

FENTURA FINANCIAL INC

Form 10-Q

May 16, 2011

**Table of Contents**

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2011

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission file number 000-23550**

**Fentura Financial, Inc.**

(Exact name of registrant as specified in its charter)

**Michigan**

**38-2806518**

(State or other jurisdiction of  
incorporation or organization)

(IRS Employee Identification No.)

**175 N Leroy, P.O. Box 725, Fenton, Michigan 48430**

(Address of Principal Executive Offices)

**(810) 629-2263**

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.)  Yes  No

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: May 2, 2011

|       |              |                    |           |
|-------|--------------|--------------------|-----------|
| Class | Common Stock | Shares Outstanding | 2,320,607 |
|-------|--------------|--------------------|-----------|

**Fentura Financial, Inc.**  
**Index to Form 10-Q**

|   | <b>Page</b> |
|---|-------------|
| <u>Part I Financial Information</u>   | 3           |
| <u>Item 1 Consolidated Financial Statements (Unaudited)</u>   | 3-32        |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 32-42       |
| <u>Item 3 Quantitative and Qualitative Disclosures about Market Risk</u>                            | 43-45       |
| <u>Item 4 Controls and Procedures</u>   | 45          |
| <u>Part II Other Information</u>  | 46          |
| <u>Item 1 Legal Proceedings</u>   | 46          |
| <u>Item 1A Risk Factors</u>   | 46          |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 46          |
| <u>Item 3 Defaults Upon Senior Securities</u>   | 46          |
| <u>Item 4 Reserved</u>  | 46          |
| <u>Item 5 Other Information</u>   | 46          |
| <u>Item 6 Exhibits</u>  | 46          |
| <u>Signatures</u>   | 47          |
| <u>Exhibit Index</u>  | 48          |
| <u>EX-10.1</u>  |             |
| <u>EX-31.1</u>  |             |
| <u>EX-31.2</u>  |             |
| <u>EX-32.1</u>  |             |
| <u>EX-32.2</u>  |             |

**Table of Contents**

**PART I FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**  
**FENTURA FINANCIAL, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(000s omitted except share data)

|  | <b>March<br/>31,<br/>2011<br/>(unaudited)</b> | <b>Dec 31,<br/>2010</b> |
|--|---|-------------------------|
| <b>ASSETS</b>                              |   |                         |
| Cash and due from banks                    | \$ 28,422                                     | \$ 11,592               |
| Federal funds sold                         | 16,000  | 21,900                  |
| Total cash and cash equivalents            | 44,422  | 33,492                  |
| Securities available for sale              | 44,870  | 41,875                  |
| Securities held to maturity                | 4,349   | 4,350                   |
| Total securities                           | 49,219  | 46,225                  |
| Loans held for sale                        | 486   | 850                     |
| Loans:                                     |   |                         |
| Commercial                                 | 41,384  | 43,395                  |
| Real estate loans commercial               | 99,350  | 106,784                 |
| Real estate loans construction             | 8,380   | 9,597                   |
| Real estate loans residential              | 19,219  | 19,046                  |
| Consumer loans                             | 27,543  | 29,153                  |
| Total loans                                | 195,876                                       | 207,975                 |
| Less: Allowance for loan losses            | (9,015)                                       | (10,027)                |
| Net loans                                  | 186,861                                       | 197,948                 |
| Bank owned life insurance                  | 5,835   | 5,800                   |
| Bank premises and equipment                | 10,302  | 10,335                  |
| Federal Home Loan Bank stock               | 740   | 740                     |
| Accrued interest receivable                | 1,060   | 1,050                   |
| Other real estate owned                    | 2,362   | 2,742                   |
| Assets of discontinued operations          | 11,387  | 122,968                 |
| Other assets                               | 1,791   | 2,078                   |
| Total assets                               | \$ 314,465                                    | \$ 424,228              |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b> |   |                         |
| Deposits:                                  |   |                         |
| Non-interest bearing                       | \$ 59,017                                     | \$ 55,044               |
| Interest bearing                           | 220,153                                       | 220,933                 |
| Total deposits                             | 279,170                                       | 275,977                 |
| Short term borrowings                      | 662   | 879                     |

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|   |                   |                   |
|---|-------------------|-------------------|
| Federal Home Loan Bank advances   | 954               | 954               |
| Subordinated debentures   | 14,000            | 14,000            |
| Liabilities of discontinued operations  | 0                 | 113,321           |
| Accrued taxes, interest and other liabilities   | 3,473             | 3,042             |
| <b>Total liabilities</b>  | <b>298,259</b>    | <b>408,173</b>    |
| Shareholders' equity  |                   |                   |
| Common stock - no par value, 5,000,000 shares authorized and outstanding 2,320,607 at March 31, 2011 (2,308,765 at December 31, 2010) | 43,062            | 43,036            |
| Retained deficit  | (26,732)          | (27,042)          |
| Accumulated other comprehensive (loss) income   | (124)             | 61                |
| <b>Total shareholders' equity</b>   | <b>16,206</b>     | <b>16,055</b>     |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 314,465</b> | <b>\$ 424,228</b> |

**See accompanying notes to consolidated financial statements.**

**Table of Contents**

**FENTURA FINANCIAL, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**  
(000s omitted except share data)

|  | <b>Three Months<br/>Ended<br/>March 31</b> |                 |
|--|--|-----------------|
|  | <b>2011</b>                                | <b>2010</b>     |
| Interest income  |  |                 |
| Loans, including fees                                      | \$ 3,017                                   | \$ 3,592        |
| Interest and dividends on securities:                      |  |                 |
| Taxable  | 279  | 225             |
| Tax-exempt   | 45   | 112             |
| Interest on federal funds sold                             | 9  | 3               |
| <b>Total interest income</b>                               | <b>3,350</b>                               | <b>3,932</b>    |
| Interest expense   |  |                 |
| Deposits   | 722  | 1,134           |
| Borrowings   | 126  | 126             |
| <b>Total interest expense</b>                              | <b>848</b>                                 | <b>1,260</b>    |
| <b>Net interest income</b>                                 | <b>2,502</b>                               | <b>2,672</b>    |
| Provision for loan losses                                  | 795  | 1,135           |
| <b>Net interest income after provision for loan losses</b> | <b>1,707</b>                               | <b>1,537</b>    |
| Non-interest income  |  |                 |
| Service charges on deposit accounts                        | 296  | 425             |
| Trust and investment services income                       | 288  | 269             |
| Gain on sale of mortgage loans                             | 68   | 81              |
| Gain on sale of securities                                 | 5  | 0               |
| Other income and fees                                      | 497  | 340             |
| <b>Total non-interest income</b>                           | <b>1,154</b>                               | <b>1,115</b>    |
| Non-interest expense                                       |  |                 |
| Salaries and employee benefits                             | 1,673                                      | 1,619           |
| Occupancy  | 284  | 321             |
| Furniture and equipment                                    | 292  | 306             |
| Loan and collection  | 110  | 373             |
| Advertising and promotional                                | 19   | 26              |
| Other operating expenses                                   | 843  | 633             |
| <b>Total non-interest expense</b>                          | <b>3,221</b>                               | <b>3,278</b>    |
| <b>Loss from continuing operations before income tax</b>   | <b>(360)</b>                               | <b>(626)</b>    |
| Federal income tax (benefit)                               | (212)                                      | (314)           |
| <b>Net loss from continuing operations</b>                 | <b>\$ (148)</b>                            | <b>\$ (312)</b> |

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|  |           |           |
|--|-----------|-----------|
| Discontinued operations, net of tax                      |           |           |
| Net loss from discontinued operations                    | (11)      | (171)     |
| Gain from sale of discontinued operations                | 469       | 0         |
| Net income (loss) from discontinued operations           | 458       | (171)     |
| Net income (loss)  | \$ 310    | \$ (483)  |
| Net loss per share from continuing operations            |           |           |
| Basic and diluted  | \$ (0.06) | \$ (0.14) |
| Net income (loss) per share from discontinued operations |           |           |
| Basic and diluted  | \$ 0.19   | \$ (0.07) |
| Net income (loss) per share                              |           |           |
| Basic and diluted  | \$ 0.13   | \$ (0.21) |
| Cash Dividends declared                                  | \$ 0.00   | \$ 0.00   |

**See accompanying notes to consolidated financial statements.**

**Table of Contents**

**FENTURA FINANCIAL, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
**(UNAUDITED)**

| <b>(000s omitted except share data)</b>  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2011</b>                             | <b>2010</b> |
| Common Stock   |   |             |
| Balance, beginning of period   | \$ 43,036                               | \$ 42,913   |
| Issuance of shares under<br>Director stock purchase plan and dividend reinvestment program (11,842 and 18,582<br>shares) | 26                                      | 32          |
| Balance, end of period   | 43,062                                  | 42,945      |
| Retained Deficit   |   |             |
| Balance, beginning of period   | (27,042)                                | (21,657)    |
| Net income (loss)  | 310                                     | (483)       |
| Balance, end of period   | (26,732)                                | (22,140)    |
| Accumulated Other Comprehensive Income (Loss)  |   |             |
| Balance, beginning of period   | 61                                      | (724)       |
| Change in unrealized (loss) gain on securities, net of tax   | (185)                                   | 162         |
| Balance, end of period   | (124)                                   | (562)       |
| Total shareholders' equity   | \$ 16,206                               | \$ 20,243   |

**See accompanying notes to consolidated financial statements.**



**Table of Contents**

**FENTURA FINANCIAL, INC**  
**CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)**

| <b>(000s omitted)</b>  | <b>Three Months Ended<br/>March 31,</b> |                |
|--|---|----------------|
|  | <b>2011</b>                             | <b>2010</b>    |
| <b>OPERATING ACTIVITIES:</b>   |   |                |
| Net income (loss)  | \$ 310                                  | \$ (483)       |
| Adjustments to reconcile net income (loss) to cash Provided by Operating Activities: |   |                |
| Depreciation, amortization and accretion   | 110                                     | 160            |
| Provision for loan losses  | 795                                     | 1,135          |
| Loans originated for sale  | (4,357)                                 | (5,570)        |
| Proceeds from the sale of loans  | 5,422                                   | 4,834          |
| Gain on sales of loans   | (701)                                   | (81)           |
| (Gain) loss on other real estate owned   | (7)                                     | 10             |
| Write downs on other real estate owned   | 34                                      | 79             |
| Gain on sale of securities   | (5)                                     | 0              |
| Earnings from bank owned life insurance  | (35)                                    | (38)           |
| Net (increase) decrease in interest receivable & other assets                        | (183)                                   | 38             |
| Net increase (decrease) in interest payable & other liabilities                      | 431                                     | (189)          |
| Net change in discontinued operations operating activities                           | 6,224                                   | (3,267)        |
| <br>Total Adjustments  | <br>7,728                               | <br>(2,889)    |
| <br>Net cash provided by (used in) operating activities                              | <br>8,038                               | <br>(3,372)    |
| <br><b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                     |   |                |
| Proceeds from maturities of securities AFS   | 1,451                                   | 2,246          |
| Proceeds from calls of securities AFS  | 2,000                                   | 0              |
| Proceeds from sales of securities AFS  | 2,024                                   | 0              |
| Purchases of securities AFS  | (8,116)                                 | 0              |
| Proceeds from sale of bank subsidiary  | 711                                     | 0              |
| Net decrease in loans  | 10,115                                  | 6,472          |
| Sales of other real estate owned   | 530                                     | 153            |
| Acquisition of premises and equipment, net   | (150)                                   | (26)           |
| Net change in discontinued operations investing activities                           | 95,290                                  | 4,017          |
| <br>Net cash provided by investing activities  | <br>103,855                             | <br>12,862     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |   |                |
| Net increase (decrease) in deposits  | 3,193                                   | (12,343)       |
| Net decrease in short term borrowings  | (217)                                   | (97)           |
| Net proceeds from stock issuance and purchase  | 26                                      | 32             |
| Net change in discontinued operations financing activities                           | (103,965)                               | (187)          |
| <br>Net cash used in financing activities  | <br>(100,963)                           | <br>(12,595)   |
| <br>Net change in cash and cash equivalents  | <br>\$ 10,930                           | <br>\$ (3,105) |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Cash and cash equivalents                                 | Beginning | \$ 33,492 | \$ 31,640 |
| Cash and cash equivalents                                 | Ending    | \$ 44,422 | \$ 28,535 |
| Less cash and cash equivalents of discontinued operations |           | 0         | 12,633    |
| Cash and cash equivalents of continuing operations        |           | \$ 44,422 | \$ 15,902 |
| Cash paid for:  |           |           |           |
| Interest  |           | \$ 732    | \$ 1,159  |
| Income taxes  |           | \$ 167    | \$ 249    |
| Non-cash Disclosures:                                     |           |           |           |
| Transfers from loans to other real estate                 |           | \$ 177    | \$ 937    |

6

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**Table of Contents**

**FENTURA FINANCIAL, INC**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

| (000s omitted)   | <b>Three Months<br/>Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2011</b>                                 | <b>2010</b> |
| Net income (loss)  | \$ 310                                      | \$ (483)    |
| Other comprehensive income (loss), net of tax:   |   |             |
| Reclassification adjustment for gains included in income   | 5   | 0           |
| Unrealized holding (losses) gains related to available-for-sale securities arising during period | (285)                                       | 245         |
| Tax effect   | 95  | (83)        |
| Other comprehensive (loss) income  | (185)                                       | 162         |
| Comprehensive income (loss)  | \$ 125                                      | \$ (321)    |

**FENTURA FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1 BASIS OF PRESENTATION**

The consolidated financial statements include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries Fentura Holdings LLC ( FHLLC ) and The State Bank in Fenton, Michigan; and reported as discontinued operations, Davison State Bank in Davison, Michigan and West Michigan Community Bank in Hudsonville, Michigan and the other subsidiaries of the Banks. Intercompany transactions and balances are eliminated in consolidation. In 2009, the Corporation entered into an agreement to sell one of its bank subsidiaries, Davison State Bank, to a private, nonaffiliated investor group. This sale closed on April 30, 2010. Additionally, the Corporation entered into an agreement to sell West Michigan Community Bank to a third-party investor group. This sale closed on January 31, 2011. Both subsidiaries are reported as discontinued operations. See Note 9 for further discussion. Financial statements are presented with discontinued operations sequestered on the balance sheet, income statement and statement of cash flows. The presentations have been updated for March 31, 2011, December 31, 2010 and March 31, 2010 to reflect the discontinued operations results.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation's annual report on Form 10-K for the year ended December 31, 2010.

**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 are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses 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, except for mortgage-

7

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**Table of Contents****NOTE 1 BASIS OF PRESENTATION** (continued)

backed securities, where prepayments are anticipated. 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.

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.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

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 decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, 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. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual loss history experienced by the Corporation over the most recent three years. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential mortgage, installment loans and home equity loans.

**Table of Contents****NOTE 1 BASIS OF PRESENTATION** (continued)

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually 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 rate or at the fair value of collateral 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. Loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loans effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral.

**Other Real Estate Owned and Foreclosed Assets:** Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

**Income Taxes:** Income tax expense is the total 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 amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized 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 Corporation recognizes interest and/or penalties related to income tax matters in income tax expense. There was no such interest or penalties in 2011 or 2010.

**Dividend Restrictions:** Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Banks to the Corporation or by the Corporation to shareholders. The State Bank has been restricted from dividend payments due to the signing of a Consent Order with the Federal Deposit Insurance Corporation (FDIC). The Holding Company has been placed under restrictions by the Federal Reserve regarding the declaration or payment of any dividends and the receipt of dividends from subsidiary Banks.

**Stock Option Plans** Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options were granted in 2011 or 2010.

**Table of Contents****NOTE 1 BASIS OF PRESENTATION** (continued)

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the Plan.

The following table summarizes stock option activity:

|  | Number<br>of<br>Options | Weighted<br>Average<br>Price |
|--|-------------------------|------------------------------|
| Options outstanding and exercisable at January 1, 2011 | 18,872                  | \$ 29.32                     |
| Options forfeited in 2011                              | (2,238)                 | \$ 20.77                     |
| Options outstanding and exercisable at March 31, 2011  | 16,634                  | \$ 30.47                     |

On February 24, 2011, the Corporation's board of directors granted 25,000 Stock Appreciation Rights (SARs) to five executives. The terms of the Stock Appreciation Rights Agreements (a SAR Agreement) provide that the SARs will be paid in cash on one or two fixed dates, which are determined as certain performance conditions are met. The conditions include the Corporation's wholly owned subsidiary, The State Bank, is no longer subject to terms, conditions and restrictions of the consent order dated December 31, 2009 and the Corporation is no longer subject to terms, conditions and restrictions of the agreement between the Corporation and the Federal Reserve Board, which was effective November 4, 2010. The first payment date under the agreement is the later of February 24, 2014, the date on which the restrictions of the consent order of the State Bank is under are met, and the date on which the Corporation is no longer subject to the restrictions of the consent order for the holding company. On the first SAR payment date a participant shall receive an amount equal to the product of the number of stock appreciation rights granted and the excess of the fair market value of one share of common stock over \$2. On the second payment date a participant shall receive an amount equal to the number of stock appreciation rights granted and the excess of the fair market value of one share of common stock over the value at the first payment date. The second SAR payment date only occurs if the first payment occurs and if the first payment occurs, the second payment date is February 24, 2016. Generally accepted accounting principles require plans settled in cash to be accounted for as liabilities only when the liability is probable and reasonably estimable and to be re-measured at each reporting period. Management has determined that as of March 31, 2011, it is not probable that the performance criteria will be met and as such no liability for the compensatory element of the awards has been recorded in the interim consolidated financial statements.

**Operating Segments** While the Corporation's chief decision-makers monitor the revenue streams of the various Corporation products and services, operations are managed and financial performance is evaluated on a Corporate-wide basis. Accordingly, all of the Corporation's financial service operations are considered by management to be aggregated in one reportable operating segment.

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

**NOTE 2 ADOPTION OF NEW ACCOUNTING STANDARDS****New Accounting Pronouncements:**

In July 2010, FASB issued Accounting Standards Update (ASU) No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The ASU amends FASB Accounting Standards Codification Topic 310, Receivables, to improve the disclosures that an entity provides about the credit quality of its financing receivables and the related allowance for credit losses. As a result of these amendments, an entity is required to disaggregate, by portfolio segment or class of financing receivable, certain

existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses. For public entities, the disclosures as of the end of a reporting period were effective for interim and annual reporting periods ending on or after December 15, 2010 and have been added to Note 4. The disclosures about activity that



**Table of Contents****NOTE 2 ADOPTION OF NEW ACCOUNTING STANDARDS** (continued)

occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010 and have been added to Note 4.

In January 2010, the FASB issued ASU 2010-06, Improving Disclosure about Fair Value Measurements. This standard requires new disclosures on the amount and reason for transfers in and out of Level 1 and Level 2 recurring fair value measurements. The standard also requires disclosure of activities (i.e., on a gross basis), including purchases, sales, issuances, and settlements, in the reconciliation of Level 3 fair value recurring measurements. The standard clarifies existing disclosure requirements on levels of disaggregation and disclosures about inputs and valuation techniques. The new disclosures regarding Level 1 and Level 2 fair value measurements and clarification of existing disclosures were effective for periods beginning after December 15, 2009. The disclosures about the reconciliation of information in Level 3 recurring fair value measurements are required for periods beginning after December 15, 2010. Adoption of this standard did not have a significant impact on our quarterly disclosures.

**Newly Issued But Not Yet Effective Accounting Guidance**

In April 2011, the FASB has issued ASU 2011-02, A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This ASU provides guidance for Corporations when determining whether a loan modification is a troubled debt restructuring. The ASU also provides additional disclosure requirements. It is effective for public companies for interim and annual periods beginning on or after June 15, 2011. The guidance is to be applied retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. The Corporation is in the process of determining the impact of adoption.

**NOTE 3 SECURITIES**

Securities are as follows:

| (000s omitted)                                    | Amortized | Gross      | Gross      | Fair      |
|---|-----------|------------|------------|-----------|
| <b>Available for Sale</b>                         | Cost      | Unrealized | Unrealized | Value     |
|   |           | Gains      | Losses     |           |
| March 31, 2011                                    |           |            |            |           |
| U.S. Government and federal agency                | \$ 3,990  | \$ 0       | \$ (19)    | \$ 3,971  |
| Mortgage-backed residential                       | 6,877     | 126        | (39)       | 6,964     |
| Collateralized mortgage obligations-agencies      | 27,946    | 197        | (92)       | 28,051    |
| Collateralized mortgage obligations-private label | 4,077     | 0          | (366)      | 3,711     |
| Equity securities                                 | 2,155     | 39         | (21)       | 2,173     |
|   | \$ 45,045 | \$ 362     | \$ (537)   | \$ 44,870 |
| December 31, 2010                                 |           |            |            |           |
| U.S. Government and federal agency                | \$ 4,005  | \$ 6       | \$ (11)    | \$ 4,000  |
| Mortgage-backed residential                       | 7,342     | 126        | (36)       | 7,432     |
| Collateralized mortgage obligations-agencies      | 24,758    | 258        | (114)      | 24,902    |
| Collateralized mortgage obligations-private label | 4,215     | 0          | (344)      | 3,871     |
| Equity securities                                 | 1,655     | 49         | (34)       | 1,670     |
|   | \$ 41,975 | \$ 439     | \$ (539)   | \$ 41,875 |

**Table of Contents****NOTE 3 SECURITIES** (continued)

| (000s omitted)          | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|-------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>Held to Maturity</b> |                   |                              |                               |               |
| March 31, 2011          |                   |                              |                               |               |
| State and municipal     | \$ 4,349          | \$ 59                        | \$ (1)                        | \$ 4,407      |
|                         | \$ 4,349          | \$ 59                        | \$ (1)                        | \$ 4,407      |
| December 31, 2010       |                   |                              |                               |               |
| State and municipal     | \$ 4,350          | \$ 41                        | \$ (8)                        | \$ 4,383      |
|                         | \$ 4,350          | \$ 41                        | \$ (8)                        | \$ 4,383      |

Contractual maturities of securities at March 31, 2011 were as follows. Securities not due at a single maturity date, mortgage-backed, collateralized mortgage obligations and equity securities are shown separately.

| (000s omitted)                                    | Amortized<br>Cost | Available for Sale<br>Fair<br>Value |
|---|-------------------|-------------------------------------|
| U.S. Government and federal agency                |                   |                                     |
| Due in one year or less                           | \$ 3,990          | \$ 3,971                            |
| Mortgage-backed residential                       | 6,877             | 6,964                               |
| Collateralized mortgage obligations-agencies      | 27,946            | 28,051                              |
| Collateralized mortgage obligations-private label | 4,077             | 3,711                               |
| Equity securities                                 | 2,155             | 2,173                               |
|   | \$ 45,045         | \$ 44,870                           |

| (000s omitted)             | Held to Maturity<br>Amortized<br>Cost | Fair<br>Value |
|----------------------------|---------------------------------------|---------------|
| Due in one year or less    | \$ 1,145                              | \$ 1,151      |
| Due from one to five years | 1,957                                 | 1,987         |
| Due from five to ten years | 879                                   | 897           |
| Due after ten years        | 368                                   | 372           |
|                            | \$ 4,349                              | \$ 4,407      |

At March 31, 2011, there were 2 private label CMO securities, with aggregate holdings totaling \$3,711,000, which exceeded 10% of shareholders' equity. At March 31, 2010, there were holdings totaling \$2,183,000 of private label CMO securities issued by Wells Fargo which exceeded 10% of shareholders' equity.

Sales of available for sale securities were as follows:

| (000s omitted) | Three months<br>ended<br>March 31, 2011 |
|----------------|---|
| Proceeds       | \$ 2,024                                |
| Gross gains    | 5                                       |
| Gross losses   | 0                                       |

There were no sales of available for sale securities for the three months ended March 31, 2010.

The costs basis used to determine the unrealized gains or losses of securities sold was the amortized cost of the individual investment security as of the trade date.

**Table of Contents****NOTE 3 SECURITIES** (continued)

Securities with unrealized losses are aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

| March 31, 2011<br>(000s omitted)<br>Description of Securities | Less than 12 months |                 | 12 months or more |                 | Total            |                 |
|---|---------------------|-----------------|-------------------|-----------------|------------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value       | Unrealized Loss |
| US Government and federal agencies                            | \$ 1,981            | \$ (19)         | \$ 0              | \$ 0            | \$ 1,981         | \$ (19)         |
| State and municipal   | 0                   | 0               | 169               | (1)             | 169              | (1)             |
| Mortgage-backed residential                                   | 3,454               | (39)            | 0                 | 0               | 3,454            | (39)            |
| Collateralized mortgage obligations-agencies                  | 5,674               | (92)            | 0                 | 0               | 5,674            | (92)            |
| Collateralized mortgage obligations-private label             | 0                   | 0               | 3,711             | (366)           | 3,711            | (366)           |
| Equity securities   | 186                 | (14)            | 453               | (7)             | 639              | (21)            |
| <b>Total temporarily impaired</b>                             | <b>\$ 11,295</b>    | <b>\$ (164)</b> | <b>\$ 4,333</b>   | <b>\$ (374)</b> | <b>\$ 15,628</b> | <b>\$ (538)</b> |

| December 31, 2010<br>(000s omitted)<br>Description of Securities | Less than 12 months |                 | 12 months or more |                 | Total            |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value       | Unrealized Loss |
| US Government and federal agencies                               | \$ 1,989            | \$ (11)         | \$ 0              | \$ 0            | \$ 1,989         | \$ (11)         |
| State and municipal  | 365                 | (3)             | 245               | (5)             | 610              | (8)             |
| Mortgage-backed residential                                      | 2,062               | (36)            | 0                 | 0               | 2,062            | (36)            |
| Collateralized mortgage obligations-agencies                     | 6,085               | (114)           | 0                 | 0               | 6,085            | (114)           |
| Collateralized mortgage obligations-private label                | 0                   | 0               | 3,871             | (344)           | 3,871            | (344)           |
| Equity securities  | 186                 | (14)            | 439               | (20)            | 625              | (34)            |
| <b>Total temporarily impaired</b>                                | <b>\$ 10,687</b>    | <b>\$ (178)</b> | <b>\$ 4,555</b>   | <b>\$ (369)</b> | <b>\$ 15,242</b> | <b>\$ (547)</b> |

**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. In evaluating OTTI, management considers the factors presented in Note 1.

As of March 31, 2011, the Corporation's security portfolio consisted of 84 securities, 10 of which were in an unrealized loss position. The majority of unrealized losses are related to the Corporation's collateralized mortgage obligations (CMOs) and equity securities, as discussed below.

**Collateralized Mortgage Obligations**

The decline in fair value of the Corporation's private label collateralized mortgage obligations is primarily attributable to the lack of liquidity and the financial crisis affecting these markets and not necessarily the expected cash flows of the individual securities. The ratings held on the private label securities are AA and A-. The underlying collateral of these CMOs is comprised largely of 1-4 family residences. In each of these securities, the Corporation holds the senior tranche and receives payments before other tranches. For private label securities, management completes an analysis to review the recent performance of the mortgage pools underlying the instruments. At March 31, 2011, the two

private label securities having an amortized cost of \$4,077,000 have an unrealized loss of \$366,000.

**Table of Contents****NOTE 3 SECURITIES** (continued)

The Corporation has also been closely monitoring the performance of the CMO and MBS portfolios. Management monitors items such as payment streams and underlying default rates, and did not determine a severe change in these items. On a quarterly basis, management uses multiple assumptions to project the expected future cash flows of the private label CMOs with prepayment speeds, projected default rates and loss severity rates. The cash flows are then discounted using the effective rate on the securities determined at acquisition. Recent historical experience is the base for determining the cash flow assumptions and is adjusted when appropriate after considering characteristics of the underlying loans collateralizing the private label CMO security.

The Corporation has four agency collateralized mortgage obligations with an unrealized loss of \$92,000. The decline in value is primarily due to changes in interest rates and other market conditions.

**Equity securities**

The Corporation's equity investments with unrealized losses are investments in three non-public bank holding companies in Michigan. These securities receive a multi-faceted review utilizing call report data. Management reviews such performance indicators as earnings, ROE, ROA, non-performing assets, brokered deposits and capital ratios. Management draws conclusions from this information, as well as any published information or trading activity received from the individual institutions, to assist in determining if any unrealized loss is other than temporary impairment.

Additionally management considers the length of time the investments have been at an unrealized loss. At the end of the first quarter, management performed its review and determined that no additional other-than-temporary impairment was necessary on the equity securities in the portfolio.

**NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES**

Major categories of loans are as follows:

| (000s omitted)                 | March 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|-------------------|----------------------|
| Commercial                     | \$ 41,384         | \$ 43,395            |
| Real estate commercial         | 99,350            | 106,784              |
| Real estate construction       | 8,380             | 9,597                |
| Real estate mortgage           | 19,219            | 19,046               |
| Consumer                       | 27,543            | 29,153               |
|                                | 195,876           | 207,975              |
| Less allowance for loan losses | 9,015             | 10,027               |
|                                | \$ 186,861        | \$ 197,948           |

The Corporation has originated primarily residential and commercial real estate loans, commercial, construction and installment loans. The Corporation estimates that the majority of their loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan with the remainder of the portfolio distributed throughout Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

Activity in the allowance for loan losses, by classification, for the three month period ended March 31, 2011 is as follows:

| (000s omitted)               | <b>Commercial</b> | <b>Commercial<br/>Real<br/>Estate</b> | <b>Residential<br/>Real<br/>Estate</b> | <b>Installment<br/>Loans</b> | <b>Home<br/>Equity</b> | <b>Unallocated</b> | <b>Total</b> |
|------------------------------|-------------------|---------------------------------------|--|------------------------------|------------------------|--------------------|--------------|
| Balance January 1,<br>2011   |                   |                                       |  |                              |                        |                    |              |
| Allowance for loan<br>losses | \$ 869            | \$ 7,942                              | \$ 411                                 | \$ 233                       | \$ 508                 | \$ 64              | \$ 10,027    |
| Provision for loan<br>losses | (158)             | 888                                   | (4)                                    | (17)                         | 148                    | (62)               | 795          |
| Loans charged off            | 0                 | (1,818)                               | (11)                                   | (32)                         | (98)                   | 0                  | (1,959)      |
| Loan recoveries              | 6                 | 124                                   | 1                                      | 6                            | 15                     | 0                  | 152          |
| Balance March 31,<br>2011    | \$ 717            | \$ 7,136                              | \$ 397                                 | \$ 190                       | \$ 573                 | \$ 2               | \$ 9,015     |

Activity in the allowance for loan losses, for the three month period ended March 31, 2010 is as follows:

|                           |          |
|---------------------------|----------|
| (000s omitted)            |          |
| Balance, January 1, 2010  | \$ 8,589 |
| Provision for loan losses | 1,135    |
| Loans charged off:        |          |
| Commercial                | (104)    |
| Commercial real estate    | (323)    |
| Installment               | (53)     |
| Home equity               | (56)     |
| Residential real estate   | (78)     |
| Total loans charged off   | (614)    |
| Loan recoveries:          |          |
| Commercial                | 19       |
| Commercial real estate    | 539      |
| Installment               | 18       |
| Home equity               | 0        |
| Residential real estate   | 0        |
| Total loan recoveries     | 576      |
| Balance, March 31, 2010   | \$ 9,686 |

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

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

| (000s omitted)                                  |                   | <b>Commercial</b>  | <b>Residential</b> |                          |                    |                    |              |  |
|---|-------------------|--------------------|--------------------|--------------------------|--------------------|--------------------|--------------|--|
| March 31, 2011                                  | <b>Commercial</b> | <b>Real Estate</b> | <b>Real Estate</b> | <b>Installment Loans</b> | <b>Home Equity</b> | <b>Unallocated</b> | <b>Total</b> |  |
| Allowance for loan losses:                      |                   |                    |                    |                          |                    |                    |              |  |
| Ending allowance balance attributable to loans: |                   |                    |                    |                          |                    |                    |              |  |
| Individually evaluated for impairment           | \$ 279            | \$ 4,083           | \$ 56              | \$ 112                   | \$ 180             | \$ 0               | \$ 4,710     |  |
| Collectively evaluated for impairment           | 438               | 3,053              | 341                | 78                       | 393                | 2                  | 4,305        |  |
| Total ending allowance balance                  | \$ 717            | \$ 7,136           | \$ 397             | \$ 190                   | \$ 573             | \$ 2               | \$ 9,015     |  |
| Loans:  |                   |                    |                    |                          |                    |                    |              |  |
| Loans individually evaluated for impairment     | \$ 2,964          | \$ 23,438          | \$ 1,019           | \$ 393                   | \$ 275             | \$ 0               | \$ 28,089    |  |
| Loans collectively evaluated for impairment     | 38,420            | 84,292             | 18,200             | 7,423                    | 19,452             | 0                  | 167,787      |  |
| Total ending loans balance                      | 41,384            | 107,730            | 19,219             | 7,816                    | 19,727             | 0                  | 195,876      |  |
| Accrued interest receivable                     | 124               | 390                | 73                 | 49                       | 58                 | 0                  | 694          |  |
| Total recorded investment in loans              | \$ 41,508         | \$ 108,120         | \$ 19,292          | \$ 7,865                 | \$ 19,785          | \$ 0               | \$ 196,570   |  |

| (000s omitted)    |                   | <b>Commercial</b>  | <b>Residential</b> |                          | <b>Home</b>   |                    |              |
|-------------------|-------------------|--------------------|--------------------|--------------------------|---------------|--------------------|--------------|
| December 31, 2010 | <b>Commercial</b> | <b>Real Estate</b> | <b>Real Estate</b> | <b>Installment Loans</b> | <b>Equity</b> | <b>Unallocated</b> | <b>Total</b> |

Allowance for loan losses:  
Ending allowance balance attributable to loans:



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|   |           |            |           |          |           |       |            |
|---|-----------|------------|-----------|----------|-----------|-------|------------|
| Individually evaluated for impairment       | \$ 184    | \$ 5,962   | \$ 95     | \$ 69    | \$ 160    | \$ 18 | \$ 6,488   |
| Collectively evaluated for impairment       | 685       | 1,980      | 316       | 164      | 348       | 46    | 3,539      |
| Total ending allowance balance              | \$ 869    | \$ 7,942   | \$ 411    | \$ 233   | \$ 508    | \$ 64 | \$ 10,027  |
| Loans:                                      |           |            |           |          |           |       |            |
| Loans individually evaluated for impairment | \$ 1,183  | \$ 25,602  | \$ 1,069  | \$ 228   | \$ 357    | \$ 0  | \$ 28,439  |
| Loans collectively evaluated for impairment | 42,212    | 90,779     | 17,977    | 7,798    | 20,770    | 0     | 179,536    |
| Total ending loans balance                  | \$ 43,395 | \$ 116,381 | \$ 19,046 | \$ 8,026 | \$ 21,127 | \$ 0  | \$ 207,975 |
| Accrued interest receivable                 | 357       | 429        | 76        | 55       | 58        | 0     | 975        |
| Total recorded investment in loans          | \$ 43,752 | \$ 116,810 | \$ 19,122 | \$ 8,081 | \$ 21,185 | \$ 0  | \$ 208,950 |

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

The following table presents loans individually evaluated for impairment by class of loans as of:

|                                      | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan<br>Losses<br>Allocated |
|--------------------------------------|--------------------------------|------------------------|--|
| March 31, 2011                       |                                |                        |  |
| With no related allowances recorded: |                                |                        |  |
| Commercial                           | \$ 2,237                       | \$ 2,239               | \$ 0   |
| Commercial Real Estate               |                                |                        |  |
| Construction                         | 428                            | 428                    | 0  |
| Other                                | 4,789                          | 4,802                  | 0  |
| Residential real estate              | 567                            | 567                    | 0  |
| Consumer                             |                                |                        |  |
| Installment Loans                    | 238                            | 239                    | 0  |
| With an allowance recorded:          |                                |                        |  |
| Commercial                           | 727                            | 728                    | 279  |
| Commercial real estate:              |                                |                        |  |
| Construction                         | 4,972                          | 4,973                  | 389  |
| Other                                | 13,249                         | 13,285                 | 3,694  |
| Residential real estate              | 452                            | 509                    | 56   |
| Consumer                             |                                |                        |  |
| Installment loans                    | 155                            | 157                    | 112  |
| Home equity                          | 275                            | 276                    | 180  |
| Total                                | \$ 28,089                      | \$ 28,203              | \$ 4,710                                     |

|                                      | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan<br>Losses<br>Allocated |
|--------------------------------------|--------------------------------|------------------------|--|
| December 31, 2010                    |                                |                        |  |
| With no related allowances recorded: |                                |                        |  |
| Commercial                           | \$ 490                         | \$ 490                 | \$ 0   |
| Commercial Real Estate               |                                |                        |  |
| Construction                         | 149                            | 149                    | 0  |
| Other                                | 4,034                          | 4,036                  | 0  |
| Residential real estate              | 544                            | 544                    | 0  |
| Consumer                             |                                |                        |  |
| Installment Loans                    | 116                            | 116                    | 0  |
| Home Equity                          | 74                             | 75                     | 0  |
| With an allowance recorded:          |                                |                        |  |
| Commercial                           | 693                            | 696                    | 184  |
| Commercial real estate:              |                                |                        |  |
| Construction                         | 348                            | 348                    | 101  |
| Other                                | 21,071                         | 21,161                 | 5,879  |
| Residential real estate              | 525                            | 529                    | 95   |

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|                   |           |    |        |          |
|-------------------|-----------|----|--------|----------|
| Consumer          |           |    |        |          |
| Installment loans | 112       |    | 112    | 69       |
| Home equity       | 283       |    | 284    | 160      |
| Total             | \$ 28,439 | \$ | 28,540 | \$ 6,488 |

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

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.

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans at:

| March 31, 2011              |                   | Loans Past Due Over<br>90<br>Days Still Accruing |
|-----------------------------|-------------------|--|
| (000s omitted)              | Nonaccrual<br>(1) | (2)  |
| Commercial                  | \$ 1,746          | \$ 0   |
| Commercial real estate      |                   |  |
| Construction                | 5,256             | 0  |
| Other                       | 7,610             | 418  |
| Consumer                    |                   |  |
| Home Equity                 | 0                 | 154  |
| Installment loans           | 115               | 5  |
| Residential real estate (1) | 522               | 0  |
| Total                       | \$ 15,249         | \$ 577   |

(1) -Includes deferred fees and costs of \$1

(2) -Includes accrued interest receivable of \$13

| December 31, 2010       |            | Loans Past Due Over<br>90<br>Days Still Accruing |
|-------------------------|------------|--|
| (000s omitted)          | Nonaccrual | (1)  |
| Commercial              | \$ 1,847   | \$ 0   |
| Commercial real estate  |            |  |
| Construction            | 5,234      | 0  |
| Other                   | 4,799      | 0  |
| Consumer                |            |  |
| Installment loans       | 121        | 0  |
| Residential real estate | 495        | 135  |
| Total                   | \$ 12,496  | \$ 135   |

(1) -Includes accrued interest receivable of \$2

The following table presents the aging of the recorded investment in past due loans by class of loans at:

| (000s omitted) | 30-59<br>Days | Greater than<br>90 |
|----------------|---------------|--------------------|
| March 31, 2011 |               |                    |

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|                         | Past<br>Due | 60-89 Days Past<br>Due | Days Past<br>Due | Total Past<br>Due |
|-------------------------|-------------|------------------------|------------------|-------------------|
| Commercial              | \$ 173      | \$ 327                 | \$ 1,658         | \$ 2,158          |
| Commercial real estate: |             |                        |                  |                   |
| Construction            | 867         | 0                      | 4,447            | 5,314             |
| Other                   | 1,368       | 1,939                  | 7,225            | 10,532            |
| Consumer:               |             |                        |                  |                   |
| Installment loans       | 11          | 11                     | 97               | 119               |
| Home Equity             | 87          | 0                      | 153              | 240               |
| Residential real estate |             |                        |                  |                   |
| Traditional             | 0           | 0                      | 522              | 522               |
| Total                   | \$ 2,506    | \$ 2,277               | \$ 14,102        | \$ 18,885         |

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

| (000s omitted)          | 30-59<br>Days<br>Past<br>Due | 60-89 Days<br>Past Due | Greater than<br>90<br>Days Past Due<br>(1) | Total Past<br>Due |
|-------------------------|------------------------------|------------------------|--|-------------------|
| December 31, 2010       |                              |                        |  |                   |
| Commercial              | \$ 26                        | \$ 235                 | \$ 1,209                                   | \$ 1,470          |
| Commercial real estate: |                              |                        |  |                   |
| Construction            | 0                            | 141                    | 4,748                                      | 4,889             |
| Other                   | 1,186                        | 11                     | 4,133                                      | 5,330             |
| Consumer:               |                              |                        |  |                   |
| Installment loans       | 46                           | 4                      | 96   | 146               |
| Home Equity             | 118                          | 5                      | 0  | 123               |
| Residential real estate |                              |                        |  |                   |
| Traditional             | 156                          | 0                      | 630  | 786               |
| Total                   | \$ 1,532                     | \$ 396                 | \$ 10,816                                  | \$ 12,744         |

**Renegotiated loans:**

Renegotiated loans totaled \$4,976,000 at March 31, 2011 compared to \$3,654,000 at December 31, 2010.

The Corporation allocated \$2,585,000 and \$71,000 of specific reserves to customers whose loan terms have been modified in renegotiated loans as of March 31, 2011 and December 31, 2010. Renegotiated loans are also included with impaired loans. The Corporation has no additional amounts committed to these customers.

**Loans in discontinued operations:**

As part of the terms of the sale of West Michigan Community Bank, certain non performing assets were transferred to a newly formed subsidiary of the Corporation. The subsidiary acquired \$1,100,000 of substandard loans, \$4,400,000 of non-accrual loans and \$800,000 of real estate in redemption. The loans were recorded at book value at the date of transfer.

Additionally \$2,900,000 of watch credit grade loans were transferred to The State Bank. The total of all loans transferred was \$9,200,000.

**Credit Quality Indicators:**

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience; credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Corporation uses the following definitions for classified risk ratings:

**Watch.** Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Table of Contents****NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES** (continued)

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The Corporation does not classify loans as doubtful. Loans that approach this status are charged-off.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be prime or pass rated loans. Based on the most recent analysis performed, the recorded investment by risk category of loans by class of loans is as follows:

(000s omitted)

| March 31, 2011          | Prime    | Pass       | Watch     | Substandard | Total      |
|-------------------------|----------|------------|-----------|-------------|------------|
| Commercial              | \$ 4,362 | \$ 32,430  | \$ 1,752  | \$ 2,964    | \$ 41,508  |
| Commercial real estate: |          |            |           |             |            |
| Construction            | 0        | 815        | 1,201     | 4,501       | 6,517      |
| Other                   | 0        | 72,199     | 10,414    | 18,990      | 101,603    |
| Total                   | \$ 4,362 | \$ 105,444 | \$ 13,367 | \$ 26,455   | \$ 149,628 |

(000s omitted)

| December 31, 2010       | Prime    | Pass       | Watch     | Substandard | Total      |
|-------------------------|----------|------------|-----------|-------------|------------|
| Commercial              | \$ 3,174 | \$ 33,871  | \$ 3,530  | \$ 3,177    | \$ 43,752  |
| Commercial real estate: |          |            |           |             |            |
| Construction            | 0        | 755        | 1,414     | 6,979       | 9,148      |
| Other                   | 0        | 81,739     | 9,863     | 16,060      | 107,662    |
| Total                   | \$ 3,174 | \$ 116,365 | \$ 14,807 | \$ 26,216   | \$ 160,562 |

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

(000s omitted)

| March 31, 2011 | Consumer    |             | Residential | Total     |
|----------------|-------------|-------------|-------------|-----------|
|                | Home Equity | Installment | Real Estate |           |
| Performing     | \$ 19,510   | \$ 7,472    | \$ 18,273   | \$ 45,255 |
| Non-performing | 275         | 393         | 1,019       | 1,687     |
| Total          | \$ 19,785   | \$ 7,865    | \$ 19,292   | \$ 46,942 |

(000s omitted)

| December 31, 2010 | Consumer    |             | Residential | Total     |
|-------------------|-------------|-------------|-------------|-----------|
|                   | Home Equity | Installment | Real Estate |           |
| Performing        | \$ 21,128   | \$ 7,553    | \$ 18,053   | \$ 46,734 |
| Non-performing    | 57          | 528         | 1,069       | 1,654     |

|       |           |          |           |           |
|-------|-----------|----------|-----------|-----------|
| Total | \$ 21,185 | \$ 8,081 | \$ 19,122 | \$ 48,388 |
|-------|-----------|----------|-----------|-----------|

20

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**Table of Contents**

**NOTE 5 FAIR VALUE**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

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

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

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

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance. The Corporation reviews the performance of the securities that comprise level 3 on a quarterly basis.

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

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

**Table of Contents****NOTE 5 FAIR VALUE** (continued)Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

| (000s omitted)                                       | Total     | Fair Value Measurements Using   |   |  |
|--|-----------|---|---|--|
|  |           | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| March 31, 2011                                       |           |   |   |  |
| Available for sale securities                        |           |   |   |  |
| US Government and federal agency                     | \$ 3,971  | \$ 0  | \$ 3,971  | \$ 0   |
| Mortgage-backed residential                          | 6,964     | 0   | 6,964   | 0  |
| Collateralized mortgage obligations-agency           | 28,051    | 0   | 28,051  | 0  |
| Collateralized mortgage obligations-private<br>label | 3,711     | 0   | 3,711   | 0  |
| Equity securities                                    | 2,173     | 0   | 1,013   | 1,160  |
|  | \$ 44,870 | \$ 0  | \$ 43,710   | \$ 1,160   |

| (000s omitted)                                       | Total     | Fair Value Measurements Using   |   |  |
|--|-----------|---|---|--|
|  |           | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| December 31, 2010                                    |           |   |   |  |
| Available for sale securities                        |           |   |   |  |
| US Government and federal agency                     | \$ 4,000  | \$ 0  | \$ 4,000  | \$ 0   |
| Mortgage-backed residential                          | 7,432     | 0   | 7,432   | 0  |
| Collateralized mortgage obligations-agency           | 24,902    | 0   | 24,902  | 0  |
| Collateralized mortgage obligations-private<br>label | 3,871     | 0   | 3,871   | 0  |
| Equity securities                                    | 1,670     | 0   | 523   | 1,147  |
|  | \$ 41,875 | \$ 0  | \$ 40,728   | \$ 1,147   |

During 2010, \$1,445,000 of equity securities were transferred from level 2 to level 3 due to no observable trades which resulted in and a change in valuation methodology.



**Table of Contents****NOTE 5 FAIR VALUE** (continued)

The table below presents a reconciliation including the respective income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

| (000s omitted)                                | Equity Securities |          |
|---|-------------------|----------|
|   | 2011              | 2010     |
| Beginning balance, Jan. 1,                    | \$ 1,147          | \$ 1,229 |
| Total gains or losses (realized / unrealized) |                   |          |
| Included in other comprehensive income        | 13                | (239)    |
| Ending balance, March 31,                     | \$ 1,160          | \$ 990   |

Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

| (000s omitted)                | Total    | Quoted Prices<br>in Active<br>Markets | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|----------|---------------------------------------|---|--|
|                               |          | for Identical<br>Assets<br>(Level 1)  |   |  |
| At March 31, 2011             |          |                                       |   |  |
| Impaired loans                |          |                                       |   |  |
| Commercial                    | \$ 174   | \$ 0                                  | \$ 0  | \$ 174   |
| Commercial real estate        | 7,318    | 0                                     | 0   | 7,318  |
| Residential real estate       | 648      | 0                                     | 0   | 648  |
| Consumer                      | 521      | 0                                     | 0   | 521  |
| Total impaired loans          | \$ 8,661 | \$ 0                                  | \$ 0  | \$ 8,661   |
| Other real estate owned       |          |                                       |   |  |
| Commercial real estate        | \$ 309   | \$ 0                                  | \$ 0  | \$ 309   |
| Total other real estate owned | \$ 309   | \$ 0                                  | \$ 0  | \$ 309   |
| At December 31, 2010          |          |                                       |   |  |
| Impaired loans                |          |                                       |   |  |
| Commercial                    | \$ 599   | \$ 0                                  | \$ 0  | \$ 599   |
| Commercial real estate        | 7,066    | 0                                     | 0   | 7,066  |
| Residential real estate       | 716      | 0                                     | 0   | 716  |
| Consumer                      | 355      | 0                                     | 0   | 355  |
| Total impaired loans          | \$ 8,736 | \$ 0                                  | \$ 0  | \$ 8,736   |

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|                               |        |    |   |    |   |        |
|-------------------------------|--------|----|---|----|---|--------|
| Other real estate owned       |        |    |   |    |   |        |
| Commercial real estate        | \$ 235 | \$ | 0 | \$ | 0 | \$ 235 |
| Residential real estate       | 60     |    | 0 |    | 0 | 60     |
| Total other real estate owned | \$ 295 | \$ | 0 | \$ | 0 | \$ 295 |

The following represent impairment charges recognized during the period:

At March 31, 2011, impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal amount of \$11,000,000 with a valuation allowance of \$2,339,000. No additional provision for loan losses was required for the three month period

**Table of Contents****NOTE 5 FAIR VALUE** (continued)

ending March 31, 2011. This is compared to December 31, 2010 when the principal amount of impaired loans was \$12,500,000 with a valuation allowance of \$3,764,000.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,362,000, of which \$309,000 was at fair value at March 31, 2011, resulting from write-downs totaling \$34,000 for the three month period. At December 31, 2010, other real estate owned had a net carrying amount of \$2,742,000, of which \$295,000 was at fair value.

Carrying amount and estimated fair value of financial instruments, not previously presented were as follows:

| (000s omitted)                   | March 31, 2011  |            | December 31, 2010 |            |
|----------------------------------|-----------------|------------|-------------------|------------|
|                                  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| <b>Assets:</b>                   |                 |            |                   |            |
| Cash and cash equivalents        | \$ 44,422       | \$ 44,422  | \$ 33,492         | \$ 33,492  |
| Securities held to maturity      | 4,349           | 4,407      | 4,350             | 4,383      |
| Loans held for sale              | 486             | 486        | 850               | 850        |
| Loans (including impaired loans) | 186,861         | 180,965    | 197,948           | 194,925    |
| FHLB stock                       | 740             | 740        | 740               | 740        |
| Accrued interest receivable      | 1,060           | 1,060      | 1,050             | 1,050      |
| <b>Liabilities:</b>              |                 |            |                   |            |
| Deposits                         | \$ 279,170      | \$ 273,563 | \$ 275,977        | \$ 272,223 |
| Short-term borrowings            | 662             | 662        | 879               | 879        |
| FHLB advances                    | 954             | 1,180      | 954               | 1,369      |
| Subordinated debentures          | 14,000          | 12,614     | 14,000            | 12,613     |
| Accrued interest payable         | 1,273           | 1,273      | 1,166             | 1,166      |

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

**Cash and cash equivalents:** The carrying amounts reported in the balance sheet for cash and short-term instruments approximate their fair values.

**Securities:** Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

**FHLB Stock:** It was not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

**Loans held for sale:** The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

**Loans:** For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans is estimated using discounted cash flow analysis. The carrying amount of accrued interest receivable approximates its fair value.

**Off-balance-sheet instruments:** The fair value of off-balance sheet items is not considered material.

**Deposit liabilities:** The fair values disclosed for demand deposits are, by definition equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money

**Table of Contents****NOTE 5 FAIR VALUE** (continued)

market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using discounted cash flow calculation that applies interest rates currently being offered on similar certificates. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings: The carrying amounts of federal funds purchased and other short-term borrowings approximate their fair values.

FHLB advances: Rates currently available for FHLB debt with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

Subordinated Debentures: The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

Limitations: Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on management's judgments regarding future expected loss experience, current economic conditions, risk characteristics and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

**NOTE 6 INCOME TAXES**

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. Management has reviewed the deferred tax position for the Corporation at March 31, 2011 and December 31, 2010. The Corporation's evaluation of taxable events, losses in recent years and the continuing deterioration of the Michigan economy led management to conclude that it was more likely than not that the benefit would not be realized. As a result, the Corporation maintained a full valuation allowance at March 31, 2011 and December 31, 2010.

An income tax benefit associated with continuing operations in the amount of \$200,000 and \$300,000 was recorded for the periods ending March 31, 2011 and 2010, respectively. The benefit recorded considers the results of current period adjustments to other comprehensive income and discontinued operations. Generally, the calculation for income tax expense (benefit) does not consider the tax effects of changes in other comprehensive income or loss, which is a component of shareholders' equity on the balance sheet. However, an exception is provided in certain circumstances when there is a pre-tax loss from continuing operations and income from other categories such as other comprehensive income or discontinued operations. In such case, pre-tax income from other categories is included in the tax expense (benefit) calculation for the current period.

There were no unrecognized tax benefits at March 31, 2011 or December 31, 2010, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months. The Corporation and its subsidiaries are subject to U.S. federal income taxes as well as income tax of the state of Michigan. The Corporation is no longer subject to examination by taxing authorities for years before 2007.

**NOTE 7 EARNINGS PER COMMON SHARE**

A reconciliation of the numerators and denominators used in the computation of basic earnings per common share and diluted earnings per common share is presented below. Earnings per common share are presented below for the three months ended March 31, 2011 and 2010:

**Table of Contents****NOTE 7 EARNINGS PER COMMON SHARE** (continued)

The factors in the earnings per share computation follow.

| (000s omitted except share and per share data)                                 | Three Months Ended |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2011               | 2010      |
| Basic  |                    |           |
| Net income (loss)  | \$ 310             | \$ (483)  |
| Weighted average common shares outstanding                                     | 2,309,912          | 2,249,917 |
| Basic income (loss) per common share   | \$ 0.13            | \$ (0.21) |
| Diluted  |                    |           |
| Net income (loss)  | \$ 310             | \$ (483)  |
| Weighted average common shares outstanding for basic earnings per common share | 2,309,912          | 2,249,917 |
| Add: Dilutive effects of assumed exercises of stock options                    | 0                  | 0         |
| Average shares and dilutive potential common shares                            | 2,309,912          | 2,249,917 |
| Diluted income (loss) per common share   | \$ 0.13            | \$ (0.21) |

The factors in the earnings per share of continuing operations follow:

| (000s omitted except share and per share data)                                 | Three Months Ended |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2011               | 2010      |
| Basic  |                    |           |
| Net loss of continuing operations  | \$ (148)           | \$ (312)  |
| Weighted average common shares outstanding                                     | 2,309,912          | 2,249,917 |
| Basic loss per common share from continuing operations                         | \$ (0.06)          | \$ (0.14) |
| Diluted  |                    |           |
| Net loss of continuing operations  | \$ (148)           | \$ (312)  |
| Weighted average common shares outstanding for basic earnings per common share | 2,309,912          | 2,249,917 |
| Add: Dilutive effects of assumed exercises of stock options                    | 0                  | 0         |
| Average shares and dilutive potential common shares                            | 2,309,912          | 2,249,917 |
| Diluted loss per common share from continuing operations                       | \$ (0.06)          | \$ (0.14) |

Stock options of 16,634 and 16,755 shares of common stock outstanding at March 31, 2011 and March 31, 2010, respectively were not considered in computing diluted earnings per common share for 2011 and 2010, because they were antidilutive.



**NOTE 8 COMMITMENTS AND CONTINGENCIES**

There are various contingent liabilities that are not reflected in the financial statements including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, there are no matters which are expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

**Table of Contents****NOTE 9 DISCONTINUED OPERATIONS**

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank. The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium to book). As a condition of the sale, the Corporation assumed certain non-performing assets of West Michigan Community Bank which totaled \$9,900,000. The assets are housed in a newly formed real estate holding company subsidiary of the Corporation. In addition, The State Bank assumed \$2,900,000 of watch rated credits. A condensed balance sheet of discontinued operations, at March 31, 2011, is presented below.

**LOANS AND OTHER REAL ESTATE ASSUMED  
CONDENSED BALANCE SHEET OF DISCONTINUED OPERATIONS**

**(Unaudited)**  
(000s omitted)

|                         | Mar 31, 2011  |
|-------------------------|---------------|
| <b>ASSETS</b>           |               |
| Loans                   | 6,949         |
| Other real estate owned | 4,438         |
| <br>Total assets        | <br>\$ 11,387 |

As discussed above, West Michigan Community Bank was sold to a third party investor group as of January 31, 2011. As a result there is no balance sheet presentation at March 31, 2011. A condensed balance sheet of discontinued operations is presented below at December 31, 2010.

**WEST MICHIGAN COMMUNITY BANK  
CONDENSED BALANCE SHEET OF DISCONTINUED OPERATIONS**

**(Unaudited)**  
(000s omitted)

|  | Dec 31, 2010   |
|--|----------------|
| <b>ASSETS</b>                                  |                |
| Cash and cash equivalents                      | \$ 8,309       |
| Securities available for sale                  | 15,080         |
| Loans, net of allowance (\$3,543-2010)         | 86,353         |
| Other assets                                   | 13,226         |
| <br>Total assets                               | <br>\$ 122,968 |
| <br><b>LIABILITIES AND SHAREHOLDERS EQUITY</b> |                |
| Deposits:                                      |                |
| Non-interest bearing                           | \$ 13,751      |
| Interest bearing                               | 93,546         |
| <br>Total deposits                             | <br>107,297    |
| Federal Home Loan Bank advances                | 5,000          |
| Accrued taxes, interest and other liabilities  | 1,024          |
| Shareholders equity                            | 9,647          |
| <br>Total liabilities and shareholders equity  | <br>\$ 122,968 |



**Table of Contents****NOTE 9 DISCONTINUED OPERATIONS** (continued)

A condensed statement of income of discontinued operations related to loans and other real estate assumed upon the sale of West Michigan Community Bank is presented for the three months ended March 31, 2011. Due to the transfer of loans at January 31, 2011, only two months of income and expense are presented.

**LOANS AND OTHER REAL ESTATE ASSUMED**  
**CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**  
**Unaudited**  
**(000s omitted)**

|   | Period<br>Ended<br>March 31<br>2011 |
|---|-------------------------------------|
| Interest income                                     | \$ 1                                |
| Net interest income after provision for loan losses | 1                                   |
| Non-interest income                                 | 41                                  |
| Non-interest expense                                | 158                                 |
| Loss before federal income tax                      | (116)                               |
| Federal income tax expense (benefit)                | 0                                   |
| Net income (loss)                                   | \$ (116)                            |

Due to the sale of West Michigan Community Bank on January 31, 2011, the income statement for 2011 represents a one month period.

**WEST MICHIGAN COMMUNITY BANK**  
**CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**  
**Unaudited**  
**(000s omitted)**

|   | Periods Ended<br>March 31 |          |
|---|---------------------------|----------|
|   | 2011                      | 2010     |
| Interest income                                     | \$ 515                    | \$ 1,796 |
| Interest expense                                    | 129                       | 754      |
| Net interest income                                 | 386                       | 1,042    |
| Provision for loan losses                           | (50)                      | 655      |
| Net interest income after provision for loan losses | 436                       | 387      |
| Non-interest income                                 | 121                       | 232      |
| Non-interest expense                                | 415                       | 1,284    |
| Income (loss) before federal income tax             | 142                       | (665)    |

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|                                      |        |          |
|--------------------------------------|--------|----------|
| Federal income tax expense (benefit) | 37     | (7)      |
| Net income (loss)                    | \$ 105 | \$ (658) |

**Table of Contents****NOTE 9 DISCONTINUED OPERATIONS** (continued)

In March 2009, The Corporation entered into an agreement to sell all of the stock of one of its bank subsidiaries, Davison State Bank, to a private, non-affiliated, investor group. As of April 30, 2010, Davison State Bank was sold to an independent financial group. As a result, there is no balance sheet for presentation at March 31, 2011.

A condensed statement of income of discontinued operations is presented for the three months ended March 31, 2010. Due to the sale of Davison State Bank, there is no income statement for presentation for the three month period ended March 31, 2011.

**DAVISON STATE BANK**  
**CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**  
**(Unaudited)**  
**(000s omitted)**

|   | Three<br>Months<br>Ended<br>March 31<br>2010 |
|---|--|
| Interest income   | \$ 457                                       |
| Interest expense  | 89   |
| Net interest income   | 368  |
| Provision for loan losses                                     | (5)  |
| Net interest income after provision for loan losses           | 373  |
| Non-interest income   | 127  |
| Non-interest expense  | 470  |
| Income before federal income tax                              | 30   |
| Reversal of estimated loss on sale of discontinued operations | 700  |
| Federal income tax expense                                    | 243  |
| Net income  | \$ 487                                       |

During the first quarter of 2010, the Corporation reversed a previously recorded gross estimated loss of \$700,000 related to the sale of Davison State Bank.

**TOTAL DISCONTINUED OPERATIONS**  
**CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**  
**Unaudited**  
**(000s omitted)**

|                  | Periods Ended<br>March 31 |          |
|------------------|---------------------------|----------|
|                  | 2011                      | 2010     |
| Interest income  | \$ 516                    | \$ 2,253 |
| Interest expense | 129                       | 843      |

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|   |         |          |
|---|---------|----------|
| Net interest income                                 | 387     | 1,410    |
| Provision for loan losses                           | (50)    | 650      |
| Net interest income after provision for loan losses | 437     | 760      |
| Non-interest income                                 | 162     | 1,059    |
| Non-interest expense                                | 573     | 1,754    |
| Income before federal income tax                    | 26      | 65       |
| Federal income tax expense                          | 37      | 236      |
| Net loss  | \$ (11) | \$ (171) |

In connection with the sale of West Michigan Community Bank, the Corporation recognized a gross gain of \$711,000. Net of tax the net gain amounted to \$469,000.

**Table of Contents****NOTE 10-REGULATORY MATTERS**

The Corporation (on a consolidated basis) and its Bank subsidiaries are subject to various regulatory capital requirements administered by the federal and state regulatory agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items that are calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require FDIC insured Banks to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of March 31, 2011 and December 31, 2010, the most recent notifications from Federal Deposit Insurance Corporation categorized the subsidiary Bank was adequately capitalized in accordance with standards.

West Michigan Community Bank was placed under a Consent Order with federal and state banking regulators containing provisions to foster improvement in West Michigan Community Bank's earnings, reduce non performing loan levels, and increase capital. The Consent Order required West Michigan Community Bank to retain a Tier 1 capital to average assets ratio of a minimum of 8.0%. As of December 31, 2010, West Michigan Community Bank had a Tier 1 capital to average assets ratio of 7.5%. West Michigan Community Bank was not in compliance with the Consent Order requirements. As previously mentioned, West Michigan Community Bank was sold on January 31, 2011.

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators containing provisions to foster improvement in The State Bank's earnings, reduce nonperforming loan levels, increase capital, and require revisions to various policies. The Consent Order requires The State Bank to maintain a Tier 1 capital to average asset ratio of a minimum of 8.0%. It also requires The State Bank to maintain a total capital to risk weighted asset ratio of 12.0%. At March 31, 2011, The State Bank had a Tier 1 capital to average assets ratio of 6.8% and a total capital to risk-weighted assets ratio of 9.6%. The State Bank is not in compliance with the Consent Order requirements, and therefore cannot be considered well capitalized.

The Consent Orders restrict the Banks from issuing or renewing brokered deposits. The Consent Orders also restrict dividend payments from The State Bank to the Corporation. The Corporation, the Board of Directors and management continue to work on plans to come into compliance with the Consent Orders recent actions included the injection of capital into The State Bank resulting from the sale of West Michigan Community Bank. At January 31, 2011, \$900,000 of capital was injected into The State Bank. Future capital injections are anticipated following the sale of non-performing assets acquired by the newly formed holding company. It is anticipated that an additional \$2,400,000 of capital that may be allocated to The State Bank following the sale of non-performing assets from the holding company. While below the compliance level required by the Orders, the Bank maintains capital levels that would be considered well capitalized by regular prompt corrective action regulatory standards. Non-compliance with Consent Order requirements may cause bank to be subject to further enforcement actions by the FDIC.

Effective in November 2010, the Corporation received a notice from The Federal Reserve which defined restrictions being placed upon the holding company. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in



**Table of Contents****NOTE 10-REGULATORY MATTERS** (continued)

Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an expectation that the Corporation maintain sufficient capital levels.

As illustrated in the table below, at March 31, 2011, the Consolidated Corporation's total capital to risk weighted assets ratio indicates that it is adequately capitalized. The Corporation's total capital to risk weighted assets ratio of 10.9% at March 31, 2011 was above the minimum requirement to be adequately capitalized of 8.0%. This is compared to December 31, 2010 when the total capital to risk weighted assets for the Corporation was at 7.8% and was under capitalized. The improvement in capital ratios was largely driven by the sale of West Michigan Community Bank and the recapture of capital related to the sale. Despite the improvements and current capital levels, the Corporation continues to be required to obtain written approval prior to payments of any dividends or for any increase or decrease to outstanding debt.

The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the limitations described above.

| (000s omitted)                           | Actual    |       | For Capital Adequacy Purposes |       | Regulatory Agreement Requirements |       |
|--|-----------|-------|-------------------------------|-------|-----------------------------------|-------|
|  | Amount    | Ratio | Amount                        | Ratio | Amount                            | Ratio |
| As of March 31, 2011                     |           |       |                               |       |                                   |       |
| Total Capital (to Risk Weighted Assets)  |           |       |                               |       |                                   |       |
| Consolidated                             | \$ 24,535 | 10.9% | \$ 17,966                     | 8.0%  | NA                                | NA    |
| The State Bank                           | 23,293    | 10.9  | 17,100                        | 8.0   | \$ 21,735                         | 12.0% |
| Tier 1 Capital (to Risk Weighted Assets) |           |       |                               |       |                                   |       |
| Consolidated                             | 21,780    | 9.7   | 8,983                         | 4.0   | NA                                | NA    |
| The State Bank                           | 20,538    | 9.6   | 8,550                         | 4.0   | NA                                | NA    |
| Tier 1 Capital (to Average Assets)       |           |       |                               |       |                                   |       |
| Consolidated                             | 21,780    | 6.5   | 13,383                        | 4.0   | NA                                | NA    |
| The State Bank                           | 20,538    | 6.8   | 12,074                        | 4.0   | 24,148                            | 8.0   |

**Table of Contents****NOTE 10-REGULATORY MATTERS** (continued)

| (000s omitted)                           | Actual    |       | For Capital Adequacy Purposes |       | Regulatory Agreement Requirements |       |
|--|-----------|-------|-------------------------------|-------|-----------------------------------|-------|
|  | Amount    | Ratio | Amount                        | Ratio | Amount                            | Ratio |
| As of December 31, 2010                  |           |       |                               |       |                                   |       |
| Total Capital (to Risk Weighted Assets)  |           |       |                               |       |                                   |       |
| Consolidated                             | \$ 25,443 | 7.8%  | \$ 26,073                     | 8.0%  | NA                                | NA    |
| The State Bank                           | 22,670    | 10.0  | 18,152                        | 8.0   | \$ 27,228                         | 12.0% |
| West Michigan Community Bank             | 10,722    | 11.0  | 7,794                         | 8.0   | NA                                | NA    |
| Tier 1 Capital (to Risk Weighted Assets) |           |       |                               |       |                                   |       |
| Consolidated                             | 21,261    | 6.5   | 13,036                        | 4.0   | NA                                | NA    |
| The State Bank                           | 19,735    | 8.7   | 9,076                         | 4.0   | NA                                | NA    |
| West Michigan Community Bank             | 9,475     | 9.7   | 3,897                         | 4.0   | NA                                | NA    |
| Tier 1 Capital (to Average Assets)       |           |       |                               |       |                                   |       |
| Consolidated                             | 21,261    | 4.9   | 17,330                        | 4.0   | NA                                | NA    |
| The State Bank                           | 19,735    | 6.5   | 12,204                        | 4.0   | 24,408                            | 8.0   |
| West Michigan Community Bank             | 9,475     | 7.5   | 5,025                         | 4.0   | 10,050                            | 8.0   |

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

Certain of the Corporation's accounting policies are important to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances, which could affect these judgments, include, but without limitation, changes in interest rates, in the performance of the economy or in the financial condition of borrowers.

**Results of Operations**

As indicated in the income statement, the income for the first three months ended March 31, 2011 was \$310,000 compared to a loss of \$483,000 for the same period in 2010. Net interest income in the first quarter of 2011, was \$170,000 below net interest income for the same quarter in 2010. The first quarter 2011 provision for loan losses was reduced \$340,000 compared to the first quarter of 2010. Management feels the allowance for loan losses is appropriate and has decreased \$426,000 when comparing the period ended March 31, 2011 to the period ended March 31, 2010. The banking industry uses standard performance indicators to help evaluate a banking institution's performance. Return on average assets is one of these indicators. For the three months ended March 31, 2011, the Corporation's return on average assets (annualized) was 0.09% compared to (0.09%) for the same period in 2010. For the three months ended March 31, 2011, the Corporation's return on average equity (annualized) was 1.86% compared to (2.33%) for the same period in 2010. Net income per share, basic and diluted, was \$0.13 in the first quarter of 2011 compared to (\$0.21) net loss per share basic and diluted for the same period in 2010.

**Table of Contents****Net Interest Income**

Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the three months ended March 31, 2011 and 2010 are summarized in Table 2.

Table 1 below displays the effects of changing rates and volumes on our net interest income for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010. The information displayed is with respect to the effects on interest income and interest expense attributable to changes in volume and rate.

As indicated in Table 1, during the three months ended March 31, 2011, net interest income decreased compared to the same period in 2010. The volume of loans decreased over the past year, along with a proportionate decrease in interest income. The mix of this change resulted in a decrease in loan yield. To mitigate the decrease in interest income, deposit rates and volumes decreased year over year. The deposit interest rate reduction was achieved by a reduction of offering rates on time deposits, which assisted in discouraging high rate instruments from renewing, with some funds exiting, thus reducing interest bearing liability costs.

**Table 1**

| (000s omitted)                     | THREE MONTHS ENDED<br>MARCH 31,<br>2011 COMPARED TO 2010<br>INCREASE (DECREASE)<br>DUE TO |                |          |
|------------------------------------|---|----------------|----------|
|                                    | VOLUME  | YIELD/<br>RATE | TOTAL    |
| Taxable securities                 | \$ 107  | \$ (53)        | \$ 54    |
| Tax-exempt securities (1)          | (108)   | 6              | (102)    |
| Federal funds sold                 | 2   | 4              | 6        |
| Total loans (1)                    | (640)   | 59             | (581)    |
| Loans held for sale                | 1   | 0              | 1        |
| Total earning assets               | (638)   | 16             | (622)    |
| Interest bearing demand deposits   | (2)   | (15)           | (17)     |
| Savings deposits                   | 2   | (6)            | (4)      |
| Time CD s \$100,000 and over       | (234)   | (6)            | (240)    |
| Other time deposits                | (47)  | (104)          | (151)    |
| Other borrowings                   | 0   | 0              | 0        |
| Total interest bearing liabilities | (281)   | (131)          | (412)    |
| Net Interest Income                | \$ (357)  | \$ 147         | \$ (210) |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

As indicated in Table 2, for the three months ended March 31, 2011, the Corporation's net interest margin (with consideration of full tax equivalency) was 3.82% compared with 3.78% for the same period in 2010. The increase in net interest margin is the result of the downward re-pricing on interest bearing assets which was offset by the decreases in rates paid on interest bearing liabilities when comparing the period ended March 31, 2011 to the period ended March 31, 2010.

Average earning assets decreased 8.6% or \$25,212,000 comparing the three months of 2011 to the same time period in 2010. Loans, the highest yielding component of earning assets, represented 73.9% of earning assets in 2011 compared

to 81.8% in 2010. Average interest bearing liabilities decreased 11.5% or \$30,483,000 comparing the first three months of 2011 to the same time period in 2010. Non-interest bearing deposits amounted to 21.0% of average earning assets in the first three months of 2011 compared with 18.1% in the same time period of 2010.

**Table of Contents**

Management reviews economic forecasts and statistics on a monthly basis. Accordingly, the Corporation will continue to strategically manage the balance sheet structure in an effort to optimize net interest income. The Corporation expects to continue to selectively seek out new loan opportunities while continuing to maintain sound credit quality. Management continually monitors the Corporation's balance sheet in an effort to insulate net interest income from significant swings caused by interest rate volatility. If market rates change in 2011, corresponding changes in funding costs will be considered to avoid the potential negative impact on net interest income. The Corporation's policies in this regard are further discussed in the section titled Interest Rate Sensitivity Management.

**Table of Contents****Table 2 Average Balance and Rates**

| (000s omitted)(Annualized)                        | THREE MONTHS ENDED MARCH 31, |                            |                |                    |                            |                |
|---|------------------------------|----------------------------|----------------|--------------------|----------------------------|----------------|
|   | AVERAGE<br>BALANCE           | 2011<br>INCOME/<br>EXPENSE | YIELD/<br>RATE | AVERAGE<br>BALANCE | 2010<br>INCOME/<br>EXPENSE | YIELD/<br>RATE |
| <b>ASSETS</b>                                     |                              |                            |                |                    |                            |                |
| Securities:                                       |                              |                            |                |                    |                            |                |
| U.S. Treasury and Government                      |                              |                            |                |                    |                            |                |
| Agencies  | \$ 40,279                    | \$ 267                     | 2.69%          | \$ 25,577          | \$ 216                     | 3.42%          |
| State and Political (1)                           | 4,350                        | 68                         | 6.34%          | 11,283             | 170                        | 6.11%          |
| Other   | 2,804                        | 12                         | 1.74%          | 2,328              | 9                          | 1.57%          |
| Total Securities                                  | 47,433                       | 347                        | 2.97%          | 39,188             | 395                        | 4.09%          |
| Fed Funds Sold                                    | 22,741                       | 9                          | 0.16%          | 14,289             | 3                          | 0.09%          |
| Loans:  |                              |                            |                |                    |                            |                |
| Commercial  | 148,538                      | 2,289                      | 6.25%          | 182,779            | 2,744                      | 6.09%          |
| Tax Free (1)                                      | 2,001                        | 32                         | 6.49%          | 2,384              | 39                         | 6.70%          |
| Real Estate-Mortgage                              | 19,393                       | 291                        | 6.09%          | 23,189             | 355                        | 6.21%          |
| Consumer  | 28,350                       | 405                        | 5.79%          | 31,901             | 460                        | 5.85%          |
| Total loans                                       | 198,282                      | 3,017                      | 6.17%          | 240,253            | 3,598                      | 6.07%          |
| Allowance for Loan Losses                         | (10,129)                     |                            |                | (8,954)            |                            |                |
| Net Loans   | 188,153                      | 3,017                      | 6.50%          | 231,299            | 3,598                      | 6.31%          |
| Loans Held for Sale                               | 637                          | 8                          | 5.09%          | 575                | 7                          | 4.94%          |
| <b>TOTAL EARNING ASSETS</b>                       | <b>\$ 269,093</b>            | <b>3,381</b>               | <b>5.10%</b>   | <b>\$ 294,305</b>  | <b>\$ 4,003</b>            | <b>5.52%</b>   |
| Cash Due from Banks                               | 17,934                       |                            |                | 12,680             |                            |                |
| Assets of Discontinued<br>Operations              | 46,045                       |                            |                | 184,550            |                            |                |
| All Other Assets                                  | 26,595                       |                            |                | 31,249             |                            |                |
| <b>TOTAL ASSETS</b>                               | <b>\$ 349,538</b>            |                            |                | <b>\$ 513,830</b>  |                            |                |
| <b>LIABILITIES &amp;<br/>SHAREHOLDERS EQUITY:</b> |                              |                            |                |                    |                            |                |
| Deposits:   |                              |                            |                |                    |                            |                |
| Interest Bearing DDA                              | \$ 48,157                    | \$ 14                      | 0.12%          | \$ 51,334          | \$ 31                      | 0.24%          |
| Savings Deposits                                  | 68,004                       | 16                         | 0.10%          | 62,102             | 20                         | 0.13%          |
| Time CDs \$100,000 and Over                       | 46,224                       | 434                        | 3.81%          | 71,172             | 674                        | 3.84%          |
| Other Time CDs                                    | 57,339                       | 258                        | 1.82%          | 65,622             | 409                        | 2.53%          |
| Total Deposits                                    | 219,724                      | 722                        | 1.33%          | 250,230            | 1,134                      | 1.84%          |
| Other Borrowings                                  | 15,354                       | 126                        | 3.33%          | 15,331             | 126                        | 3.33%          |
|   | \$ 235,078                   | 848                        | 1.46%          | \$ 265,561         | 1,260                      | 1.92%          |

INTEREST BEARING  
LIABILITIES

|  |        |         |
|--|--------|---------|
| Non-Interest bearing DDA               | 57,342 | 53,148  |
| Liabilities of Discontinued Operations | 37,422 | 171,292 |
| All Other Liabilities                  | 3,040  | 3,079   |
| Shareholders Equity                    | 16,656 | 20,750  |

|   |            |            |
|---|------------|------------|
| TOTAL LIABILITIES & SHAREHOLDERS EQUITY | \$ 349,538 | \$ 513,830 |
|---|------------|------------|

|                          |  |       |  |       |
|--------------------------|--|-------|--|-------|
| Net Interest Rate Spread |  | 3.64% |  | 3.60% |
|--------------------------|--|-------|--|-------|

|                             |          |       |          |       |
|-----------------------------|----------|-------|----------|-------|
| Net Interest Income /Margin | \$ 2,533 | 3.82% | \$ 2,743 | 3.78% |
|-----------------------------|----------|-------|----------|-------|

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

**Table of Contents****Allowance and Provision For Loan Losses**

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is appropriate to provide for probable incurred losses in the loan portfolio. While the Corporation's loan portfolio has no significant concentrations in any one industry or any exposure in foreign loans, the loan portfolio has a concentration connected with commercial real estate loans. Specific strategies have been deployed to reduce the concentration levels and limit exposure to this type of lending in the future. The Michigan economy, employment levels and other economic conditions in the Corporation's local markets may have a significant impact on the level of credit losses. Management continues to identify and devote attention to credits that are not performing as agreed. Of course, deterioration of economic conditions could have an impact on the Corporation's credit quality, which could impact the need for greater provision for loan losses and the level of the allowance for loan losses as a percentage of gross loans. Non-performing loans are discussed further in the section titled "Non-Performing Assets." The allowance for loan losses reflects management's judgment as to the level considered appropriate to absorb probable losses in the loan portfolio. The Corporation's methodology in determining the adequacy of the allowance is based on ongoing quarterly assessments and relies on several key elements, which include specific allowances for identified problem loans and a formula-based risk-allocated allowance for the remainder of the portfolio. This includes a review of individual loans, size, and composition of the loan portfolio, historical loss experience, current economic conditions, financial condition of borrowers, the level and composition of non-performing loans, portfolio trends, estimated net charge-offs and other pertinent factors. While we consider the allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, delinquencies, or loss rates. Although portions of the allowance have been allocated to various portfolio segments, the allowance is general in nature and is available for the portfolio in its entirety. The provision for loan losses remains high as a result of continued weaknesses in the national and local economies, elevated amounts of non-performing loans and elevated charge-off levels over the past three years. Rolling twelve quarter periods of historical charge off experience is considered when calculating the current required level of the allowance for loan losses. The amount of the allowance for loan losses specifically allocated to impaired loans decreased by \$1,778,000 during the quarter as a result of charge offs incurred on loans for which specific allocations were previously recorded.

At March 31, 2011, the allowance was \$9,015,000, or 4.61% of total loans compared to \$10,027,000, or 4.82%, at December 31, 2010, a decrease of \$1,012,000 during the first three months of 2011. Non performing loan levels, discussed later, increased during the period and net charge-offs increased to \$1,807,000 during the first three months of 2011 compared to \$38,000 during the first three months of 2010. As discussed above, a majority of the charge-offs relate to loans for which specific allocations were recorded at December 31, 2010.

Table 3 below summarizes loan losses and recoveries for the first three months of 2011 and 2010. During the first three months of 2011, the Corporation experienced net charge-offs of \$1,807,000 or 0.92% of gross loans compared with net charge-offs of \$38,000 or 0.02% of gross loans in the first three months of 2010. The provision for loan loss was \$795,000 in the first three months of 2011 and \$1,135,000 for the same time period in 2010. Continuing declines in appraised values of properties in Michigan along with additional loans migrating to watch status due to economic conditions, have contributed to the ongoing elevated level of provision for loan losses. The application of historical loss rates to the current portfolio has the potential to be a lagging indicator and management evaluates whether these allocations should be adjusted. While there are indications that asset quality is improving, uncertain current economic conditions justify the use of high historical loss rates in estimating the required level of allowance for loan losses.



**Table of Contents****Table 3 Analysis of the Allowance for Loan Losses**

| (000s omitted)                          | Three Months Ended<br>March 31, |               |
|---|---------------------------------|---------------|
|   | 2011                            | 2010          |
| Balance at Beginning of Period          | \$ 10,027                       | \$ 8,589      |
| Charge-Offs:                            |                                 |               |
| Commercial, Financial and Agriculture   | (1,818)                         | (427)         |
| Real Estate-Mortgage                    | (98)                            | (78)          |
| Installment Loans to Individuals        | (43)                            | (109)         |
| Total Charge-Offs                       | (1,959)                         | (614)         |
| Recoveries:                             |                                 |               |
| Commercial, Financial and Agriculture   | 130                             | 558           |
| Real Estate-Mortgage                    | 1                               | 0             |
| Installment Loans to Individuals        | 21                              | 18            |
| Total Recoveries                        | 152                             | 576           |
| Net Charge-Offs<br>Provision            | (1,807)<br>795                  | (38)<br>1,135 |
| Balance at End of Period                | \$ 9,015                        | \$ 9,686      |
| Ratio of Net Charge-Offs to Gross Loans | 0.93%                           | 0.02%         |

**Non-Interest Income**

Non-interest income increased slightly during the three months ended March 31, 2011 as compared to the same period in 2010. Overall non-interest income was \$1,154,000 for the three months ended March 31, 2011 compared to \$1,115,000 for the same period in 2010. This represents an increase of 3.5%.

Service charges on deposit accounts are approximately 26% of non-interest income. These fees from continuing operations were \$296,000 in the first quarter of 2011, compared to \$425,000 for the same period of 2010. This represents a decrease of 30.4% from year to year in NSF charges collected.

Gain on the sale of mortgage loans originated by the Banks and sold into the secondary market decreased by \$13,000 or 16.0% to \$68,000 in the first quarter of 2011 compared to \$81,000 for the same period in 2010. Management believes for the remainder of 2011, mortgage income will remain relatively flat as governmental purchase incentives have expired and property values remain under stress.

Trust, investment and financial planning services income increased \$19,000 or 7.1% in the first quarter of 2011 compared to the same period in the prior year. The increase is attributable to favorable changes in market value, which resulted in higher fee income.

Other operating income increased by \$157,000 or 46.2% in the first quarter of 2011 compared to the same time period in 2010. The increases consist of increased interchange income from debit cards, an increase in gain on sale of real estate owned, and increases in charges related to providing support services to other banks.

**Non-Interest Expense**

Total non-interest expense decreased 1.7% to \$3,221,000 in the three months ended March 31, 2011, compared with \$3,278,000 in the same period of 2010. The decrease is attributable to decreases in loan and collection expenses which were largely offset by increases in salaries and benefits, FDIC assessments and other insurance costs.

Salary and benefit costs, the Corporation's largest non-interest expense category, were \$1,673,000 in the first quarter of 2011, compared with \$1,619,000, or an increase of 3.3%, for the same time period in 2010. Salary and benefits expense increased due to higher benefit cost for staff.

Occupancy expenses, at \$284,000, were significantly reduced in the three months ended March 31, 2011 compared to the same period in 2010 with a decrease of \$37,000 or 11.5%. Decreases of occupancy

**Table of Contents**

expenses were in property insurance, depreciation, utility costs and reductions in building repairs and maintenance. During the three months ended March 31, 2011, furniture and equipment expenses were \$292,000 compared to \$306,000 for the same period in 2010, a decrease of 4.6%. The decrease was due to the lower depreciation expense in the first quarter of 2011. Also, equipment rental expense dropped over 25% for the quarter.

Loan and collection expenses, at \$110,000, were down \$263,000 or 70.5% during the three months ended March 31, 2011 compared to the same time period in 2010. The decrease was related to lower write downs of other real estate owned; lower expenses related to other real estate owned, in the form of property taxes and property maintenance and expenses related to troubled loans.

Advertising expenses decreased \$7,000 for the three months ended March 31, 2011 compared to the same period in 2010. For the three months ended March 31, 2011, advertising expenses were \$19,000 compared to \$26,000 for the same period in 2010.

Other operating expenses, from continued operations, were \$843,000 in the three months ended March 31, 2011 compared to \$633,000 in the same time period in 2010, an increase of \$210,000 or 33.2%. Increases year over year include increases in our general insurance from first quarter 2010 totals and significantly higher FDIC assessments in 2011 versus 2010.

**Financial Condition**

Proper management of the volume and composition of the Corporation's earning assets and funding sources is essential for ensuring strong and consistent earnings performance, maintaining adequate liquidity and limiting exposure to risks caused by changing market conditions. The Corporation's securities portfolio is structured to provide a source of liquidity through maturities and to generate an income stream with relatively low levels of principal risk. The Corporation does not engage in securities trading. Loans comprise the largest component of earning assets and are the Corporation's highest yielding assets. Customer deposits are the primary source of funding for earning assets while short-term debt and other sources of funds could be further utilized if market conditions and liquidity needs change.

The Corporation's total assets were \$314,465,000 at March 31, 2011 compared to total assets of \$424,228,000 at December 31, 2010. This includes assets from discontinued operations of \$11,387,000 at March 31, 2011 compared to \$122,968,000 at December 31, 2010. Loans comprised 62.3% of total assets at March 31, 2011 compared to 49.0% at December 31, 2010. Loans decreased \$12,099,000 during the first three months of 2011.

Bank premises and equipment decreased \$33,000 to \$10,302,000 at March 31, 2011 compared to \$10,335,000 at December 31, 2010. The decrease was a result of normal depreciation.

Other assets decreased \$287,000 when comparing March 31, 2011 to December 31, 2010. The decrease is mainly attributable to a decrease in interest receivable which correlates to lower loan volumes.

On the liability side of the balance sheet, the ratio of non-interest bearing deposits to total deposits was 21.1% at March 31, 2011 and 20.0% at December 31, 2010. Interest bearing deposit liabilities totaled \$220,153,000 at March 31, 2011 compared to \$220,933,000 at December 31, 2010. Total deposits increased \$3,193,000 with non-interest bearing demand deposits increasing \$3,973,000 and interest bearing deposits decreasing \$780,000. Short-term borrowings decreased \$217,000 due to the decrease in treasury tax and loan payments outstanding at the end of the two periods. FHLB advances did not change when comparing the two periods.

**Table of Contents****Non-Performing Assets**

Non-performing assets include loans on which interest accruals have ceased, loans past due 90 days or more and still accruing, loans that have been renegotiated, and real estate acquired through foreclosure or deed-in-lieu of foreclosure. Table 4 reflects the levels of these assets at March 31, 2011 and December 31, 2010.

Non-performing assets increased \$3,297,000 from December 31, 2010 to March 31, 2011. Non-accrual loans increased \$1,404,000 to \$13,900,000 at March 31, 2011. Renegotiated loans increased \$1,322,000 to \$4,976,000 at March 31, 2011 and other real estate decreased \$380,000 to \$2,362,000. REO in redemption increased \$520,000 to \$1,348,000 and was also moved from the non-performing assets classification to the non-performing loans classification at March 31, 2011 and December 31, 2011.

The level and composition of non-performing assets is affected by economic conditions in the Corporation's local markets. Non-performing assets, charge-offs, and provisions for loan losses tend to decline in a strong economy and increase in a weak economy, potentially impacting the Corporation's operating results. In addition to non-performing loans, management carefully monitors other credits that are current in terms of principal and interest payments but, in management's opinion, may deteriorate in quality if economic conditions change.

**Table 4 Non-Performing Assets and Past Due Loans**

|  | March<br>31,<br>2011 | December<br>31,<br>2010 |
|--|----------------------|-------------------------|
| (000s omitted)   |                      |                         |
| Non-Performing Loans:  |                      |                         |
| Loans Past Due 90 Days or More & Still Accruing                  | \$ 564               | \$ 133                  |
| Non-Accrual Loans  | 13,900               | 12,496                  |
| Renegotiated Loans   | 4,976                | 3,654                   |
| REO in Redemption  | 1,348                | 828                     |
| <b>Total Non-Performing Loans</b>                                | <b>20,788</b>        | <b>17,111</b>           |
| Other Non-Performing Assets:                                     |                      |                         |
| Other Real Estate  | 2,362                | 2,742                   |
| <b>Total Other Non-Performing Assets</b>                         | <b>2,362</b>         | <b>2,742</b>            |
| <b>Total Non-Performing Assets</b>                               | <b>\$ 23,150</b>     | <b>\$ 19,853</b>        |
| <br>   |                      |                         |
| Non-Performing Loans as a % of Total Loans                       | 10.61%               | 8.23%                   |
| Non-Performing Loans as a % of Total Loans and Other Real Estate | 10.49%               | 8.12%                   |
| Allowance for Loan Losses as a % of Non-Performing Loans         | 43.37%               | 58.60%                  |
| Accruing Loans Past Due 90 Days or More to Total Loans           | 0.29%                | 0.06%                   |
| Non-performing Assets as a % of Total Assets                     | 7.36%                | 4.68%                   |

While total non performing assets increased from December 31, 2010 to March 31, 2011, the ratio of non-performing loans to the allowance for loan losses decreased. This was the result of loans that transitioned into non-accrual loans at March 31, 2011. These loans had previously been specifically reserved for in the allowance for loan losses, therefore no additional provision was required.

Certain portions of the Corporation's non-performing loans included in Table 4 are considered impaired. The Corporation measures impairment on all large balance non-accrual commercial loans. Certain large balance accruing loans rated watch or monitor are also analyzed for possible impairment. Impairment losses are believed to be appropriately covered by the allowance for loan losses.

**Table of Contents**

The Corporation maintains policies and procedures to identify and monitor non-accrual loans. A loan is placed on non-accrual when there is doubt regarding collection of principal or interest, or when principal or interest is past due 90 days or more. Accrued but uncollected interest is reversed against income for the current quarter when a loan is placed on non-accrual. At March 31, 2011, there were \$577,000 loans past due 90 days or more and still accruing. Management is not aware of any loans that have not been moved to non-accrual or not been reclassified to troubled debt restructures at March 31, 2011. The potential, however, remains that a borrower may become financially distressed in the future and management may place that loan into non-accrual, but this is difficult to predict.

**Liquidity and Interest Rate Risk Management**

Asset/Liability management is designed to assure liquidity and reduce interest rate risks. The goal in managing interest rate risk is to maintain a strong and relatively stable net interest margin. It is the responsibility of the Asset/Liability Management Committee (ALCO) to set policy guidelines and to establish short-term and long-term strategies with respect to interest rate exposure and balance sheet liquidity. The ALCO, which is comprised of key members of management, meets regularly to review financial performance and soundness, including interest rate risk and liquidity in relation to present and prospective markets and business conditions. Accordingly, the committee adopts funding and balance sheet management strategies that are intended to maximize earnings, maintain liquidity, and achieve balance sheet composition objectives.

Liquidity maintenance together with a solid capital base and strong earnings performance are key objectives of the Corporation. The Corporation's liquidity is derived from a strong deposit base comprised of individual and business deposits. Deposit accounts of customers in the mature market represent a substantial portion of deposits of individuals. The Banks' deposit base plus other funding sources (federal funds purchased, short-term borrowings, FHLB advances, other liabilities and shareholders' equity) provided primarily all funding needs in the first three months of 2011. While these sources of funds are expected to continue to be available to provide funds in the future, the mix and availability of funds will depend upon future economic conditions. The Corporation does not foresee any difficulty in meeting its funding requirements.

Primary liquidity is provided through short-term investments or borrowings (including federal funds sold and purchased) while the securities portfolio provides secondary liquidity. The securities portfolio has increased \$3.0 million since December 31, 2010 due to purchases in the available for sale investment portfolio. Multiple available for sale securities with elevated credit risk were sold and the proceeds used to purchase mortgage backed instruments with lower credit risk during the fourth quarter of 2010. The Corporation has re-invested some of the funds, from the call and maturities of these securities, back into the securities portfolio to increase yield and manage the asset ratios on the balance sheet. The Corporation regularly monitors liquidity to ensure adequate cash flows to cover unanticipated reductions in the availability of funding sources.

Interest rate risk is managed by controlling and limiting the level of earnings volatility arising from rate movements. The Corporation regularly performs reviews and analysis of those factors impacting interest rate risk. Factors include maturity and re-pricing frequency of balance sheet components, impact of rate changes on interest margin and prepayment speeds, market value impacts of rate changes, and other issues. Both actual and projected performance are reviewed, analyzed, and compared to policy and objectives to assure present and future financial viability.

The Corporation had cash used in financing activities resulting from the increase of deposits, a decrease in short term borrowings and the sale of a subsidiary bank. In the first three months of 2011 deposits, increased \$3,193,000, while short term borrowings decreased \$217,000. Cash provided by investing activities was \$103,855,000 in first three months of 2011 compared to \$12,862,000 in first three months of 2010. The change in investing activities was due to the sale of a subsidiary bank.

**Table of Contents**

**Capital Resources**

Management closely monitors bank capital levels to provide for current and future business needs and to comply with regulatory requirements. Regulations prescribed under the Federal Deposit Insurance Corporation Improvement Act of 1991 have defined adequately capitalized institutions as those having total risk-based ratios, tier 1 risk-based capital ratios and tier 1 leverage ratios of at least 8%, 4%, and 4%, respectively. At March 31, 2011, The State Bank was in excess of the minimum adequately capitalized capital and leverage requirements as defined by federal law; however The State Bank and was not in compliance with the capital requirements prescribed by the Consent Order. Total shareholders equity increased 0.9% to \$16,206,000 at March 31, 2011 compared with \$16,055,000 at December 31, 2010. The increase was due to the net income in the first three months of 2011, partially offset by decreases in other comprehensive loss as noted below. The Corporation's equity to asset ratio was 5.2% at March 31, 2011 and 3.8% at December 31, 2010.

As indicated on the balance sheet at December 31, 2010, the Corporation had an accumulated other comprehensive income of \$61,000 compared to accumulated other comprehensive loss at March 31, 2011 of \$124,000. The fluctuation in the loss position is attributable to a combination of the fluctuation of the market price of securities held in the available for sale portfolio.

For additional information on the Corporation's capital resources please refer to Note 10 to the financial statements which is incorporated herein by this reference.

**Regulatory Orders**

The Corporation's primary source of cash to service its subordinated debt is dividends from the subsidiary banks. Since the subsidiary banks have suspended dividends to the holding company, the Corporation has elected to defer interest payments for five years on \$14,000,000 of subordinated debentures. The reason for the interest deferral is to maintain liquidity at the Holding Company. The Corporation is not in default under either of the indentures. During this five year period, the Corporation is precluded from paying shareholder dividends on its outstanding common stock. The Corporation subsequently may give notice that it elects to shorten the deferral period, pay accrued interest and return to the normal course of shareholder dividend payments.

On October 27, 2010, management received a notice from The Federal Reserve which defined restrictions being placed upon the Holding Company. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary Banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an indication for the Corporation to maintain sufficient capital levels.

**Critical Accounting Policies and Estimates**

The Management's Discussion and Analysis of financial condition and results of operations are based on the Corporation's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, income taxes, other real estate owned, and investment securities valuation. Actual results could differ from those estimates. Management believes that its critical accounting policies include determining the allowance for loan losses and determining the fair value of securities, carrying value of deferred tax assets and other financial instruments.

The allowance for loan losses is maintained at a level we believe is appropriate to absorb probable losses identified and inherent in the loan portfolio. Our evaluation of the appropriateness of the allowance for loan losses is an estimate based on reviews of individual loans, assessments of the impact of current and anticipated economic conditions on the portfolio, and historical loss experience. The allowance for loan losses represents management's best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance for loan losses in

**Table of Contents**

the near future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance for loan losses. In either instance unanticipated changes could have a significant impact on operating earnings.

The allowance for loan losses is increased through a provision charged to operating expense. Uncollectible loans are charged-off through the allowance for loan losses. Recoveries of loans previously charged-off are added to the allowance for loan losses. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement.

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. A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. Management has reviewed the deferred tax position for the Corporation at March 31, 2011 and December 31, 2010. During the second quarter of 2009, the Corporation recognized a full valuation allowance. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the related deferred income tax assets are realized or the valuation allowance is otherwise no longer required. Management will continue to monitor our deferred tax assets quarterly for changes affecting their realizability.

Other Real Estate Owned and Foreclosed Assets are acquired through or as an alternative to loan foreclosure. Such properties are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is expensed as are costs after acquisition.

The Corporation evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In determining other-than-temporary impairment ( 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 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.

**Off Balance Sheet Arrangements**

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at:

| (000s omitted)                               | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| Commitments to make loans (at market rates)  | \$ 5,524          | \$ 8,403             |
| Unused lines of credit and letters of credit | 29,427            | 29,746               |



**Table of Contents**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

The information concerning quantitative and qualitative disclosures about market risk contained on page 62 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2010, is incorporated herein by reference.

Fentura Financial, Inc. faces market risk to the extent that both earnings and the fair value of its financial instruments are affected by changes in interest rates. The Corporation manages this risk with static GAP analysis and simulation modeling. For the first three months of 2011, the results of these measurement techniques were within the Corporation's policy guidelines. The Corporation does not believe that there has been a material change in the nature of the Corporation's primary market risk exposures, including the categories of market risk to which the Corporation is exposed and the particular markets that present the primary risk of loss to the Corporation, or in how those exposures have been managed in 2011 compared to 2010.

The Corporation's market risk exposure is mainly comprised of its vulnerability to interest rate risk. Prevailing interest rates and interest rate relationships in the future will be primarily determined by market factors, which are outside of the Corporation's control. All information provided in this section consists of forward-looking statements. Reference is made to the section captioned "Forward Looking Statements" in this quarterly report for a discussion of the limitations on the Corporation's responsibility for such statements.

**Interest Rate Sensitivity Management**

Interest rate sensitivity management seeks to maximize net interest income as a result of changing interest rates, within prudent ranges of risk. The Corporation attempts to accomplish this objective by structuring the balance sheet so that re-pricing opportunities exist for both assets and liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these re-pricing opportunities at any point in time constitute a bank's interest rate sensitivity. The Corporation currently does not utilize derivatives in managing interest rate risk.

An indicator of the interest rate sensitivity structure of a financial institution's balance sheet is the difference between rate sensitive assets and rate sensitive liabilities, and is referred to as "GAP." Table 5 sets forth the distribution of re-pricing of the Corporation's earning assets and interest bearing liabilities as of March 31, 2011, the interest rate sensitivity GAP, as defined above, the cumulative interest rate sensitivity GAP, the interest rate sensitivity GAP ratio (i.e. interest rate sensitive assets divided by interest rate sensitive liabilities) and the cumulative sensitivity GAP ratio. The table also sets forth the time periods in which earning assets and liabilities will mature or may re-price in accordance with their contractual terms.

**Table of Contents**

Table 5 GAP Analysis March 31, 2011

| (000s omitted)                                 | <b>Within<br/>Three<br/>Months</b> | <b>Three<br/>Months to<br/>One Year</b> | <b>One to<br/>Five<br/>Years</b> | <b>After<br/>Five<br/>Years</b> | <b>Total</b>      |
|--|------------------------------------|---|----------------------------------|---------------------------------|-------------------|
| <b>Earning Assets:</b>                         |                                    |   |                                  |                                 |                   |
| Federal Funds Sold                             | \$ 16,000                          | \$ 0                                    | \$ 0                             | \$ 0                            | \$ 16,000         |
| Securities                                     | 12,020                             | 5,635                                   | 14,621                           | 16,943                          | 49,219            |
| Loans  | 44,816                             | 35,755                                  | 86,617                           | 28,688                          | 195,876           |
| Loans Held for Sale                            | 486                                | 0                                       | 0                                | 0                               | 486               |
| FHLB Stock                                     | 740                                | 0                                       | 0                                | 0                               | 740               |
| <b>Total Earning Assets</b>                    | <b>\$ 74,062</b>                   | <b>\$ 41,390</b>                        | <b>\$ 101,238</b>                | <b>\$ 45,631</b>                | <b>\$ 262,321</b> |
| <b>Interest Bearing Liabilities:</b>           |                                    |   |                                  |                                 |                   |
| Interest Bearing Demand Deposits               | \$ 46,059                          | \$ 0                                    | \$ 0                             | \$ 0                            | \$ 46,059         |
| Savings Deposits                               | 70,591                             | 0                                       | 0                                | 0                               | 70,591            |
| Time Deposits Less than \$100,000              | 7,976                              | 17,059                                  | 30,651                           | 90                              | 55,776            |
| Time Deposits Greater than \$100,000           | 8,210                              | 12,667                                  | 26,850                           | 0                               | 47,727            |
| Short term borrowings                          | 662                                | 0                                       | 0                                | 0                               | 662               |
| Other Borrowings                               | 30                                 | 0                                       | 149                              | 775                             | 954               |
| Subordinated debentures                        | 14,000                             | 0                                       | 0                                | 0                               | 14,000            |
| <b>Total Interest Bearing Liabilities</b>      | <b>\$ 147,528</b>                  | <b>\$ 29,726</b>                        | <b>\$ 57,650</b>                 | <b>\$ 865</b>                   | <b>\$ 235,769</b> |
| Interest Rate Sensitivity GAP                  | (\$73,466)                         | \$ 11,664                               | \$ 43,588                        | \$ 44,766                       | \$ 26,552         |
| Cumulative Interest Rate Sensitivity GAP       | (\$73,466)                         | (\$61,802)                              | (\$18,214)                       | \$ 26,552                       |                   |
| Interest Rate Sensitivity GAP Ratio            | 0.50                               | 1.39                                    | 1.76                             | 52.75                           |                   |
| Cumulative Interest Rate Sensitivity GAP Ratio | 0.50                               | 0.65                                    | 0.92                             | 1.11                            |                   |

As indicated in Table 5, the short-term (one year and less) cumulative interest rate sensitivity gap is negative. Accordingly, if market interest rates increase, this negative gap position could have a short-term negative impact on interest margin. Conversely, if market rates decline this should theoretically have a short-term positive impact. However, gap analysis is limited and may not provide an accurate indication of the impact of general interest rate movements on the net interest margin since the re-pricing of various categories of assets and liabilities is subject to the Corporation's needs, competitive pressures, and the needs of the Corporation's customers. In addition, various assets and liabilities indicated as re-pricing within the same period may in fact re-price at different times within such period and at different rate indices. The Prime Rate has remained steady over the past twelve months. This steadiness allowed management to close the gap related to interest rate sensitivity. Management was able to reduce liquid interest bearing liability rates to extremely low rates, while maintaining relatively similar volumes. The Banks were also able to re-price maturing time deposits, usually in a downward fashion as longer term certificates at higher rates matured during the year. On the asset side of the balance sheet, rates on the investment portfolios remained relatively steady and the yields on loans increased slightly. Management worked to re-price loans favorably as they renewed and were priced accordingly for risk, however overall loan yields decreased. This was due to increases in non-performing loans. The Corporation expects to continue to make strides in managing interest rate sensitivity.

**Forward Looking Statements**

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us management, are intended to identify

**Table of Contents**

forward-looking statements. The presentation and discussion of the provision and allowance for loan losses and statements concerning future profitability or future growth or increases, are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our other filings with the Securities and Exchange Commission.

**ITEM 4: CONTROLS AND PROCEDURES**

- (a) Evaluation of Disclosure Controls and Procedures. The Corporation's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Corporation's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Corporation's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Corporation would be made known to them by others within the Corporation, particularly during the period in which this Form 10-Q was being prepared.
- (b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Corporation's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.** None

**Item 1A. Risk Factors** This item is not applicable to smaller reporting companies.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.** None

**Item 3. Defaults Upon Senior Securities.** None

**Item 4. [Reserved]**

**Item 5. Other Information.** None

**Item 6. Exhibits.**

(a) Exhibits

10.1 Severance compensation agreement with Ronald L. Justice.

10.2 Amended and restated supplemental executive retirement plan with Daniel J. Wollschlager (Incorporated by reference from Form 8-K filed on May 2, 2010)

31.1 Certificate of the President and Chief Executive Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certificate of the Chief Executive Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

Signatures

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

Fentura Financial, Inc.

Dated: May 13, 2011

/s/ Donald L. Grill  
Donald L. Grill  
President & CEO

Dated: May 13, 2011

/s/ Douglas J. Kelley  
Douglas J. Kelley  
Chief Financial Officer and  
Principal Accounting Officer  
47

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**Table of Contents**

**EXHIBIT INDEX**

| Exhibit | Description   |
|---------|---|
| 10.1    | Severance compensation agreement with Ronald L. Justice.  |
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