

First Federal of Northern Michigan Bancorp, Inc.  
Form 10-Q  
May 13, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
**For the quarterly period ended March 31, 2014**

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-31957

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

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of  
incorporation or organization)

**32-0135202**

(I.R.S. Employer  
Identification No.)

**100 S. Second Avenue, Alpena, Michigan 49707**

(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Yes No

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

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

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

Yes No

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

Common Stock, Par Value \$0.01	Outstanding at May 13, 2014
(Title of Class)	2,884,049 shares

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

**FORM 10-Q**

**Quarter Ended March 31, 2014**

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

Litigation Reform Act of 1995.

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

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

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

	March 31, 2014 (Unaudited)	December 31, 2013
<b>ASSETS</b>		
Cash and cash equivalents:		
Cash on hand and due from banks	\$2,868,380	\$2,760,010
Overnight deposits with FHLB	278,575	5,823
Total cash and cash equivalents	3,146,955	2,765,833
Securities available for sale	56,442,499	50,358,175
Securities held to maturity	2,255,000	2,255,000
Loans held for sale	235,500	175,400
Loans receivable, net of allowance for loan losses of \$1,458,130 and \$1,471,622 as of March 31, 2014 and December 31, 2013, respectively	135,326,174	136,314,964
Foreclosed real estate and other repossessed assets	1,938,058	1,780,058
Federal Home Loan Bank stock, at cost	3,266,100	3,266,100
Premises and equipment	5,159,558	5,203,301
Accrued interest receivable	828,205	744,730
Intangible assets	10,087	39,732
Deferred tax asset	657,705	798,163
Originated mortgage servicing rights	812,421	860,024
Bank owned life insurance	4,638,674	4,610,070
Other assets	549,713	485,234
<b>Total assets</b>	<b>\$215,266,649</b>	<b>\$209,656,784</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Deposits	\$165,719,953	\$160,029,115
Advances from borrowers for taxes and insurance	321,427	151,254
Advances from Federal Home Loan Bank	24,232,904	24,813,409
Accrued expenses and other liabilities	1,031,238	1,138,324
<b>Total liabilities</b>	<b>191,305,522</b>	<b>186,132,102</b>
Stockholders' equity:		
Common stock (\$0.01 par value 20,000,000 shares authorized 3,191,799 shares issued)	31,918	31,918
Additional paid-in capital	23,853,891	23,853,891
Retained earnings	2,927,034	2,763,242
Treasury stock at cost (307,750 shares)	(2,963,918 )	(2,963,918 )

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Accumulated other comprehensive income (loss)	112,202	(160,451 )
Total stockholders' equity	23,961,127	23,524,682
Total liabilities and stockholders' equity	\$215,266,649	\$209,656,784

See accompanying notes to consolidated financial statements.

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

	For the Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Interest income:		
Interest and fees on loans	\$1,710,414	\$1,816,613
Interest and dividends on investments		
Taxable	150,676	115,329
Tax-exempt	41,456	37,695
Interest on mortgage-backed securities	142,294	115,371
Total interest income	2,044,840	2,085,008
Interest expense:		
Interest on deposits	186,527	221,902
Interest on borrowings	62,766	99,441
Total interest expense	249,293	321,343
Net interest income	1,795,547	1,763,665
Provision for loan losses	15,765	144,074
Net interest income after provision for loan losses	1,779,782	1,619,591
Non-interest income:		
Service charges and other fees	181,092	192,440
Mortgage banking activities	95,838	170,432
Net income (loss) on sale of premises and equipment, real estate owned and other repossessed assets	(4,813)	6,479
Other	64,118	70,992
Total non-interest income	336,235	440,343
Non-interest expense:		
Compensation and employee benefits	1,109,043	1,159,257
FDIC Insurance Premiums	45,544	45,699
Advertising	27,635	38,919
Occupancy	236,375	233,446
Amortization of intangible assets	29,646	29,646
Service bureau charges	62,386	77,494
Professional services	129,258	72,863
Collection activity	18,205	42,173
Real estate owned & other repossessed assets	16,949	33,266
Other	219,503	259,527
Total non-interest expense	1,894,544	1,992,290

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Income before income tax expense	221,473	67,644
Income tax expense	—	—
Net Income	221,473	67,644
Other Comprehensive Income (Loss):		
Unrealized (loss) gain on investment securities - available for sale securities - net of tax	\$272,653	\$(99,797 )
Reclassification adjustment for gains realized in earnings - net of tax	—	—
Comprehensive Income (Loss)	\$494,126	\$(32,153 )
Per share data:		
Net Income per share		
Basic	\$0.08	\$0.02
Diluted	\$0.08	\$0.02
Weighted average number of shares outstanding		
Basic	2,884,049	2,884,049
Including dilutive stock options	2,884,049	2,884,049
Dividends per common share	\$0.02	\$—

See accompanying notes to consolidated financial statements.



**First Federal of Northern Michigan Bancorp Inc. and Subsidiaries**

## Consolidated Statement of Changes in Stockholders' Equity (Unaudited)

	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2013	31,918	(2,963,918)	23,853,891	2,763,242	(160,451 )	23,524,682
Net income	—	—	—	221,473	—	221,473
Change in unrealized gain on available-for-sale securities (net of tax of \$140,458)	—	—	—	—	272,653	272,653
Dividends declared	—	—	—	(57,681 )	—	(57,681 )
Balance at March 31, 2014	31,918	(2,963,918)	23,853,891	2,927,034	112,202	23,961,127

See accompanying notes to consolidated financial statements.

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

	For Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
<b>Cash Flows from Operating Activities:</b>		
Net income	\$221,473	\$67,644
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	101,720	100,605
Provision for loan loss	15,765	144,074
Amortization and accretion on securities	97,569	152,447
Gain on sale of loans held for sale	(41,739 )	(70,471 )
Originations of loans held for sale	(2,524,403)	(4,427,961 )
Proceeds from sale of loans held for sale	2,506,042	4,462,144
Gain on sale of fixed assets	(1,725 )	—
(Gain) loss on sale of real estate owned and other repossessed assets	6,538	(6,479 )
Net change in:		
Accrued interest receivable	(83,475 )	(63,960 )
Other assets	(16,876 )	76,000
Prepaid FDIC insurance premiums	—	42,573
Bank owned life insurance	(28,604 )	(33,079 )
Accrued expenses and other liabilities	(107,086 )	(129,826 )
Net cash provided by operating activities	145,199	313,711
<b>Cash Flows from Investing Activities:</b>		
Net decrease in loans	728,025	975,988
Proceeds from maturities and calls of available-for-sale securities	2,336,150	3,990,226
Proceeds from sale of real estate and other repossessed assets	80,462	196,645
Proceeds from sale of property and equipment	1,725	—
Purchase of securities	(8,104,932)	(5,433,778 )
Purchase of premises and equipment	(28,332 )	—
Net cash used in investing activities	(4,986,902)	(270,919 )
<b>Cash Flows from Financing Activities:</b>		
Dividends paid on common stock	(57,681 )	—
Net (decrease) increase in deposits	5,690,838	(172,334 )
Net increase in Repo Sweep accounts	—	682,630
Net increase in advances from borrowers	170,173	171,815
Advances from Federal Home Loan Bank	6,980,000	13,930,000
Repayments of Federal Home Loan Bank advances	(7,560,505)	(15,425,077)
Net cash provided by (used in) financing activities	5,222,825	(812,966 )
Net decrease in cash and cash equivalents	381,122	(770,174 )
Cash and cash equivalents at beginning of period	2,765,833	2,751,810

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Cash and cash equivalents at end of period	\$3,146,955	\$1,981,636
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Supplemental disclosure of cash flow information:

Cash paid during the period for interest	\$251,505	\$332,503
Transfers of loans to foreclosed real estate and repossessed assets	245,000	208,000

See accompanying notes to consolidated financial statements.

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

**AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1— BASIS OF FINANCIAL STATEMENT PRESENTATION**

The accompanying unaudited condensed consolidated interim financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q. Accordingly, certain information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The interim financial statements should be read in conjunction with the financial statements of First Federal of Northern Michigan Bancorp, Inc. and Subsidiaries and the notes thereto included in the Company's annual report on Form 10-K for the year ended December, 31, 2013.

All adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary for a fair presentation of financial position, results of operations and cash flows, have been made. The results of operations for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

**Note 2— PRINCIPLES OF CONSOLIDATION**

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

**Note 3— PROPOSED BUSINESS COMBINATION**

On January 23, 2014, the Company entered into a definitive merger agreement with Alpena Banking Corporation, the Michigan corporation and the bank holding company for Bank of Alpena. Under the terms of the merger agreement, each share of Alpena Banking Corporation will be converted into 1.549 shares of the Company's common stock. As of March 31, 2014, Bank of Alpena operated one office in Alpena, Michigan and had assets of \$69.9 million, deposits of \$62.7 million, other liabilities of \$269,000 and stockholders' equity of \$7.0 million. The merger agreement has been approved by the boards of directors of each company and is subject to the approvals of shareholders of the Company and of Alpena Banking Corporation, for which each company will hold a special meeting of shareholders, expected, in the third quarter of 2014. The merger is also subject to the requisite regulatory approvals and other customary closing conditions. As the merger has not been completed, the transaction is not reflected in the balance sheet or results of operation for the periods presented in this document.

**Note 4—SECURITIES**

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

	March 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Market Value
	(in thousands)			
Securities Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 10,345	\$ 34	\$ (94 )	10,285
Municipal obligations	14,568	258	(181 )	14,645
Corporate bonds & other obligations	1,072	10	—	1,082
Mortgage-backed securities	30,284	343	(207 )	30,420
Equity securities	3	7	—	10
Total	\$ 56,272	\$ 652	\$ (482 )	\$ 56,442
Securities Held to Maturity				
Municipal obligations	\$ 2,255	\$ 140	\$ —	\$ 2,395
	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Market Value
	(in thousands)			
Securities Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 7,111	\$ 36	\$ (105 )	7,042
Municipal obligations	13,694	216	(301 )	13,609
Corporate bonds & other obligations	1,085	12	—	1,097
Mortgage-backed securities	28,708	279	(384 )	28,603
Equity securities	3	4	—	7
Total	\$ 50,601	\$ 547	\$ (790 )	\$ 50,358
Securities Held to Maturity				
Municipal obligations	\$ 2,255	\$ 145	\$ —	\$ 2,400

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The amortized cost and estimated market value of securities at March 31, 2014, by contract maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities with no specified maturity date are separately stated.

	March 31, 2014	
	Amortized Cost	Market Value
	(in thousands)	
Available For Sale:		
Due in one year or less	\$2,401	\$2,414
Due after one year through five years	15,508	15,585
Due in five year through ten years	6,841	6,705
Due after ten years	1,235	1,308
Subtotal	25,985	26,012
Equity securities	3	10
Mortgage-backed securities	30,284	30,420
Total	\$56,272	\$56,442
Held To Maturity:		
Due in one year or less	\$90	\$91
Due after one year through five years	490	512
Due in five year through ten years	700	749
Due after ten years	975	1,043
Total	\$2,255	\$2,395

At March 31, 2014 and December, 31, 2013, securities with a carrying value and fair value of \$34,122,000 and \$36,000,000, respectively, were pledged to secure our REPO sweep accounts, FHLB advances and our line of credit at the Federal Reserve.

There were no security sales in either the three months ended March 31, 2014 or 2013.

The following is a summary of temporarily impaired investments that have been impaired for less than and more than twelve months as of March 31, 2014 and December, 31, 2013:

	March 31, 2014			
	Gross Unrealized Losses		Gross Unrealized Losses	
	Fair Value	<12 months	Fair Value	> 12 months
	(in thousands)			
Available For Sale:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$2,236	\$ (13 )	\$918	\$ (81 )
Municipal obligations	6,014	(134 )	1,220	(47 )
Mortgage-backed securities	10,391	(158 )	2,404	(49 )
Equity securities	—	—	—	—
<b>Total</b>	<b>\$18,641</b>	<b>\$ (305 )</b>	<b>\$4,542</b>	<b>\$ (177 )</b>
Held to Maturity:				
Municipal obligations	\$—	\$ —	\$—	\$ —
December 31, 2013				
	Gross Unrealized Losses		Gross Unrealized Losses	
	Fair Value	<12 months	Fair Value	> 12 months
	(in thousands)			
Available For Sale:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$—	\$ —	\$894	\$ (105 )
Municipal obligations	7,902	(243 )	1,668	(58 )
Mortgage-backed securities	14,471	(334 )	2,052	(50 )
Equity securities	—	—	—	—
<b>Total</b>	<b>\$22,373</b>	<b>\$ (577 )</b>	<b>\$4,614</b>	<b>\$ (213 )</b>



The Company held 33 securities with unrealized losses totaling \$482,000 and 39 securities with unrealized losses totaling \$790,000 at March 31, 2014 and December 31, 2013, respectively. The unrealized losses on the securities held in the portfolio are not considered other than temporary and have not been recognized into income. This decision is based on the Company's ability and intent to hold any potentially impaired security until maturity. The performance of the security is based on the contractual terms of the agreement, the extent of the impairment and the financial condition and credit quality of the issuer. The decline in market value is considered temporary and a result of changes in interest rates and other market variables.

**Note 5—LOANS AND ALLOWANCE FOR LOAN LOSSES**

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

	At March 31, 2014	At December 31, 2013
	(in thousands)	
Real estate loans:		
Residential mortgage	\$63,576	\$ 63,839
Commercial loans:		
Construction - real estate	173	173
Secured by real estate	51,382	51,726
Other	12,252	12,451
Total commercial loans	63,807	64,350
Consumer loans:		
Secured by real estate	8,490	8,730
Other	1,171	1,165
Total consumer loans	9,661	9,895
Total gross loans	\$137,044	\$ 138,084
Less:		
Net deferred loan fees	(260 )	(297 )
Allowance for loan losses	(1,458 )	(1,472 )
Total loans, net	\$135,326	\$ 136,315

The following table illustrates the contractual aging of the recorded investment in past due loans by class of loans as of March 31, 2014 and December, 31, 2013:

As of March 31, 2014

30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
(dollars in thousands)						

Commercial Real Estate:

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Commercial Real Estate - construction	\$—	\$ —	\$ 173	\$ 173	\$—	\$ 173	\$ —
Commercial Real Estate - other	2,203	12	1,441	3,656	47,726	51,382	—
Commercial - non real estate	18	—	—	18	12,234	12,252	—
Consumer:							
Consumer - Real Estate	83	2	—	85	8,405	8,490	—
Consumer - Other	6	—	—	6	1,165	1,171	—
Residential:							
Residential	1,304	—	159	1,463	62,113	63,576	—
Total	\$3,614	\$ 14	\$ 1,773	\$ 5,401	\$ 131,643	\$ 137,044	\$ —

As of December 31, 2013

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
(dollars in thousands)							
Commercial Real Estate:							
Commercial Real Estate - construction	\$—	\$—	\$ 173	\$ 173	\$—	\$ 173	\$ —
Commercial Real Estate - other	—	521	1,441	1,962	49,764	51,726	—
Commercial - non real estate	33	20	—	53	12,398	12,451	—
Consumer:							
Consumer - Real Estate	54	55	—	109	8,621	8,730	—
Consumer - Other	—	4	2	6	1,159	1,165	2
Residential:							
Residential	1,973	393	353	2,719	61,120	63,839	24
Total	\$2,060	\$ 993	\$ 1,969	\$ 5,022	\$ 133,062	\$ 138,084	\$ 26

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

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

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

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

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

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

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

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

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

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

The following table presents the risk category of loans by class of loans based on the most recent analysis performed and the contractual aging as of March 31, 2014 and December, 31, 2013:

As of March 31, 2014

Loan Grade	Commercial		
	Real Estate	Commercial Real Estate	Commercial
	Construction	Other	Commercial
	(dollars in thousands)		
1-2	\$ —	\$ —	\$ —
3	—	16,028	5,831
4	—	22,926	5,761
4.5	—	5,001	481
5	—	4,531	17
6	173	2,896	162
7	—	—	—
8	—	—	—
Total	\$173	\$ 51,382	\$ 12,252

As of December 31, 2013

Loan Grade	Commercial		
	Real Estate	Commercial Real Estate	Commercial
	Construction	Other	Commercial
	(dollars in thousands)		
1-2	\$ —	\$ —	\$ —
3	—	16,187	5,602
4	—	24,327	6,528
4.5	—	3,462	171
5	—	4,835	45
6	173	2,915	105
7	—	—	—
8	—	—	—
Total	\$173	\$ 51,726	\$ 12,451

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

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The following tables present the risk category of loans by class based on the most recent analysis performed as of March 31, 2014 and December, 31, 2013.

As of March 31, 2014

(dollars in thousands)

Residential

Loan Grade:

Pass	\$ 63,247
Special Mention	—
Substandard	329
Total	\$ 63,576

Consumer -

Real Estate

Consumer  
- Other

Performing	\$ 8,484	\$ 1,171
Nonperforming	6	—
Total	\$ 8,490	\$ 1,171

As of December 31, 2013

(dollars in thousands)

Residential

Loan Grade:

Pass	\$ 63,164
Special Mention	—
Substandard	675
Total	\$ 63,839

Consumer -

Real Estate

Consumer  
- Other

Performing	\$ 8,723	\$ 1,163
Nonperforming	7	2
Total	\$ 8,730	\$ 1,165

The following table presents the recorded investment in non-accrual loans by class as of March 31, 2014 and December, 31, 2013:

	As of	
	March	December
	31,	31,
	2014	2013
	(dollars in thousands)	
Commercial Real Estate:		
Commercial Real Estate - construction	\$ 173	\$ 173
Commercial Real Estate - other	1,453	1,454
Commercial	—	—
Consumer:		
Consumer - real estate	6	7
Consumer - other	—	—
Residential:		
Residential	329	651
Total	\$ 1,961	\$ 2,285

The key features of the Company's loan modifications are determined on a loan-by-loan basis. Generally, our restructurings have related to interest rate reductions and loan term extensions. In the past the Company has granted reductions in interest rates, payment extensions and short-term payment forbearances as a means to maximize collectability of troubled credits. The Company has not forgiven principal to date, although this would be considered if necessary to ensure the long-term collectability of the loan. The Company's loan modifications are typically short-term in nature, although the Company would consider a long-term modification to ensure the long-term collectability of the credit. In general, a borrower must make at least six consecutive timely payments before the Company would consider a return of a restructured loan to accruing status in accordance with Federal Deposit Insurance Corporation guidelines regarding restoration of credits to accrual status.

The Bank has classified approximately \$2.4 million of its impaired loans as troubled debt restructurings as of March 31, 2014. For the three months ended March 31, 2014, the Bank did not classify any loans as troubled debt restructurings; nor were there any troubled debt restructures that subsequently defaulted.

<p>Troubled Debt Restructurings</p>	<p>Troubled Debt Restructurings that Subsequently Defaulted</p>
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	For the three months ended March 31, 2013		For the three months ended March 31, 2013		
	Number of Loans	Pre-modification outstanding recorded investment	Position modification outstanding recorded investment	Number of Loans	Recorded Investment
	(dollars in thousands)		(dollars in thousands)		
Commerical Real Estate - Construction	—	\$ —	\$ —	—	\$ —
Commercial Real Estate - Other	1	412	410	—	—
Consumer - Other	—	—	—	—	—
Residential	2	331	270	1	190
Total	3	\$ 743	\$ 680	1	\$ 190

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

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

The following table presents the loans individually evaluated for impairment by class of loans as of March 31, 2014 and December, 31, 2013:

	Impaired Loans As of March 31, 2014			March 31, 2014	
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Interest Recorded Investment	Income Recognized
	(dollars in thousands)			(dollars in thousands)	
With no related allowance recorded:					
Commercial	\$—	\$ —	\$ —	\$—	\$ —
Commercial Real Estate - Construction	—	—	—	—	—
Commercial Real Estate - Other	1,478	1,477	—	1,595	21
Consumer - Real Estate	7	6	—	6	—
Consumer - Other	—	—	—	—	—
Residential	485	375	—	382	1
With a specific allowance recorded:					
Commercial	—	—	—	—	—
Commercial Real Estate - Construction	1,589	173	48	173	—
Commercial Real Estate - Other	2,426	1,838	137	1,840	4
Consumer - Real Estate	—	—	—	—	—
Consumer - Other	—	—	—	—	—
Residential	53	30	5	30	—
Totals:					
Commercial	\$—	\$ —	\$ —	\$—	\$ —
Commercial Real Estate - Construction	\$1,589	\$ 173	\$ 48	\$173	\$ —
Commercial Real Estate - Other	\$3,904	\$ 3,315	\$ 137	\$3,435	\$ 25
Consumer - Real Estate	\$7	\$ 6	\$ —	\$6	\$ —
Consumer - Other	\$—	\$ —	\$ —	\$—	\$ —
Residential	\$538	\$ 405	\$ 5	\$412	\$ 1

	Impaired Loans As of December 31, 2013			December 31, 2013	
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Interest Recorded Investment	Income Recognized
	(dollars in thousands)			(dollars in thousands)	
With no related allowance recorded:					
Commercial	\$—	\$ —	\$ —	\$—	\$ —
Commercial Real Estate - Construction	—	—	—	—	—
Commercial Real Estate - Other	1,789	1,788	—	1,894	104
Consumer - Real Estate	8	7	—	7	—

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Consumer - Other	—	—	—	—	—
Residential	954	722	—	727	6
With a specific allowance recorded:					
Commercial	—	—	—	—	—
Commercial Real Estate - Construction	1,589	173	48	173	—
Commercial Real Estate - Other	3,980	3,391	182	3,397	94
Consumer - Real Estate	—	—	—	—	—
Consumer - Other	—	—	—	—	—
Residential	53	30	5	30	—
Totals:					
Commercial	\$—	\$ —	\$ —	\$—	\$ —
Commercial Real Estate - Construction	\$1,589	\$ 173	\$ 48	\$173	\$ —
Commercial Real Estate - Other	\$5,769	\$ 5,179	\$ 182	\$5,291	\$ 198
Consumer - Real Estate	\$8	\$ 7	\$ —	\$7	\$ —
Consumer - Other	\$—	\$ —	\$ —	\$—	\$ —
Residential	\$1,007	\$ 752	\$ 5	\$757	\$ 6

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

Activity in the allowance for loan and lease losses was as follows for the quarters ended March 31, 2014 and 2013, respectively:

Allowance for Credit Losses and Recorded Investment in Financing Receivables

For the Three Months Ended March 31, 2014

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$48	\$ 444	\$ 63	\$ 62	\$ 21	\$ 784	\$ 50	\$1,472
Charge-offs	—	(16 )	—	(11 )	(6 )	(35 )	—	(68 )
Recoveries	—	19	—	9	—	10	—	38
Provision	—	(55 )	(2 )	(11 )	1	33	50	16
Ending Balance	\$48	\$ 392	\$ 61	\$ 49	\$ 16	\$ 792	\$ 100	\$1,458

Loan Balances Individually Evaluated for Impairment

As of March 31, 2014

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
Ending balance: individually evaluated for impairment	\$48	\$ 137	\$ —	\$ —	\$ —	\$ 5	\$ —	\$190
Ending balance: loans collectively evaluated for impairment	\$—	\$ 255	\$ 61	\$ 49	\$ 16	\$ 787	\$ 100	\$1,268
Loans:								
Ending Balance	\$173	\$ 51,382	\$ 12,252	\$ 8,490	\$ 1,171	\$ 63,576	\$ —	\$137,044
Ending balance: individually evaluated for impairment	\$173	\$ 3,315	\$ —	\$ 6	\$ —	\$ 405	\$ —	\$3,899
Ending balance: loans collectively evaluated for impairment	\$—	\$ 48,067	\$ 12,252	\$ 8,484	\$ 1,171	\$ 63,171	\$ —	\$133,145

For the Three Months Ended March 31, 2013

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
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## Allowance for credit losses:

Beginning Balance	\$64	\$ 579	\$ 69	\$ 99	\$ 33	\$ 906	\$ —	\$1,750
Charge-offs	—	(85 )	—	(7 )	(6 )	(162 )	—	(260 )
Recoveries	—	10	—	15	4	12	—	41
Provision	25	5	18	(20 )	(5 )	121	—	144
Ending Balance	\$89	\$ 509	\$ 87	\$ 87	\$ 26	\$ 877	\$ —	\$1,675

Loan Balances Individually Evaluated for Impairment  
As of March 31, 2013

	Commercial Construction	Commercial Real Estate	Commercial	Consumer Real Estate	Consumer	Residential	Unallocated	Total
	(dollars in thousands)							
Ending balance: individually evaluated for impairment	\$—	\$ 48	\$ —	\$ —	\$ —	\$ 89	\$ —	\$137
Ending balance: loans collectively evaluated for impairment	\$89	\$ 461	\$ 87	\$ 87	\$ 26	\$ 788	\$ —	\$1,538
Loans:								
Ending Balance	\$2,618	\$ 50,156	\$ 9,473	\$ 9,813	\$ 1,156	\$ 66,364	\$ —	\$139,580
Ending balance: individually evaluated for impairment	\$173	\$ 6,703	\$ —	\$ 9	\$ —	\$ 1,910	\$ —	\$8,795
Ending balance: loans collectively evaluated for impairment	\$2,445	\$ 43,453	\$ 9,473	\$ 9,804	\$ 1,156	\$ 64,454	\$ —	\$130,785

**Note 6—DIVIDENDS**

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

**Note 7—STOCK-BASED COMPENSATION**

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

During the three months ended March 31, 2014 no shares were awarded under either the 1996 Plan or the 2006 Plan. Shares issued under the plans and exercised pursuant to the exercise of the stock options awarded under the plans may be either authorized but unissued shares or reacquired shares held by the Company as treasury stock.

**Stock Options** - A summary of option activity under the Plans during the three months ended March 31, 2014 is presented below:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	150,030	\$ 9.52	2.4	\$ 0
Granted	0	N/A		
Exercised	0	N/A		
Forfeited or expired	(1,200 )	\$ 7.60		
Outstanding at March 31, 2014	148,830	\$ 9.54	2.1	\$ 0
Options Exercisable at March 31, 2014	148,830	\$ 9.54	2.1	\$ 0

The aggregate intrinsic value of outstanding options shown in the table above represents the total pretax intrinsic value (i.e. the difference between the Company's closing stock price of \$5.00 on March 31, 2014 and the exercise price times the number of shares) that would have been received by the option holder had all option holders exercised their options on March 31, 2014. The amount changes based on the fair market value of the stock.

As of March 31, 2014 the Company had no unrecognized compensation cost related to nonvested options under the Plan. There were no shares which vested during the quarter ended March 31, 2014. In addition, there were no non-vested options as of March 31, 2014.

**Restricted Stock Awards** - As of March 31, 2014 all restricted stock awards have vested; therefore the Company had no unrecognized compensation cost under the Plans.

**Note 8— COMMITMENTS TO EXTEND CREDIT**

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

At March 31, 2014, the Company had outstanding commitments to originate loans of \$19.2 million. These commitments included the following:

	As of March 31, 2014 (in thousands)
Commitments to grant loans	\$ 6,544
Unfunded commitments under lines of credit	12,631
Commercial and standby letters of credit	59

**Note 9— FAIR VALUE MEASUREMENTS**

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

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

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



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

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of March 31, 2014 and December, 31, 2013, and the valuation techniques used by the Company to determine those fair values.

## Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2014

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at March 31, 2014
Assets				
Investment securities- available-for-sale:				
US Treasury securities and obligations of U.S. government corporations and agencies	\$—	\$ 10,285	\$ —	\$ 10,285
Municipal obligations	—	14,645	—	14,645
Corporate bonds & other obligations	—	1,082	—	1,082
Mortgage-backed securities	—	30,420	—	30,420
Equity securities	—	10	—	10
Total investment securities - available-for-sale	\$—	\$ 56,442	\$ —	\$ 56,442

## Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2013

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value as of December 31, 2013
Assets				
Investment securities - available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$—	\$ 7,042	\$ —	\$ 7,042

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Municipal obligations	—	13,609	—	13,609
Corporate bonds & other obligations	—	1,097	—	1,097
Mortgage-backed securities	—	28,603	—	28,603
Equity securities	—	7	—	7
Total investment securities - available-for-sale	\$—	\$ 50,358	\$ —	\$ 50,358

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

There were no transfers between Levels 1 and 2 of the fair value hierarchy from December, 31, 2013 to March 31, 2014. For the available for sale securities, the Company obtains fair value measurements from an independent third-party service.

The Company has assets that, under certain conditions, are subject to measurement at fair value on a nonrecurring basis. At March 31, 2014 and December, 31, 2013, such assets consist primarily of impaired loans and other real estate owned. The Company has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

## Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2014

	Balance at March 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans accounted for under FASB ASC 310-10	\$3,488	\$ —	\$ —	\$ 3,488
Other real estate owned -residential mortgages	443	—	—	443
Other Real estate owned - commercial	472	—	—	472
Other repossessed assets	1,023	—	—	1,023
Total assets at fair value on a non-recurring basis				\$ 5,426

## Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2013

	Balance at December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans accounted for under FASB ASC 310-10	\$5,352	\$ —	\$ —	\$ 5,352
Other real estate owned -residential mortgages	285	—	—	285
Other real estate owned - commercial	472	—	—	472
Other repossessed assets	1,023	—	—	1,023
Total assets at fair value on a non-recurring basis				\$ 7,132

A loan is considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the original loan agreement. Loans identified as impaired are measured using one of three methods: the loan's observable market price; the fair value of collateral; or the present value of expected future cash flows. For each period presented, no loans

were measured using the loan's observable market price. Collateral may be in the form of real estate and/or business assets such as accounts receivable, inventory or business equipment.

Real estate is the collateral for the vast majority of our secured lending. The real estate's value is based on observable market prices and market values provided by independent, third-party licensed or certified appraisers, selected from a list of Company-approved appraisers. Appraisals for all types of collateral-dependent loans are typically requested within 30 days of a loan being deemed impaired. The fair value of impaired loans with specific allocations is essentially based on recent real estate appraisals less costs to sell. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised collateral values may be further discounted based on management's historical knowledge of the property and/or changes in market conditions from the time of valuation or management's plan for disposal. Subsequent evaluations of collateral are performed on a loan by loan basis as additional facts and circumstances related to the individual credit require, but not less than annually.

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

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

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

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

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

**Federal Home Loan Bank Stock** - The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

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

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

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

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

March 31, 2014	Carrying Value	Level 1	Level 2	Level 3	Total Estimated Fair Value
	(dollars in thousands)				
Financial assets:					
Cash and cash equivalents	\$3,147	\$3,147	\$—	\$—	\$3,147
Securities available for sale	56,442	—	56,442	—	56,442
Securities held to maturity	2,255	—	2,395	—	2,395
Loans held for sale	236	—	—	240	240
Loans receivable - net	135,326	—	—	134,043	134,043
Federal Home Loan Bank stock	3,266	—	3,266	—	3,266
Accrued interest receivable	828	—	—	828	828
Financial liabilities:					
Customer deposits	165,720	—	166,214	—	166,214
Federal Home Loan Bank advances	24,233	—	23,927	—	23,927
Accrued interest payable	88	—	—	88	88
December 31, 2013	Carrying Value	Level 1	Level 2	Level 3	Total Estimated Fair Value
	(dollars in thousands)				
Financial assets:					

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Cash and cash equivalents	\$2,766	\$2,766	\$—	\$—	\$2,766
Securities available for sale	50,358	—	50,358	—	50,358
Securities held to maturity	2,255	—	2,400	—	2,400
Loans held for sale	175	—	—	178	178
Loans receivable - net	136,315	—	—	135,172	135,172
Federal Home Loan Bank stock	3,266	—	3,266	—	3,266
Accrued interest receivable	745	—	—	745	745
Financial liabilities:					
Customer deposits	160,029	—	160,784	—	160,784
Federal Home Loan Bank advances	24,813	—	24,458	—	24,458
Accrued interest payable	89	—	—	89	89



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

**AND SUBSIDIARIES**

**PART - FINANCIAL INFORMATION**

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

The following discussion compares the consolidated financial condition of the Company at March 31, 2014 and December, 31, 2013, and the results of operations for the three-month periods ended March 31, 2014 and 2013. This discussion should be read in conjunction with the interim financial statements and footnotes included herein.

**OVERVIEW**

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

For the quarter ended March 31, 2014, the Company had net income of \$221,000, or \$0.08 per basic and diluted share, compared to \$68,000, or \$0.02 per basic and diluted share, for the year earlier period, an increase of \$153,000.

Total assets increased \$5.6 million, or 2.7%, from \$209.7 million as of December, 31, 2013 to \$215.3 million as of March 31, 2014. Cash and cash equivalents increased \$381,000, investment securities available for sale increased \$6.0 million and net loans receivable decreased \$989,000 during the quarter. Total deposits increased \$5.7 million from December, 31, 2013 to March 31, 2014 while Federal Home Loan Bank advances decreased \$580,000 and stockholders' equity increased \$436,000.

## CRITICAL ACCOUNTING POLICIES

As of March 31, 2014, there have been no changes in the critical accounting policies as disclosed in the Company's Form 10-K for the year ended December, 31, 2013. The Company's critical accounting policies are described in the Management's Discussion and Analysis and financial sections of its 2013 Annual Report. Management believes its critical accounting policies relate to the Company's allowance for loan losses, mortgage servicing rights, valuation of deferred tax assets and impairment of intangible assets.

## COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2014 AND DECEMBER, 31, 2013

**ASSETS:** Total assets increased \$5.6 million, or 2.7%, to \$215.3 million at March 31, 2014 from \$209.7 million at December, 31, 2013. Net loans receivable decreased \$989,000, or 0.7%, to \$135.3 million at March 31, 2014 from \$136.3 million at December, 31, 2013, resulting primarily from decreases of \$266,000, \$233,000 and \$503,000 in our mortgage, consumer and commercial loan portfolios, respectfully. Investment securities AFS increased \$6.0 million from \$50.4 million at December, 31, 2013 to \$56.4 million at March 31, 2014, due primarily to purchases of \$3.3 million in agency securities and \$1.5 million in mortgage-backed securities during the period. Cash and cash equivalents increased \$381,000, or 13.8%, to \$3.1 million at March 31, 2014 from \$2.8 million at December, 31, 2013.

**LIABILITIES:** Deposits increased \$5.7 million to \$165.7 million at March 31, 2014 from \$160.0 million at December, 31, 2013. During this time period, we experienced an increase of \$6.4 million in our savings, money market and checking accounts, which was partially offset by a decrease of \$707,000 in our certificates of deposit. FHLB advances decreased \$580,000, or 2.3%, to \$24.2 million at March 31, 2014 from \$24.8 million at December, 31, 2013, as proceeds from loan payments and payoffs, as well as cash on hand, were used to pay off maturing advances.

**EQUITY:** Stockholders' equity increased \$436,000 to \$24.0 million at March 31, 2014 from \$23.5 million at December, 31, 2013. The increase was due to net earnings for the three-month period of \$221,000 and an increase of \$273,000 in the unrealized gain on available-for-sale investment securities. Partially offsetting these increases was a dividend payment of \$58,000.

## RESULTS OF OPERATIONS

### *Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013*

**General:** Net income increased \$153,000 to \$221,000 for the three months ended March 31, 2014 from \$68,000 for the quarter ended March 31, 2013.

**Interest Income:** Interest income decreased to \$2.0 million for the three months ended March 31, 2014 from \$2.1 million for the comparable period in 2013 as the average balance of interest earning assets increased \$503,000 from \$196.3 million for the three months ended March 31, 2013 to \$196.8 million for the three months ended March 31, 2014 while the average yield on interest earning assets decreased 10 basis points from 4.28% to 4.18%. The yield on our mortgage loan portfolio decreased by 26 basis points to 4.88% for the three months period to period ended March 31, 2014 from 5.14% for the year-earlier period, while the average balance of that portfolio decreased \$3.2 million, to \$63.6 million, period over period. The average balance of our non-mortgage loan portfolio decreased \$467,000 to \$73.5 million for the three months ended March 31, 2014 from the 2013 quarter, while the yield on this portfolio decreased 9 basis points to 5.16% from 5.25% period over period. The average balance of our investment portfolio increased \$3.6 million for the three months ended March 31, 2014 to the same period in 2013 and the yield on our investments increased 24 basis points period over period.

**Interest Expense:** Interest expense decreased to \$249,000 for the three months ended March 31, 2014 from \$321,000 for the three months ended March 31, 2013. The decrease was due in part to a \$3.8 million decrease in the average balance of our interest-bearing liabilities and a decrease in our overall cost of funds of 16 basis points from 0.78% to 0.62% period over period. Most notably, the average balance of our REPO sweep deposit accounts decreased \$3.9 million and the cost of these deposits decreased 21 basis points when compared to the same period in 2013, as we discontinued offering this product in the fourth quarter of 2013. The average balance of Federal Home Loan Bank advances decreased \$3.0 million for the three-month period ended March 31, 2014 from the same period in 2013. The cost of these advances decreased 40 basis points from 1.47% to 1.07% period over period. In addition, our average balance in certificates of deposit decreased \$6.2 million with the cost of these deposits decreasing 13 basis points from 1.09% to 0.96% for the quarter ended March 31, 2013 and March 31, 2014, respectively. These decreases were partially offset by average balance increases of \$7.3 million in money market and NOW accounts and \$2.0 million in savings deposits when comparing the three months ended March 31, 2014 to the same period in 2013.



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

	Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013 Increase (Decrease) Due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning assets:			
Loans receivable	\$(72 )	\$(34 )	\$(106)
Investment securities	18	31	\$49
Other investments	3	14	\$17
Total interest-earning assets	(51 )	11	(40 )
Interest-bearing liabilities:			
Savings Deposits	—	—	—
Money Market/NOW accounts	4	(1 )	3
Certificates of Deposit	(24 )	(14 )	(38 )
Deposits	(20 )	(15 )	(35 )
Borrowed funds	(611)	574	(37 )
Total interest-bearing liabilities	(631)	559	(72 )
Change in net interest income	\$580	\$(548)	\$32

**Net Interest Income:** Net interest income increased slightly by \$32,000 and remained at \$1.8 million for the three months ended March 31, 2014 and March 31, 2013. For the three months ended March 31, 2014, average interest-earning assets increased \$503,000, or 0.3%, to \$196.8 million when compared to the same period in 2013. Average interest-bearing liabilities decreased \$3.8 million, or 2.3%, to \$164.5 million for the quarter ended March 31, 2014 from \$168.3 million for the quarter ended March 31, 2013. The Company saw the average balance of core interest-bearing deposits increase \$9.3 million for the three months ended March 31, 2014 compared to the same period in 2013, while the average balance of our certificates of deposit decreased \$6.2 million period over period. In addition, the average balance of non-interest bearing deposits increased \$3.2 million for the three-month period ended March 31, 2014 compared to the same period in 2013. The yield on average interest-earning assets decreased to 4.18% for the three month period ended March 31, 2014 from 4.28% for the same period ended in 2013 as we continued to see a decline in loan rates period over period. In addition, the cost of average interest-bearing liabilities decreased to 0.62% from 0.78% for the three month periods ended March 31, 2014 and 2013, respectively. Our interest rate spread increased 6 basis points to 3.56% from 3.50% and our net interest margin increased 5 basis points to 3.66% for the three-month period ended March 31, 2014 from 3.61% for same period in 2013. At March 31, 2014 the Company had outstanding loan commitments of \$19.2 million. During the three months ended March 31, 2014 the Company grew

average interest bearing core deposits by \$7.7 million.

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

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

The provision for loan losses for the three-month period ended March 31, 2014 was \$16,000, as compared to \$144,000 for the three months ended March 31, 2013. Prior to 2012, our provision for loan losses was based on an eight-quarter rolling average of actual net charge-offs adjusted for environmental factors for each segment of loans in our portfolio. Management has decided that eight quarters is no longer reflective of the inherent loss in the loan portfolios. Beginning with the quarter ended March 31, 2013, we began moving towards a twelve-quarter rolling average of actual net charge-offs by adding an additional quarter of net charge-offs each quarter in 2013. By the end of 2013 we were using a twelve-quarter rolling average. During the quarter ended March 31, 2014, we reduced specific reserves of approximately \$44,000 on one commercial credit relationship, which was classified as Troubled Debt Restructurings, as a result of securing a guarantee from the Small Business Administration on this credit. By comparison, the first quarter of 2014 had fewer loans requiring specific reserves along with lower levels of charge-offs. The provision was based on management's review of the components of the overall loan portfolio, the status of non-performing loans and various subjective factors.

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

	Portfolio Balance	Delinquent Loans Over 90 Days	Non-Accrual Loans
(Dollars in thousands)			
<u>At March 31, 2014</u>			
Real estate loans:			
One - to four - family	\$63,576	\$ —	\$ 329
Commercial construction real estate	173	—	173
Commercial Mortgages	51,382	—	1,453
Home equity lines of credit/ Junior liens	8,490	—	—
Commercial loans	12,252	—	—
Consumer loans	1,171	—	6
Total gross loans	\$137,044	\$ —	\$ 1,961
Less:			
Net deferred loan fees	(260 )	—	(1 )
Allowance for loan losses	(1,458 )	—	(196 )
Total loans, net	\$135,326	\$ —	\$ 1,764
<u>At December 31, 2013</u>			
Real estate loans:			
Construction	\$1,756	\$ —	\$ 173
One - to four - family	62,256	24	651
Commercial Mortgages	51,726	—	1,454
Home equity lines of credit/Junior liens	8,730	—	7
Commercial loans	12,451	—	—
Consumer loans	1,165	2	—

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Total gross loans	\$ 138,084	\$ 26	\$ 2,285
Less:			
Net deferred loan fees	(297 )	—	(1 )
Allowance for loan losses	(1,472 )	—	(200 )
Total loans, net	\$ 136,315	\$ 26	\$ 2,084

**Non Interest Income:** Non-interest income decreased \$104,000, or 23.6%, to \$336,000 for the quarter ended March 31, 2014 from \$440,000 in the 2013 quarter. Mortgage banking activities decreased \$75,000, service charges and other fees decreased \$11,000 and loss on sale of real estate owned and other repossessed assets increased \$11,000 for the three months ended March 31, 2014 when compared to the same period a year earlier.

**Non Interest Expense:** Non interest expense decreased \$98,000 to \$1.9 million for the 2014 period from \$2.0 million for the three months ended March 31, 2013. The decrease occurred in the following areas; compensation and employee benefits decreased \$50,000 period over period, as we reduced staffing and self insured a portion of our health insurance premiums, \$15,000 in service bureau expense, \$11,000 in marketing expense and \$41,000 in expenses related to troubled credits and real estate owned. In addition, other expenses decreased \$40,000 related commercial loan expenses. Partially offsetting these decreases was an increase of \$56,000 in professional service fees primarily related to the proposed merger.

**Income Taxes:** The Company recorded no federal income tax expense for the three months ended March 31, 2014 and March 31, 2013 as a result of the valuation allowance against the Company's deferred tax asset.



The Company will continue to evaluate the future benefits from these carryforwards and at such time as it becomes “more likely than not” that they would be utilized prior to expiration, the Company will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will fully expire in the year 2033.

## **LIQUIDITY**

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

Liquidity represents the amount of an institution’s assets that can be quickly and easily converted into cash without significant loss. The most liquid assets are cash, short-term U.S. Government securities, U.S. Government agency securities and certificates of deposit. The Company is required to maintain sufficient levels of liquidity as defined by OCC regulations. This requirement may be varied at the direction of the OCC. Regulations currently in effect require that the Bank maintain sufficient liquidity to ensure its safe and sound operation. The Company’s objective for liquidity is to be above 20%. Liquidity as of March 31, 2014 was \$65.1 million, or 50.4%, compared to \$53.4 million, or 42.4%, at December, 31, 2013. The levels of these assets are dependent on the Company’s operating, financing, lending and investing activities during any given period. The liquidity calculated by the Company includes additional borrowing capacity available with the FHLB. This borrowing capacity is based on pledged collateral. As of March 31, 2014, the Bank had unused borrowing capacity totaling \$28.5 million at the FHLB based on pledged collateral.

The Company intends to retain for its portfolio certain originated residential mortgage loans (primarily adjustable rate and shorter term fixed rate mortgage loans) and to generally sell the remainder of these loans. The Bank will from time to time participate in or originate commercial real estate loans, including real estate development loans. During the three month period ended March 31, 2014, the Company originated \$3.8 million in residential mortgage loans, of which \$2.5 million were retained in portfolio while the remainder were sold or are being held for sale. This compares to \$6.9 million in originations during the first three months of 2013 of which \$2.5 million were retained in portfolio. The Company also originated \$5.5 million of commercial loans and \$439,000 of consumer loans in the first three months of 2014 compared to \$6.2 million of commercial loans and \$253,000 of consumer loans for the same period in 2013. Of total loans receivable, excluding loans held for sale, mortgage loans comprised 46.4% and 47.6%, commercial loans 46.6% and 44.6% and consumer loans 7.0% and 7.9% at March 31, 2014 and March 31, 2013, respectively.

Deposits are a primary source of funds for use in lending and for other general business purposes. At March 31, 2014 deposits funded 77.0% of the Company's total assets compared to 76.3% at December, 31, 2013. Certificates of deposit scheduled to mature in less than one year at March 31, 2014 totaled \$31.3 million. Management believes that a significant portion of such deposits will remain with the Bank. The Bank monitors the deposit rates offered by competition in the area and sets rates that take into account the prevailing market conditions along with the Bank's liquidity position. Future liquidity needs are expected to be satisfied through the use of FHLB borrowings, as necessary, and through growth in deposits. Management does not generally plan on paying above-market rates on deposit products, although from time-to-time we may do so as liquidity needs dictate.

Borrowings may be used to compensate for seasonal or other reductions in normal sources of funds or for deposit outflows at more than projected levels. Borrowings may also be used on a longer-term basis to support increased lending or investment activities. At March 31, 2014 the Company had \$24.2 million in FHLB advances, of which \$5.4 million will mature during 2014. FHLB borrowings as a percentage of total assets were 11.3% at March 31, 2014 as compared to 11.8% at December, 31, 2013. The Company has sufficient available collateral to obtain additional advances of \$28.5 million.

**CAPITAL RESOURCES**

Stockholders' equity at March 31, 2014 was \$24.0 million, or 11.1% of total assets, compared to \$23.5 million, or 11.2% of total assets, at December, 31, 2013 (See "Consolidated Statement of Changes in Stockholders' Equity"). The Bank is subject to certain capital-to-assets levels in accordance with OCC regulations. The Bank exceeded all regulatory capital requirements at March 31, 2014. The following table summarizes the Bank's actual capital with the regulatory capital requirements and with requirements to be "Well Capitalized" under prompt corrective action provisions, as of March 31, 2014:

	Actual		Regulatory Minimum		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	Dollars in Thousands					
Tier 1 (Core) capital ( to adjusted assets)	\$22,773	10.61 %	\$8,586	4.00 %	\$10,732	5.00 %
Total risk-based capital ( to risk- weighted assets)	\$24,231	18.14 %	\$10,686	8.00 %	\$13,357	10.00 %
Tier 1 risk-based capital ( to risk weighted assets)	\$22,773	17.05 %	\$5,343	4.00 %	\$8,014	6.00 %
Tangible Capital ( to tangible assets)	\$22,773	10.61 %	\$3,220	1.50 %	\$4,293	2.00 %

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

Not applicable to smaller reporting companies.

**ITEM 4. CONTROLS AND PROCEDURES**

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

There has been no change in the Company's internal control over financial reporting during the Company's first quarter of 2014 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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

**FORM 10-Q**

**Quarter Ended March 31, 2014**

**PART II – OTHER INFORMATION**

Item 1 - Legal  
Proceedings:

At March 31,  
2014 there were  
no material legal  
proceedings to  
which the  
Company is a  
party or of which  
any of its  
property is  
subject. From  
time to time the  
Company is a  
party to various  
legal proceedings  
incident to its  
business.

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

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

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

Item 3 - Defaults upon  
Senior Securities:

Not applicable.

Item 4 - Mine Safety  
Disclosures  
Not applicable

Item 5 - Other  
Information:  
Not applicable

Item 6 - Exhibits

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

Exhibit 31.2  
Certification by  
VP - Director of  
Financial  
Reporting &  
Accounting  
pursuant to  
section 302 of the  
Sarbanes-Oxley  
Act of 2002

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

Exhibit 32.2  
Statement of VP -  
Director of  
Financial  
Reporting &  
Accounting  
furnished  
pursuant to  
Section 906 of

the  
Sarbanes-Oxley  
Act of 2002

101.INS XBRL Taxonomy Instance Document  
101.SCH XBRL Taxonomy Extension Schema Linkbase  
101.CAL XBRL Taxonomy Extension Calculation Linkbase  
101.DEF XBRL Taxonomy Extension Definition Linkbase  
101.LAB XBRL Taxonomy Extension Label Linkbase  
101.PRE XBRL Taxonomy Extension Presentation Linkbase

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

**FORM 10-Q**

**Quarter Ended March 31, 2014**

**SIGNATURES**

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

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

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

Date: May 13, 2014

By: /s/ Eileen M Budnick  
Eileen M. Budnick, VP - Director of Financial Reporting & Accounting  
(Principal Financial and Accounting Officer)

Date: May 13, 2014