policies on certain officers. BOLI is recorded at its currently realizable cash surrender value. During the third quarter of 2016, the Bank purchased an additional $10.0 million in such policies, bringing the total balance to $39.3 million at December 31, 2016 compared to $28.9 million at December 31, 2015.

Deposits and Other Borrowings: Total deposits increased $13.2 million to $1.449 billion at December 31, 2016, as compared to $1.436 billion at December 31, 2015. Noninterest checking account balances increased $24.4 million in 2016. Interest bearing demand account balances decreased $17.6 million and savings and money market account balances increased $19.9 million in 2016. We decreased higher costing certificates of deposits by $13.5 million in 2016. We believe our success in maintaining and increasing the 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 branch network and the breadth and depth of our product line.

Noninterest bearing demand accounts comprised 35% of total deposits at December 31, 2016 compared to 33% of total deposits at December 31, 2015. Because of the generally low rates paid on interest bearing account alternatives, many of our business customers chose to keep their balances in these more liquid noninterest bearing demand account types. Interest bearing demand, money market and savings accounts, comprised 60% of total deposits at December 31, 2016 and 61% at December 31, 2015. Time accounts as a percentage of total deposits were 5% at December 31, 2016 and 6% at December 31, 2015.

Borrowed funds totaled $125.4 million at December 31, 2016 including $84.2 million in Federal Home Loan Bank advances and $41.2 million in long-term debt associated with trust preferred securities. Borrowed funds totaled $137.4 million at December 31, 2015 including $96.2 million of Federal Home Loan Bank advances and $41.2 million in long-term debt associated with trust preferred securities. Borrowed funds decreased by $12.0 million in 2016 due an annual payment on an amortizing Federal Home Loan Bank advance and maturity of two $10 million FHLB advances in the third quarter of 2016, partially offset by the addition of a $10 million FHLB advance in the second quarter of 2016.

The Company has outstanding $40.0 million aggregate liquidation amount of pooled trust preferred securities (“TRUPs”) issued through its wholly-owned subsidiary grantor trusts, Macatawa Statutory Trust I (issued $20.0 million aggregate liquidation amount with floating interest rate of three-month LIBOR plus 3.05%) and Macatawa Statutory Trust II (issued $20.0 million aggregate liquidation amount with a floating interest rate of three-month LIBOR plus 2.75%). In December 2009, the Company exercised its right to defer interest payments on the TRUPs for 20 consecutive quarters or until such earlier time as determined by further action of the Board of Directors. Through June 30, 2013, the Company had deferred interest payments on the TRUPs for 15 quarters. In the second half of 2013, we discontinued the deferral and resumed regular payment of quarterly interest payments on our trust preferred securities and paid all accrued and unpaid interest that had been previously deferred and became due and payable upon the discontinuance of the deferral. For Macatawa Statutory Trust I, a total of $3.0 million, representing all of the deferred and current interest payment due was distributed on September 30, 2013. For Macatawa Statutory Trust II, a total of $2.7 million, representing all of the deferred and current interest payment due was distributed on October 7, 2013.

In 2009, the Company received proceeds of $1,650,000 from the issuance of unsecured subordinated debt in the form of 11% subordinated notes due in 2017. On August 13, 2013, the Company prepaid and redeemed all of the subordinated notes for $1,650,000 plus interest accrued through the prepayment date.

Information regarding our off-balance sheet commitments may be found in Item 8 of this report in Note 15 to the Consolidated Financial Statements.

CAPITAL RESOURCES

Total shareholders' equity increased by $10.3 million from December 31, 2015 to December 31, 2016. Shareholders' equity was increased by $16.0 million of net income in 2016, partially offset by cash dividends of $4.0 million, or $0.12 per share. Shareholders' equity also decreased by $1.8 million in 2016 as a result of a swing in accumulated other comprehensive income due to the effect of interest rate movement on the fair value of our available for sale securities portfolio. As of December 31, 2016, the Bank was categorized as "well capitalized" under applicable regulatory guidelines.

Our regulatory capital ratios (on a consolidated basis) were stable in 2016 and ended among the highest year-end levels in the Company's history.

The following table shows our regulatory capital ratios (on a consolidated basis) for the past five years.

	December 31,				
	2016	2015	2014	2013	2012
Total capital to risk weighted assets	14.9%	14.8%	15.6%	15.7%	15.0%
Common Equity Tier 1 to risk weighted assets	11.0	10.8	N/A	N/A	N/A
Tier 1 capital to risk weighted assets	13.7	13.6	14.3	14.4	13.4
Tier 1 capital to average assets	12.0	11.5	11.6	10.6	10.4

On December 30, 2013, we completed the cancellation and exchange (the "Exchange") of each share of issued and outstanding Series A and Series B Preferred Stock for shares of common stock and cash, at the election of the holder. Pursuant to the Exchange, we canceled and exchanged each share of Preferred Stock for shares of Company common stock, no par value, in an amount equal to $1,000, the preferred stocks' liquidation preference amount, divided by $5.25 plus, at the election of the holder, an amount of cash equal to $142.00, in the case of Series A Preferred Stock, or $182.00, in the case of Series B Preferred Stock, or a number of shares of Company common stock equal to this cash amount divided by $5.25. The one-time cash payments approximated a 5.0% and 4.5% dividend rate for the Series A and Series B, respectively, after considering previous dividends paid. The Exchange resulted in cash payments of $4.4 million for the Series A Preferred Stock and $319,000 for the Series B Preferred Stock. Under the accounting guidance, the cash payments were recorded as a reduction to common stock, rather than retained earnings, as we had a retained deficit at December 30, 2013.

In addition to the cash payment discussed above, the Exchange resulted in the issuance of 5,973,519 shares of Company common stock in exchange for the Series A Preferred Stock and 457,159 shares in exchange for the Series B Preferred Stock. The total of the fair value of the new common shares issued and the $4.7 million cash payment exceeded the fair value of the securities issuable according to the original conversion terms by $17.6 million, which amount is reflected as a reduction of net income available to common shares in the computation of earnings per share for the year ended December 31, 2013.

As discussed above, these actions as well as a consideration of our levels of cash, earnings, capital and prospects for sustained economic growth and improved performance allowed our Board of Directors to declare our first quarterly cash dividend to common shareholders in over five years beginning with the first quarter of 2014, and each subsequent quarter in 2014, 2015 and 2016. The declaration and payment of future dividends to common shareholders will be considered by the Board of Directors in its discretion and will depend on a number of factors, including our financial condition and anticipated profitability.

All of the $40.0 million of trust preferred securities outstanding at December 31, 2016 qualified as Tier 1 capital.

Capital sources include, but are not limited to, additional private and public common stock offerings, preferred stock offerings and subordinated debt.

On July 3, 2013, the FDIC Board of Directors approved the Regulatory Capital Interim Final Rule, implementing Basel III. This rule redefined Tier 1 capital as two components (Common Equity Tier 1 and Additional Tier 1), created a new capital ratio (Common Equity Tier 1 Risk-based Capital Ratio) and implemented a capital conservation buffer. It also revised the prompt corrective action thresholds and made changes to risk weights for certain assets and off-balance-sheet exposures. Banks were required to transition into the new rule beginning on January 1, 2015. Based on our capital levels and balance sheet composition at December 31, 2016, we believe implementation of the new rule had no material impact on our capital needs.

Macatawa Bank:

The Bank was categorized as "well capitalized" at December 31, 2016 and 2015. The following table shows the Bank's regulatory capital ratios for the past five years.

	December 31,				
	2016	2015	2014	2013	2012
Average equity to average assets	11.5%	11.2%	11.6%	11.2%	9.2 %
Total capital to risk weighted assets	14.5	14.4	15.3	15.4	14.5
Common Equity Tier 1 to risk weighted assets	13.4	13.2	N/A	N/A	N/A
Tier 1 capital to risk weighted capital	13.4	13.2	14.0	14.2	13.3
Tier 1 capital to average assets	11.7	11.2	11.4	10.5	10.3

Table of Contents

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, federal funds sold and other short-term investments, and the various capital resources discussed above.

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.

We have actively pursued initiatives to further strengthen our liquidity position. The Bank reduced its reliance on non-core funding sources, including brokered deposits, and focused on achieving a non-core funding dependency ratio below its peer group average. We have had no brokered deposits on our balance sheet since before December 2012 and we reduced other borrowed funds by $56.8 million in 2012, $1.8 million in 2013 and $1.9 million in 2014. We increased other borrowed funds by $8.1 million in 2015, and reduced it by $12.0 million in 2016. We continue to maintain significant on-balance sheet liquidity. At December 31, 2016, the Bank held $89.8 million of federal funds sold and other short-term investments as well as $181.0 million of unpledged securities available for sale. In addition, the Bank’s available borrowing capacity from correspondent banks has been improved and was approximately $261.7 million as of December 31, 2016.

In the normal course of business, we enter into certain contractual obligations, including obligations which are considered in our overall liquidity management.

The table below summarizes our significant contractual obligations at December 31, 2016.

	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long term debt	$ ---	$ ---	$ ---	$ 41,238
Time deposit maturities	42,778	28,376	2,524	73,678
Other borrowed funds	2,055	62,118	20,000	---
Operating lease obligations	237	597	---	---
Total	$ 45,070	$ 91,091	$ 22,524	$ 114,916

In addition to normal loan funding, we also maintain liquidity to meet customer financing needs through unused lines of credit, unfunded loan commitments and standby letters of credit. The level and fluctuation of these commitments is also considered in our overall liquidity management. At December 31, 2016, we had a total of $437.4 million in unused lines of credit, $90.3 million in unfunded loan commitments and $13.8 million in standby letters of credit.

Liquidity of Holding Company: The primary sources of liquidity for the Company are dividends from the Bank, existing cash resources and the capital markets if the need to raise additional capital arises. 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 and pay to the Company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Company in excess of retained earnings. In December 2013, the Bank paid a dividend of $5.0 million to the Company in anticipation of the preferred stock exchange, in which the Company paid a total of $4.8 million in cash as a part of the transaction, retaining the remaining balance for general corporate purposes. In 2014, the Company resumed payment of quarterly cash dividends to Company shareholders. In 2014, the Bank paid dividends to the Company totaling $4.1 million. In the same period, the Company paid dividends to its shareholders totaling $2.7 million. In 2015, the Bank paid dividends to the Company totaling $5.1 million. In the same period, the Company paid dividends to its shareholders totaling $3.7 million. In 2016, the Bank paid dividends to the Company totaling $6.2 million. In the same period, the Company paid dividends to its shareholders totaling $4.0 million. The Company retained the remaining balance in each period for general corporate purposes. At December 31, 2016, the Bank had a retained earnings balance of $37.1 million.

Table of Contents

During 2016, 2015 and 2014, the Company received payments from the Bank totaling $7.1 million, $3.2 million and $4.0 million, respectively, representing the Bank’s intercompany tax liability for the 2016, 2015 and 2014 tax years, respectively, in accordance with the Company’s tax allocation agreement.

The Company has the right to defer interest payments for 20 consecutive quarters on its trust preferred securities if necessary for liquidity purposes. During the deferral period, the Company may not declare or pay any dividends on its common stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities.

The Company’s cash balance at December 31, 2016 was $5.5 million. The Company believes that it has sufficient liquidity to meet its cash flow obligations.

Table of Contents

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 2016.

Assets acquired through or instead of foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated 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 December 31, 2016, we had gross deferred tax assets of $11.4 million and gross deferred tax liabilities of $2.5 million resulting in a net deferred tax asset of $8.9 million. 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. Prior to December 31, 2012, we had maintained a full valuation allowance on our net deferred tax asset. At December 31, 2012, we considered all reasonably available positive and negative evidence and determined that with completing our eleventh consecutive profitable quarter, continued significant improvement in asset quality measures for the third straight year, the termination of our previous regulatory orders and our moving to a cumulative income position in the most recent three year period, that it was “more likely than not” that we will be able to realize our deferred tax assets and, as such, the full $18.9 million valuation allowance was reversed as of December 31, 2012. With the positive results in 2016, we concluded at December 31, 2016 that no valuation allowance on our net deferred tax asset was required. 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.

Table of Contents
Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity (“EVE”) resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of December 31, 2016 (dollars in thousands).

Interest Rate Scenario	Economic Value of Equity	Percent Change	Net Interest Income	Percent Change
Interest rates up 200 basis points	$210,078	(1.14)%	$54,422	4.52 %
Interest rates up 100 basis points	211,986	(0.24)	53,203	2.18
No change	212,504	---	52,068	---
Interest rates down 100 basis points	193,688	(8.85)	49,705	(4.54)

If interest rates were to increase, this analysis suggests that we are positioned for an improvement in net interest income over the next twelve months.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

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

Table of Contents
ITEM 8: Financial Statements and Supplementary Data.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Macatawa Bank Corporation
Holland, Michigan

We have audited the accompanying consolidated balance sheets of Macatawa Bank Corporation as of December 31, 2016 and 2015 and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Macatawa Bank Corporation at December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Macatawa Bank Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 16, 2017 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Grand Rapids, Michigan
February 16, 2017

Table of Contents

MACATAWA BANK CORPORATION
CONSOLIDATED BALANCE SHEETS
December 31, 2016 and 2015
(Dollars in thousands)

	2016	2015
ASSETS		
Cash and due from banks	$27,690	$29,104
Federal funds sold and other short-term investments	62,129	152,372
Cash and cash equivalents	89,819	181,476
Interest-bearing time deposits in other financial institutions	---	20,000
Securities available for sale, at fair value	184,433	166,815
Securities held to maturity (fair value 2016 - $69,849 and 2015 - $52,837)	69,378	51,856
Federal Home Loan Bank (FHLB) stock	11,558	11,558
Loans held for sale, at fair value	2,181	2,776
Total loans	1,280,812	1,197,932
Allowance for loan losses	(16,962)	(17,081)
Net loans	1,263,850	1,180,851
Premises and equipment – net	50,026	51,456
Accrued interest receivable	4,092	3,622
Bank-owned life insurance	39,274	28,858
Other real estate owned - net	12,253	17,572
Net deferred tax asset	8,863	8,819
Other assets	5,286	3,984
Total assets	$1,741,013	$1,729,643
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$501,478	$477,032
Interest-bearing	947,246	958,480
Total deposits	1,448,724	1,435,512
Other borrowed funds	84,173	96,169
Long-term debt	41,238	41,238
Accrued expenses and other liabilities	4,639	4,747
Total liabilities	1,578,774	1,577,666
Commitments and contingent liabilities	---	---
Shareholders' equity		
Common stock, no par value, 200,000,000 shares authorized; 33,940,788 and 33,925,113 shares issued and outstanding at December 31, 2016 and December 31, 2015	216,731	216,540
Retained deficit	(53,008)	(64,910)
Accumulated other comprehensive income (loss)	(1,484)	347
Total shareholders' equity	162,239	151,977
Total liabilities and shareholders' equity	$1,741,013	$1,729,643

See accompanying notes to consolidated financial statements

Table of Contents

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2016, 2015 and 2014
(Dollars in thousands, except per share data)

	2016	2015	2014
Interest income			
Loans, including fees	$47,400	$44,857	$42,911
Securities			
Taxable	2,322	2,065	2,006
Tax-exempt	1,819	1,557	1,161
FHLB Stock	491	472	471
Federal funds sold and other short-term investments	467	435	439
Total interest income	52,499	49,386	46,988
Interest expense			
Deposits	1,771	2,210	2,576
Other borrowings	1,685	1,765	1,709
Long-term debt	1,503	1,331	1,311
Total interest expense	4,959	5,306	5,596
Net interest income	47,540	44,080	41,392
Provision for loan losses	(1,350)	(3,500)	(3,350)
Net interest income after provision for loan losses	48,890	47,580	44,742
Noninterest income			
Service charges and fees	4,425	4,377	4,334
Net gains on mortgage loans	3,024	2,925	1,939
Trust fees	3,096	2,927	2,701
ATM and debit card fees	4,980	4,750	4,654
Gain on sales of securities	124	129	75
Bank owned life insurance ("BOLI") income	977	663	678
Other	2,448	2,022	1,833
Total noninterest income	19,074	17,793	16,214
Noninterest expense			
Salaries and benefits	24,867	24,668	23,137
Occupancy of premises	3,789	3,714	3,840
Furniture and equipment	3,256	3,237	3,190
Legal and professional	863	833	846
Marketing and promotion	1,000	951	1,056
Data processing	2,787	2,483	2,423
FDIC assessment	778	1,137	1,218
Interchange and other card expense	1,286	1,151	1,109
Bond and D&O Insurance	527	584	659
Net losses (gains) on repossessed and foreclosed properties	318	1,651	999
Administration and disposition of problem assets	977	1,381	2,072
Other	5,334	5,163	5,361
Total noninterest expenses	45,782	46,953	45,910
Income before income tax	22,182	18,420	15,046
Income tax expense	6,231	5,626	4,573
Net income	$15,951	$12,794	$10,473
Basic earnings per common share	$0.47	$0.38	$0.31

Diluted earnings per common share	$0.47	$0.38	$0.31
Cash dividends per common share	$0.12	$0.11	$0.08

See accompanying notes to consolidated financial statements

Table of Contents

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2016, 2015 and 2014
(Dollars in thousands)

	2016	2015	2014
Net income	$ 15,951	$ 12,794	$ 10,473
Other comprehensive income:			
Unrealized gains (losses):			
Net change in unrealized gains (losses) on securities available for sale	(2,694)	569	3,177
Tax effect	943	(199)	(1,112)
Net change in unrealized gains (losses) on securities available for sale, net of tax	(1,751)	370	2,065
Less: reclassification adjustments:			
Reclassification for gains included in net income	124	129	75
Tax effect	(44)	(45)	(26)
Reclassification for gains included in net income, net of tax	80	84	49
Other comprehensive income (loss), net of tax	(1,831)	286	2,016
Comprehensive income	$ 14,120	$ 13,080	$ 12,489

See accompanying notes to consolidated financial statements

Table of Contents

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2016, 2015 and 2014
(Dollars in thousands, except per share data)

	Common Stock	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, January 1, 2014	$216,263	$(81,786)	$ (1,955)	$ 132,522
Net income	---	10,473	---	10,473
Common stock issuance costs	(102)	---	---	(102)
Issuance of 392 shares of Common Stock on exercise of stock purchase warrants	4	---	---	4
Cash dividends at $.08 per share	---	(2,689)	---	(2,689)
Repurchase of 20,534 shares for taxes withheld on vested restricted stock	(106)	---	---	(106)
Tax effect of vested stock awards	63	---	---	63
Net change in unrealized gain on securities available for sale, net of tax	---	---	2,016	2,016
Stock compensation expense	338	---	---	338
Balance, December 31, 2014	$216,460	$(74,002)	$ 61	$ 142,519
Net income	---	12,794	---	12,794
Cash dividends at $.11 per share	---	(3,702)	---	(3,702)
Repurchase of 29,676 shares for taxes withheld on vested restricted stock	(171)	---	---	(171)
Tax effect of vested stock awards	53	---	---	53
Net change in unrealized gain on securities available for sale, net of tax	---	---	286	286
Tax effect of expired common stock warrants	(280)	---	---	(280)
Stock compensation expense	478	---	---	478
Balance, December 31, 2015	$216,540	$(64,910)	$ 347	$ 151,977
Net income	---	15,951	---	15,951
Cash dividends at $.12 per share	---	(4,049)	---	(4,049)
Repurchase of 30,350 shares for taxes withheld on vested restricted stock	(269)	---	---	(269)
Tax effect of vested stock awards	143	---	---	143
Net change in unrealized loss on securities available for sale, net of tax	---	---	(1,831)	(1,831)
Tax effect of expired common stock options	(219)	---	---	(219)
Stock compensation expense	536	---	---	536
Balance, December 31, 2016	$216,731	$(53,008)	$ (1,484)	$ 162,239

See accompanying notes to consolidated financial statements

Table of Contents
MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2016, 2015 and 2014
(Dollars in thousands)

	2016	2015	2014
Cash flows from operating activities			
Net income	$15,951	$12,794	$10,473
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	2,805	2,969	3,139
Stock compensation expense	536	478	338
Tax effect of vested stock awards	143	53	63
Tax effect of expired common stock options and warrants	(219)	(280)	---
Provision for loan losses	(1,350)	(3,500)	(3,350)
Origination of loans for sale	(103,385)	(99,998)	(73,516)
Proceeds from sales of loans originated for sale	107,004	102,494	75,023
Net gains on mortgage loans	(3,024)	(2,925)	(1,939)
Gain on sales of securities	(124)	(129)	(75)
Write-down of other real estate	964	724	1,623
Net (gain) loss on sales of other real estate	(645)	926	(624)
Deferred income tax expense	942	3,291	2,849
Change in accrued interest receivable and other assets	(1,585)	(1,323)	1,555
Earnings in bank-owned life insurance	(977)	(663)	(678)
Change in accrued expenses and other liabilities	(108)	(910)	1,737
Net cash from operating activities	16,928	14,001	16,618
Cash flows from investing activities			
Loan originations and payments, net	(81,988)	(80,350)	(79,524)
Change in interest-bearing deposits in other financial institutions	20,000	---	5,000
Purchases of securities available for sale	(89,159)	(59,807)	(43,882)
Purchases of securities held to maturity	(33,702)	(36,547)	(25,225)
Purchase of bank-owned life insurance	(10,000)	---	---
Purchase of FHLB stock	---	(320)	(2,519)
Proceeds from:			
Maturities and calls of securities	68,952	47,056	22,528
Sales of securities available for sale	11,729	20,625	10,936
Principal paydowns on securities	4,159	3,670	3,642
Sales of other real estate	5,339	11,540	12,487
Death benefit from bank-owned life insurance	518	---	---
Sale of FHLB stock	---	---	2,517
Additions to premises and equipment	(1,188)	(1,170)	(1,766)
Net cash from investing activities	(105,340)	(95,303)	(95,806)
Cash flows from financing activities			
Change in deposits	13,212	129,187	56,591
Repayments and maturities of other borrowed funds	(21,996)	(1,938)	(1,884)
Proceeds from other borrowed funds	10,000	10,000	---
Proceeds from issuance of common stock	---	---	4
Cash paid related to tax impact of vested stock awards	(143)	(53)	(63)
Cash dividends paid	(4,049)	(3,702)	(2,689)

Common stock issuance costs	---	---	(102)
Repurchase of shares for taxes withheld on vested restricted stock	(269)	(171)	(106)
Net cash from financing activities	(3,245)	133,323	51,751
Net change in cash and cash equivalents	(91,657)	52,021	(27,437)
Cash and cash equivalents at beginning of period	181,476	129,455	156,892
Cash and cash equivalents at end of period	$89,819	$181,476	$129,455

See accompanying notes to consolidated financial statements

Table of Contents

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
Years ended December 31, 2016, 2015 and 2014
(Dollars in thousands)

	2016	2015	2014
Supplemental cash flow information			
Interest paid	$4,950	$5,322	$5,615
Income taxes paid	6,160	4,300	90
Supplemental noncash disclosures:			
Transfers from loans to other real estate	339	2,520	4,932

See accompanying notes to consolidated financial statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation ("Macatawa" or the "Company") 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 securities of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are discussed in a separate note. Under generally accepted accounting principles, these trusts are not consolidated into the financial statements of the Company.

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.

Concentration of Credit Risk: Loans are granted to, and deposits are obtained from, customers primarily in the western Michigan area as described above. Substantially all loans are secured by specific items of collateral, including residential real estate, commercial real estate, commercial assets and consumer assets. Commercial real estate loans are the largest concentration, comprising 40% of total loans at December 31, 2016. Commercial and industrial loans total 35%, while residential real estate and consumer loans make up the remaining 25%. Other financial instruments, which potentially subject the Company to concentrations of credit risk, include deposit accounts in other financial institutions.

Cash Flow Reporting: Cash and cash equivalents include cash on hand, demand deposits with other financial institutions and short-term securities (securities with maturities equal to or less than 90 days and federal funds sold). Cash flows are reported net for customer loan and deposit transactions, interest-bearing time deposits with other financial institutions and short-term borrowings with maturities of 90 days or less.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities available for sale consist of those securities which might be sold prior to maturity due to changes in interest rates, prepayment risks, yield and availability of alternative investments, liquidity needs or other factors. Securities classified as available for sale are reported at their fair value and the related unrealized holding gain or loss is reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level yield method without anticipating prepayments. Gains and losses on sales are based on the amortized cost of the security sold.

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. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, Investments — Debt and Equity Instruments.

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. Management has determined that no OTTI charges were necessary during 2016, 2015 and 2014.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value. Management has determined that there is no impairment of FHLB stock. Both cash and stock dividends are reported as income.

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at fair value, as determined by outstanding commitments from investors. As of December 31, 2016 and 2015, these loans had a net unrealized gain of $28,000 and $65,000, respectively, which are reflected in their carrying value. Changes in fair value of loans held for sale are included in net gains on mortgage loans. Loans are sold servicing released; therefore no mortgage servicing right assets are established.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs and an allowance for loan losses.

Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income over the respective term of the loan using the level yield method without anticipating prepayments.

Interest income on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer loans are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and recoveries, and decreased by charge-offs of loans. Management believed the estimated allowance for loan losses 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 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.

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 environmental factors. The Company maintains a loss migration analysis that tracks loan losses and recoveries based on loan class as well as the loan risk grade assignment for commercial loans. At December 31, 2016, an 18 month (six quarter) annualized historical loss experience was used for commercial loans and a 12 month (four quarter) 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 environmental factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, competition, increasing interest rates, 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 for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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 so that the loan is reported, net, 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, accordingly, they are not separately identified for impairment disclosures.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated 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.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 15 years. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized.

Bank-Owned Life Insurance (BOLI): The Bank has purchased life insurance policies on certain officers. Bank-owned life insurance is recorded at its currently realizable cash surrender value. Changes in cash surrender value are recorded in other income.

Goodwill and Acquired Intangible Assets: Goodwill resulting from business combinations represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. The Company had no goodwill at December 31, 2016 and 2015.

Acquired intangible assets consist of core deposit and customer relationship intangible assets arising from acquisitions. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives, which range from ten to sixteen years. The Company had no acquired intangible assets at December 31, 2016 and 2015.

Long-term Assets: Premises and equipment and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Loan Commitments and Related Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Mortgage Banking Derivatives: Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as derivatives not qualifying for hedge accounting. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. At times, the Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans.

Changes in the fair values of these interest rate lock and forward commitment derivatives are included in net gains on mortgage loans. The net fair value of mortgage banking derivatives was approximately $51,000 and $38,000 at December 31, 2016 and 2015, respectively.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivatives: Certain of our commercial loan customers have entered into interest rate swap agreements directly with the Bank. At the same time the Bank enters into a swap agreement with its customer, the Bank enters into a corresponding interest rate swap agreement with a correspondent bank at terms mirroring the Bank's interest rate swap with its commercial loan customer. This is known as a back-to-back swap agreement. Under this arrangement the Bank has two freestanding interest rate swaps, both of which are carried at fair value. As the terms mirror each other, there is no income statement impact to the Bank. At December 31, 2016, the total notional amount of such agreements was $48.1 million and resulted in a derivative asset with a fair value of $494,000 which was included in other assets and a derivative liability of $494,000 which was included in other liabilities. At December 31, 2015, the total notional amount of such agreements was $43.9 million and resulted in a derivative asset with a fair value of $790,000 which was included in other assets and a derivative liability of $790,000 which was included in other liabilities.

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.

The Company recognizes 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.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

Earnings Per Common Share: Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. All outstanding unvested restricted stock awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation and are included in both basic and diluted earnings per share. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. In the event of a net loss, our unvested restricted stock awards are excluded from both basic and diluted earnings per share.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of $5,610,000 and $5,181,000 at December 31, 2016 and 2015, respectively, was required to meet regulatory reserve and clearing requirements.

Stock Splits and Dividends: Stock dividends in excess of 20% are reported as stock splits, resulting in no adjustment to the Company's equity accounts. Stock dividends for 20% or less are reported by transferring the fair value, as of the ex dividend date, of the stock issued from retained earnings to common stock. Fractional share amounts are paid in cash with a reduction in retained earnings. All share and per share amounts are retroactively adjusted for stock splits and dividends.

Dividend Restriction: Banking regulations require maintaining certain capital levels and impose limitations on dividends paid by the Bank to the Company and by the Company to shareholders.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Values of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed separately. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on-and off-balance sheet financial instruments do not include the value of anticipated future business or the values of assets and liabilities not considered financial instruments.

Segment Reporting: The Company, through the branch network of the Bank, provides a broad range of financial services to individuals and companies in western Michigan. These services include demand, time and savings deposits; lending; ATM and debit card processing; cash management; and trust and brokerage services. While the Company's management team monitors the revenue streams of the various Company products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the Company's banking operations are considered by management to be aggregated in one operating segment – commercial banking.

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

Adoption of New Accounting Standards: The Financial Accounting Standards Board "FASB" issued Accounting Standards Update ("ASU") 2015-03, Simplifying the Presentation of Debt Issuance Costs. This ASU requires that debt issuance costs be reported in the balance sheet as a direct deduction from the face amount of the related liability, consistent with the presentation of debt discounts. Further, the ASU requires the amortization of debt issuance costs to be reported as interest expense. Similarly, debt issuance costs and any discount or premium are considered in the aggregate when determining the effective interest rate on the debt. The new guidance was effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The new guidance must be applied retrospectively. The impact of adoption of this ASU by the Company was not material.

FASB issued ASU 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. This ASU provides guidance related to the accounting for internal-use software accessed through a hosting arrangement (e.g., cloud computing, software as a service, etc.) only if both of the following criteria are met: (1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty (there is no significant penalty if the customer has the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without significant loss of utility or value); and (2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. If both of the criteria are present in a hosting arrangement, then the arrangement contains a software license and the customer should generally capitalize and subsequently amortize the cost of the license. If both of the criteria are not present, the customer should account for the arrangement as a service contract (i.e., expense fees as incurred). The new guidance was effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The impact of adoption of this ASU by the Company was not material.

Newly Issued Not Yet Effective Standards: FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this Update create a new topic in the Codification, Topic 606. In addition to superseding and replacing nearly all existing U.S. GAAP revenue recognition guidance, including industry-specific guidance, ASC 606 establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, ASU 2014-09 adds a new Subtopic to the Codification, ASC 340-40, Other Assets and Deferred Costs: Contracts with Customers, to provide guidance on costs related to obtaining a contract with a customer and costs incurred in fulfilling a contract with a customer that are not in the scope of another ASC Topic. The new guidance does not apply to certain contracts within the scope of other ASC Topics, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product or service warranties, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers. The amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. This ASU may require us to change how we recognize certain recurring revenue streams within trust and investment management fees, however, we do not expect these changes to have a significant effect on our financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

FASB issued ASU 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. As the Company owns most of its branch locations, this ASU will apply primarily to operating leases and the impact of adoption of this ASU by the Company is not expected to be material.

FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting. This ASU simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the following: Accounting for income taxes, classification of excess tax benefits on the statement of cash flows, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities and classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax-withholding purposes. The amendments are effective for annual periods beginning after December 15, 2016, and for interim periods within those annual periods. The impact of adoption of this ASU by the Company is not expected to be material, but could cause some volatility in income tax expense in periods where stock awards vest.

FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU provides financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The new guidance eliminates the probable initial recognition threshold and, instead, reflects an entity’s current estimate of all expected credit losses. The new guidance broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually to include forecasted information, as well as past events and current conditions. There is no specified method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Although an entity may still use its current systems and methods for recording the allowance for credit losses, under the new rules, the inputs used to record the allowance for credit losses generally will need to change to appropriately reflect an estimate of all expected credit losses and the use of reasonable and supportable forecasts. Additionally, credit losses on available-for-sale debt securities will now have to be presented as an allowance rather than as a write-down. This ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within those years. The Company is currently evaluating the impact of this new ASU on its consolidated financial statements.

FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force). This ASU addresses concerns regarding diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. In particular, this ASU addresses eight specific cash flow issues in an effort to reduce this diversity in practice: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon bonds; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5)

proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments are effective for annual periods beginning after December 15, 2017, and for interim periods within those annual periods. The impact of adoption of this ASU by the Company is not expected to be material.

NOTE 2 – SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016				
Available for Sale:				
U.S. Treasury and federal agency securities	$ 85,582	$ 49	$ (1,281)	$ 84,350
U.S. Agency MBS and CMOs	12,037	11	(231)	11,817
Tax-exempt state and municipal bonds	39,578	212	(603)	39,187
Taxable state and municipal bonds	34,255	65	(437)	33,883
Corporate bonds and other debt securities	13,765	16	(55)	13,726
Other equity securities	1,500	---	(30)	1,470
	$ 186,717	$ 353	$ (2,637)	$ 184,433
Held to Maturity				
Tax-exempt state and municipal bonds	$ 69,378	$ 573	$ (102)	$ 69,849
December 31, 2015				
Available for Sale:				
U.S. Treasury and federal agency securities	$ 74,618	$ 48	$ (274)	$ 74,392
U. S. Agency MBS and CMOs	13,828	35	(108)	13,755
Tax-exempt state and municipal bonds	32,943	692	(37)	33,598
Taxable state and municipal bonds	28,554	246	(37)	28,763
Corporate bonds and other debt securities	14,838	19	(44)	14,813
Other equity securities	1,500	---	(6)	1,494
	$ 166,281	$ 1,040	$ (506)	$ 166,815
Held to Maturity:				
Tax-exempt state and municipal bonds	$ 51,856	$ 986	$ (5)	$ 52,837

Proceeds from the sale of securities available for sale were $11.7 million, $20.6 million and $10.9 million, respectively, for the years ended December 31, 2016, 2015 and 2014, resulting in net gains on sale of $124,000, $129,000 and $75,000, respectively, as reported in the consolidated statements of income. This resulted in reclassifications of $124,000 ($80,000 net of tax), $129,000 ($84,000 net of tax) and $75,000 ($49,000 net of tax), respectively, from accumulated other comprehensive income to gain on sale of securities in the consolidated statements of income in years ended December 31, 2016, 2015 and 2014.

Contractual maturities of debt securities at December 31, 2016 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	$ 25,203	$ 25,156	$ 17,192	$ 17,228
Due from one to five years	14,801	15,069	94,916	94,067

Due from five to ten years	8,279	8,443	57,224	56,200
Due after ten years	21,095	21,181	15,885	15,468
	$ 69,378	$ 69,849	$ 185,217	$ 182,963

NOTE 2 – SECURITIES (Continued)

Securities with unrealized losses at December 31, 2016 and 2015, 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):

	Less than 12 Months		12 Months or More		Total	
December 31, 2016	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and federal agency securities	$ 59,129	$ (1,271)	$ 3,053	$ (10)	$ 62,182	$ (1,281)
U.S. Agency MBS and CMOs	10,702	(231)	---	---	10,702	(231)
Tax-exempt state and municipal bonds	49,508	(698)	1,672	(7)	51,180	(705)
Taxable state and municipal bonds	22,633	(437)	---	---	22,633	(437)
Corporate bonds and other debt securities	5,745	(50)	500	(5)	6,245	(55)
Other equity securities	1,470	(30)	---	---	1,470	(30)
Total temporarily impaired	$ 149,187	$ (2,717)	$ 5,225	$ (22)	$ 154,412	$ (2,739)

	Less than 12 Months		12 Months or More		Total	
December 31, 2015	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and federal agency securities	$ 35,090	$ (187)	$ 7,036	$ (82)	$ 42,126	$ (269)
U.S. Agency MBS and CMOs	8,842	(108)	---	---	8,842	(108)
Tax-exempt state and municipal bonds	3,487	(9)	2,022	(33)	5,509	(42)
Taxable state and municipal bonds	8,158	(29)	640	(8)	8,798	(37)
Corporate bonds and other debt securities	9,330	(47)	499	(2)	9,829	(49)
Other equity securities	1,494	(6)	---	---	1,494	(6)
Total temporarily impaired	$ 66,401	$ (386)	$ 10,197	$ (125)	$ 76,598	$ (511)

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 the unrealized losses for each period were attributable to changes in interest rates and not due to credit quality. As such, no OTTI charges were necessary during 2016, 2015 and 2014.

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 at December 31, 2016 and 2015.

NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

	December 31, 2016	December 31, 2015
Commercial and industrial	$ 449,342	$ 377,298
Commercial real estate:		
Residential developed	11,970	10,448
Unsecured to residential developers	4,734	7,372
Vacant and unimproved	40,286	42,881
Commercial development	378	