

FENTURA FINANCIAL INC  
Form 10-Q  
May 17, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2012

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE 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)

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**Michigan** **38-2806518**  
(State or other jurisdiction of **(IRS Employee**  
**incorporation or organization)** **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

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 1, 2012

Class	Common Stock	Shares Outstanding
		2,403,741

**Table of Contents**

**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>	3-31
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32-43
<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

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****FENTURA FINANCIAL, INC.****CONSOLIDATED BALANCE SHEETS****(Unaudited)**

(000s omitted except share and per share data)

	March 31, 2012	Dec 31, 2011
<b><u>ASSETS</u></b>		
Cash and cash equivalents	\$ 30,476	\$ 18,634
Securities:		
Securities available for sale	59,708	58,687
Securities held to maturity	2,963	2,963
Total securities	62,671	61,650
Loans held for sale	593	123
Loans:		
Commercial	33,207	33,956
Commercial real estate	113,238	118,984
Residential real estate	26,845	26,829
Consumer	25,397	25,998
Total loans	198,687	205,767
Less: Allowance for loan losses	(7,675)	(8,164)
Net loans	191,012	197,603
Bank owned life insurance	5,967	5,941
Bank premises and equipment	10,106	10,202
Federal Home Loan Bank stock	661	661
Accrued interest receivable	984	1,039
Other real estate owned	3,006	1,949
Other assets	990	1,059
Total assets	\$ 306,466	\$ 298,861
<b><u>LIABILITIES AND STOCKHOLDERS EQUITY</u></b>		
Deposits:		
Non-interest bearing	\$ 72,348	\$ 62,713
Interest bearing	201,306	203,168
Total deposits	273,654	265,881
Federal Home Loan Bank advances	923	923
Subordinated debentures	14,000	14,000
Accrued taxes, interest and other liabilities	3,719	3,397
Total liabilities	292,296	284,201

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Stockholders' equity		
Common stock - no par value, 5,000,000 shares authorized 2,403,741 shares issued and outstanding at March 31, 2012 (2,388,225 at December 31, 2011)	43,229	43,191
Accumulated deficit	(29,293)	(28,554)
Accumulated other comprehensive income	234	23
Total stockholders' equity	14,170	14,660
Total liabilities and stockholders' equity	\$ 306,466	\$ 298,861

See accompanying notes to consolidated financial statements.

**Table of Contents****FENTURA FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

(000s omitted except share and per share data)

	<b>Three Months Ended March 31</b>	
	<b>2012</b>	<b>2011</b>
Interest income		
Loans, including fees	\$ 2,757	\$ 3,081
Interest and dividends on securities:		
Taxable	320	279
Tax-exempt	30	45
Interest on federal funds sold	8	9
<b>Total interest income</b>	<b>3,115</b>	<b>3,414</b>
Interest expense		
Deposits	496	722
Borrowings	132	126
<b>Total interest expense</b>	<b>628</b>	<b>848</b>
<b>Net interest income</b>	<b>2,487</b>	<b>2,566</b>
Provision for loan losses	863	795
<b>Net interest income after provision for loan losses</b>	<b>1,624</b>	<b>1,771</b>
Non-interest income		
Service charges on deposit accounts	239	296
Trust and investment services income	219	288
Gain on sale of mortgage loans	215	68
Gain on sale of securities	18	5
Other income and fees	428	502
<b>Total non-interest income</b>	<b>1,119</b>	<b>1,159</b>
Non-interest expense		
Salaries and employee benefits	1,723	1,673
Occupancy	269	284
Furniture and equipment	253	292
Loan and collection	143	161
Advertising and promotional	31	19
Other operating expenses	1,187	845
<b>Total non-interest expense</b>	<b>3,606</b>	<b>3,274</b>
<b>Loss from continuing operations before income tax</b>	<b>(863)</b>	<b>(344)</b>
Federal income tax benefit	(124)	(212)
<b>Net loss from continuing operations</b>	<b>\$ (739)</b>	<b>\$ (132)</b>
Discontinued operations, net of tax		
Net loss from discontinued operations	0	(27)

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Gain from sale of discontinued operations	0	469
Net income from discontinued operations	0	442
Net (loss) income	\$ (739)	\$ 310
Net loss per share from continuing operations Basic and diluted	\$ (0.31)	\$ (0.06)
Net income per share from discontinued operations Basic and diluted	\$ 0.00	\$ 0.19
Net income (loss) per share Basic and diluted	\$ (0.31)	\$ 0.13

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

**Table of Contents****FENTURA FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY****(Unaudited)**

(000s omitted except share and per share data)

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Common Stock</b>		
Balance, beginning of period	\$ 43,191	\$ 43,036
Issuance of shares under		
Director stock purchase plan and dividend reinvestment program (15,516 and 11,842 shares)	38	26
<b>Balance, end of period</b>	<b>43,229</b>	<b>43,062</b>
<b>Accumulated Deficit</b>		
Balance, beginning of period	(28,554)	(27,042)
Net income (loss)	(739)	310
<b>Balance, end of period</b>	<b>(29,293)</b>	<b>(26,732)</b>
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance, beginning of period	23	61
Change in unrealized gain (loss) on securities, net of tax	211	(185)
<b>Balance, end of period</b>	<b>234</b>	<b>(124)</b>
<b>Total stockholders equity</b>	<b>\$ 14,170</b>	<b>\$ 16,206</b>

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



**Table of Contents****FENTURA FINANCIAL, INC****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

(000s omitted)	Three Months Ended March 31,	
	2012	2011
<b>OPERATING ACTIVITIES:</b>		
Net (loss) income	\$ (739)	\$ 310
Adjustments to reconcile net (loss) income to cash Provided by operating activities:		
Depreciation	162	183
Amortization and accretion	(145)	(73)
Provision for loan losses	863	795
Loans originated for sale	(12,642)	(4,357)
Proceeds from the sale of loans	12,387	4,789
Gain on sales of loans	(215)	(68)
Loss (gain) on other real estate owned	2	(7)
Write downs on other real estate owned	0	85
Net gain on sale of securities	(18)	(5)
Net earnings from bank owned life insurance	(26)	(35)
Net decrease (increase) in interest receivable & other assets	124	(182)
Net increase in interest payable & other liabilities	322	431
Net change in discontinued operations operating activities	0	6,224
<b>Total Adjustments</b>	<b>814</b>	<b>7,780</b>
Net cash provided by operating activities	75	8,090
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities of securities AFS	2,719	1,451
Proceeds from calls of securities AFS	5,150	2,000
Proceeds from sales of securities AFS	9,570	2,024
Purchases of securities AFS	(18,086)	(8,116)
Origination of loans, net of principal repayments	4,622	10,588
Sales of other real estate owned	47	531
Acquisition of premises and equipment, net	(66)	(150)
Net change in discontinued operations investing activities	0	95,475
Net cash provided by investing activities	3,956	103,803
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	7,773	3,193
Net decrease in short term borrowings	0	(217)
Net proceeds from stock issuance	38	26
Net change in discontinued operations financing activities	0	(103,965)
Net cash provided by (used in) financing activities	7,811	(100,963)
Net change in cash and cash equivalents	\$ 11,842	\$ 10,930
Cash and cash equivalents Beginning	\$ 18,634	\$ 33,492
Cash and cash equivalents Ending	\$ 30,476	\$ 44,422

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Cash paid for:

Interest	\$ 507	\$ 732
Income taxes	\$ 9	\$ 167

Non-cash Disclosures:

Transfers from loans to other real estate	\$ 1,106	\$ 851
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**See accompanying notes to consolidated financial statements.**

**Table of Contents****FENTURA FINANCIAL, INC****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>(000s omitted)</b>		
Net (loss) income	\$ (739)	\$ 310
Other comprehensive income (loss), net of tax:		
Reclassification adjustment for net gains included in income	(18)	(5)
Unrealized holding gains (losses) related to available-for-sale securities arising during period	229	(180)
<b>Other comprehensive income (loss), net of tax</b>	<b>211</b>	<b>(185)</b>
Comprehensive (loss) income	\$ (528)	\$ 125

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****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 (the Bank ), Michigan and the other subsidiaries of the Bank. Intercompany transactions and balances are eliminated in consolidation.

As announced at the 2011 Shareholder Meeting, the Corporation had entered into an agreement to sell West Michigan Community Bank to a third-party investor group. The sale closed on January 31, 2011. West Michigan Community Bank is reported as discontinued operations.

Financial statements are presented with discontinued operations sequestered on the balance sheet, statement of operations and statement of cash flows, as applicable. The presentations have been updated for March 31, 2011 to reflect the discontinued operations results to the extent applicable (see Note 9).

During the third quarter of 2011 management decided the Corporation no longer intended to dispose of the residual assets remaining from the sale of West Michigan Community Bank. As a result of the change in intent, amounts and results of operations for the period ended March 31, 2011, as well as balance sheet data as of March 31, 2011 were reclassified to reflect this change in intent.

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 considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. 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, 2011.

**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.

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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- backed securities, where prepayments are anticipated. Gains and losses on sales are based on the amortized cost of the security sold.

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**Table of Contents**

**NOTE 1 BASIS OF PRESENTATION** (continued)

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 uncollectability 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. Rolling eight quarter periods of historical charge off experience is considered when calculating the current required level of the allowance for loan losses. 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.

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

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**Table of Contents**

**NOTE 1 BASIS OF PRESENTATION** (continued)

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.

**Troubled debt restructurings:** Under certain circumstances, the Corporation will provide borrowers relief through loan restructurings and modifications. A loan restructuring constitutes a troubled debt restructuring ( TDR ) if for economic or legal reasons related to the borrower's financial difficulties the Corporation grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment as described above.

**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 including the appeals process. 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.

The liability recorded at December 31, 2011 has been settled with the IRS.

**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 the subsidiary Bank.

**Stock Option Plans:** Compensation cost is recognized for stock options, restricted stock awards issued to employees, and stock appreciation rights 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 and stock appreciation rights, 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 2012 or 2011.

**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 a purchase price 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 of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2012	13,786	\$ 29.60		
Options forfeited during 2012	(2,296)	21.90		
Options outstanding and exercisable at March 31, 2012	11,490	\$ 31.14	1.81	\$ 0

	Number of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2011	18,872	\$ 29.32		
Options forfeited during 2011	(5,086)	28.57		
Options outstanding and exercisable at December 31, 2011	13,786	\$ 29.60	1.73	\$ 0

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 (the SAR Agreements) 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, no longer being subject to terms, conditions and restrictions of the consent order dated December 31, 2009 (the Consent Order) and the Corporation no longer being subject to terms, conditions and restrictions of the agreement between the Corporation and the Federal Reserve Board, which was effective November 4, 2010 (the FRB Agreement). The first payment date under the agreement is the later of February 24, 2014, the date on which the State Bank is no longer subject to the terms, conditions and restrictions of the Consent Order, and the date on which the Corporation is no longer subject to the terms, conditions and restrictions of the FRB Agreement. 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 the Corporation's common stock over \$2.00. If the first SAR payment date does not occur prior to February 24, 2016, then the SARs shall be cancelled without any payment to the participant. If the first SAR payment date occurs prior to February 24, 2016, then the second SAR payment date shall be February 24, 2016. 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 the Corporation's common stock on the second SAR payment date over the value of one share of the Corporation's common stock on the first SAR payment date. If the fair market value of one share of the Corporation's common stock on the second SAR payment date does not exceed the fair market value of one share of the Corporation's common stock on the first SAR payment date, then no payment shall be made to the participant on the second SAR payment date. There were 20,000 SARs outstanding at March 31, 2012 as a result of this issuance as 5,000 SARs were forfeited during the period ended March 31, 2012 as a result of one of the executive's departure.

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**Table of Contents**

**NOTE 1 BASIS OF PRESENTATION** (continued)

On March 13, 2012, the Corporation's board of directors granted 10,000 Stock Appreciation Rights to a new executive officer. The terms of this Stock Appreciation Rights Agreement is the same as those previously discussed except that the first and second payment dates are March 12, 2015 and March 13, 2017, respectively.

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, 2012, 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 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 ACCOUNTING STANDARDS UPDATE**

*ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU 2011-04 amends *Topic 820, Fair Value Measurements and Disclosures*, to converge the fair value measurement guidance in U.S. generally accepted accounting principals and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principals in Topic 820 and requires additional fair value disclosures. ASU 2011-04 was effective for interim and annual periods beginning on or after December 15, 2011 and increased the level of disclosures related to fair value measurements in the Corporation's consolidated financial statements.

*ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income.* ASU 2011-05 amends *Topic 220, Comprehensive Income*, to require that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate by consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 was effective for interim and annual periods beginning on or after December 15, 2011, and did not have impact on the Corporation's consolidated financial statements as the Corporation has historically elected to present a separate statement of comprehensive income.

*ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities.* ASU 2011-11 requires that an entity disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The differences in the offsetting requirements in U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) account for a significant difference in the amounts presented in statements of financial position prepared in accordance with U.S. GAAP and in the amounts presented in those statements prepared in accordance with IFRS for certain institutions. Entities



**Table of Contents****NOTE 2 ACCOUNTING STANDARDS UPDATE (continued)**

are required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The effective date for ASU 2011-11 is January 1, 2013, though the Corporation currently does not hold instruments of this type and does not anticipate any impact to the presentation of its consolidated financial statements.

**NOTE 3 SECURITIES**

Securities are as follows:

(000s omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for Sale</b>				
<u>March 31, 2012</u>				
U.S. Government and federal agency	\$ 5,992	\$ 4	\$ (91)	\$ 5,905
Mortgage-backed residential	15,777	212	(17)	15,972
Collateralized mortgage obligations-agencies	33,677	513	(33)	34,157
Collateralized mortgage obligations-private label	1,860	0	(228)	1,632
Equity securities	2,155	79	(192)	2,042
	\$ 59,461	\$ 808	\$ (561)	\$ 59,708
<u>December 31, 2011</u>				
U.S. Government and federal agency	\$ 6,144	\$ 23	\$ (2)	\$ 6,165
Mortgage-backed residential	15,625	312	(15)	15,922
Collateralized mortgage obligations-agencies	31,002	457	(5)	31,454
Collateralized mortgage obligations-private label	3,725	0	(702)	3,023
Equity securities	2,155	100	(132)	2,123
	\$ 58,651	\$ 892	\$ (856)	\$ 58,687
<b>Held to Maturity</b>				
<u>March 31, 2012</u>				
State and municipal	\$ 2,963	\$ 72	\$ 0	\$ 3,035
	\$ 2,963	\$ 72	\$ 0	\$ 3,035
<u>December 31, 2011</u>				
State and municipal	\$ 2,963	\$ 90	\$ 0	\$ 3,053
	\$ 2,963	\$ 90	\$ 0	\$ 3,053

**Table of Contents**

**NOTE 3 SECURITIES** (continued)

Contractual maturities of securities at March 31, 2012 were as follows. Securities not due at a single maturity date, mortgage-backed, collateralized mortgage obligations and equity securities are shown separately.

(000s omitted)	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. government and federal agency				
Due in one year or less	\$ 0	\$ 0	\$ 395	\$ 396
Due from one to five years	0	0	1,656	1,683
Due from five to ten years	3,000	3,004	544	567
Due after ten years	2,992	2,901	368	389
Mortgage backed residential	15,777	15,972	0	0
Collateralized mortgage obligations-agencies	33,677	34,157	0	0
Collateralized mortgage obligations-private label	1,860	1,632	0	0
Equity securities	2,155	2,042	0	0
	\$ 59,461	\$ 59,708	\$ 2,963	\$ 3,035

At March 31, 2012, one holding totaling \$1,860,000 in a security issued by Bear Stearns exceeded 10% of stockholders' equity. At December 31, 2011, two holdings totaling \$3,023,000 in securities issued by Wells Fargo and Bear Stearns exceeded 10% of stockholders' equity. The Corporation sold the Wells Fargo security during the first quarter of 2012.

Sales of available for sale securities, for the three month periods, were as follows:

(000s omitted)	March 31, 2012	March 31, 2011
Proceeds	\$ 9,570	\$ 2,024
Gross gains	196	5
Gross losses	(178)	0

The cost 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.

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

March 31, 2012 (000s omitted)	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Description of Securities</b>						
US Government and federal agencies	\$ 2,901	\$ (91)	\$ 0	\$ 0	\$ 2,901	\$ (91)
Mortgage-backed residential	5,151	(17)	0	0	5,151	(17)
Collateralized mortgage obligations-agencies	2,622	(13)	3,440	(20)	6,062	(33)
Collateralized mortgage obligations-private label	0	0	1,632	(228)	1,632	(228)
Equity securities	317	(130)	396	(62)	713	(192)
<b>Total temporarily impaired</b>	<b>\$ 10,991</b>	<b>\$ (251)</b>	<b>\$ 5,468</b>	<b>\$ (310)</b>	<b>\$ 16,459</b>	<b>\$ (561)</b>



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

December 31, 2011 (000s omitted)	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Description of Securities</b>						
US government and federal agencies	\$ 0	\$ 0	\$ 1,498	\$ (2)	\$ 1,498	\$ (2)
Mortgage-backed residential	6,766	(15)	0	0	6,766	(15)
Collateralized mortgage obligations-agencies	0	0	4,985	(5)	4,985	(5)
Collateralized mortgage obligations-private label	0	0	3,023	(702)	3,023	(702)
Equity securities	771	(128)	1	(4)	772	(132)
<b>Total temporarily impaired</b>	<b>\$ 7,537</b>	<b>\$ (143)</b>	<b>\$ 9,507</b>	<b>\$ (713)</b>	<b>\$ 17,044</b>	<b>\$ (856)</b>

As of March 31, 2012, the Corporation's security portfolio consisted of 82 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 obligation 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 security. The Standard and Poors rating held on the private label security is A-. The underlying collateral of this CMO is comprised largely of 1-4 family residences. In this security, the Corporation holds the senior tranche and receives payments before other tranches. For the private label security, management completes an analysis to review the recent performance of the mortgage pools underlying the instruments. At March 31, 2012, the private label security has an amortized cost of \$1,860,000 and an unrealized loss of \$228,000.

The Corporation has been closely monitoring the performance of the CMO and MBS portfolios. Management evaluates items such as payment streams and underlying default rates, and did not recognize a material adverse change in these items. On a quarterly basis, management uses multiple assumptions to project the expected future cash flows of the private label CMO 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 three agency collateralized mortgage obligations with an unrealized loss of \$33,000. 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 two 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.

**Table of Contents**

**NOTE 3 SECURITIES (continued)**

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.

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

Major categories of loans are as follows:

(000s omitted)	March 31, 2012	December 31, 2011
<b>Commercial</b>	<b>\$ 33,207</b>	<b>\$ 33,956</b>
Commercial real estate	113,238	118,984
Residential real estate	26,845	26,829
Consumer	25,397	25,998
<b>Total loans</b>	<b>198,687</b>	<b>205,767</b>
Less allowance for loan losses	(7,675)	(8,164)
<b>Net loans</b>	<b>\$ 191,012</b>	<b>\$ 197,603</b>

The Corporation originates primarily residential and commercial real estate loans, commercial 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.

Activity in the allowance for loan losses, by classification, for the three month periods ended March 31, 2012 and 2011 are as follows:

(000s omitted)	Commercial	Commercial	Residential	Installment Loans	Home Equity	Unallocated	Total
		Real Estate	Real Estate				
Allowance for loan losses							
Balance January 1, 2012	\$ 891	\$ 5,759	\$ 476	\$ 215	\$ 482	\$ 341	\$ 8,164
Provision for loan losses	181	1,068	74	(36)	(87)	(337)	863
Loans charged off	(551)	(680)	(60)	(10)	(104)	0	(1,405)
Loan recoveries	13	29	1	6	4	0	53
Balance March 31, 2012	\$ 534	\$ 6,176	\$ 491	\$ 175	\$ 295	\$ 4	\$ 7,675

(000s omitted)	Commercial	Commercial	Residential	Installment Loans	Home Equity	Unallocated	Total
		Real Estate	Real Estate				
Allowance for loan losses							
Balance January 1, 2011	\$ 871	9,155	\$ 411	\$ 233	\$ 508	\$ 46	\$ 11,224
Provision for loan losses	(158)	888	(4)	(17)	148	(62)	795

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Loans charged off	(2)	(3,031)	(11)	(32)	(98)	0	(3,174)
Loan recoveries	6	124	1	6	15	18	170
Balance March 31, 2011	\$ 717	\$ 7,136	\$ 397	\$ 190	\$ 573	\$ 2	\$ 9,015

**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)

	Commercial		Residential		Installment Loans	Home Equity	Unallocated	Total
	Commercial	Real Estate	Real Estate					
March 31, 2012								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 191	\$ 3,011	\$ 296	\$ 54	\$ 97	\$ 0	\$ 3,649	
Collectively evaluated for impairment	343	3,165	195	121	198	4	4,026	
<b>Total ending allowance balance</b>	<b>\$ 534</b>	<b>\$ 6,176</b>	<b>\$ 491</b>	<b>\$ 175</b>	<b>\$ 295</b>	<b>\$ 4</b>	<b>\$ 7,675</b>	
Loans:								
Loans individually evaluated for impairment	\$ 2,842	24,007	\$ 1,109	\$ 101	\$ 470	\$ 0	\$ 28,529	
Loans collectively evaluated for impairment	30,365	89,231	25,736	5,866	18,960	0	170,158	
<b>Total ending loans balance</b>	<b>33,207</b>	<b>113,238</b>	<b>26,845</b>	<b>5,967</b>	<b>19,430</b>	<b>0</b>	<b>198,687</b>	
Accrued interest receivable	273	167	85	38	53	0	616	
<b>Total recorded investment in loans</b>	<b>\$ 33,480</b>	<b>\$ 113,405</b>	<b>\$ 26,930</b>	<b>\$ 6,005</b>	<b>\$ 19,483</b>	<b>\$ 0</b>	<b>\$ 199,303</b>	

(000s omitted)

	Commercial		Residential		Installment Loans	Home Equity	Unallocated	Total
	Commercial	Real Estate	Real Estate					
December 31, 2011								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 714	\$ 2,907	\$ 201	\$ 60	\$ 275	\$ 0	\$ 4,157	
Collectively evaluated for impairment	177	2,852	275	155	207	341	4,007	
<b>Total ending allowance balance</b>	<b>\$ 891</b>	<b>\$ 5,759</b>	<b>\$ 476</b>	<b>\$ 215</b>	<b>\$ 482</b>	<b>\$ 341</b>	<b>\$ 8,164</b>	
Loans:								
Loans individually evaluated for impairment	\$ 3,823	\$ 24,797	\$ 844	\$ 133	\$ 494	\$ 0	\$ 30,091	
Loans collectively evaluated for impairment	30,133	94,187	25,985	6,270	19,101	0	175,676	
<b>Total ending loans balance</b>	<b>\$ 33,956</b>	<b>\$ 118,984</b>	<b>\$ 26,829</b>	<b>\$ 6,403</b>	<b>\$ 19,595</b>	<b>\$ 0</b>	<b>\$ 205,767</b>	
Accrued interest receivable	143	341	75	47	61	0	667	
<b>Total recorded investment in loans</b>	<b>\$ 34,099</b>	<b>\$ 119,325</b>	<b>\$ 26,904</b>	<b>\$ 6,450</b>	<b>\$ 19,656</b>	<b>\$ 0</b>	<b>\$ 206,434</b>	

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

The following tables present loans individually evaluated for impairment by class of loans as of:

(000s omitted)	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>
March 31, 2012			
<b>With no related allowances recorded:</b>			
Commercial	\$ 2,849	\$ 1,612	\$ 0
Commercial real estate	12,714	9,203	0
Residential real estate	289	253	0
Consumer			
Installment Loans	13	10	0
Home Equity	326	279	0
<b>With an allowance recorded:</b>			
Commercial	717	705	191
Commercial real estate	17,966	15,467	3,011
Residential real estate	1,077	856	296
Consumer			
Installment loans	91	91	54
Home equity	191	191	97
<b>Total</b>	<b>\$ 36,233</b>	<b>\$ 28,667</b>	<b>\$ 3,649</b>

(000s omitted)	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>
December 31, 2011			
<b>With no related allowances recorded:</b>			
Commercial	\$ 2,280	\$ 2,116	\$ 0
Commercial real estate	16,275	11,302	0
Residential real estate	279	168	0
Consumer			
Installment Loans	13	13	0
Home Equity	119	119	0
<b>With an allowance recorded:</b>			
Commercial	1,903	1,715	714
Commercial real estate	15,814	13,532	2,907
Residential real estate	894	675	201
Consumer			
Installment loans	121	121	60
Home equity	377	379	275
<b>Total</b>	<b>\$ 38,705</b>	<b>\$ 30,140</b>	<b>\$ 4,157</b>



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

The following table presents the average recorded investment and interest income recognized on loans individually evaluated for impairment by class of loans for the period ended:

	March 31, 2012		March 31, 2011	
	Average Recorded	Interest Income	Average Recorded	Interest Income
(000s omitted)	Investment	Recognized	Investment	Recognized
With no related allowances recorded:				
Commercial	\$ 1,864	\$ 7	\$ 971	\$ 11
Commercial real estate	10,253	40	9,003	39
Residential real estate	211	4	226	0
Consumer				
Installment Loans	12	0	127	1
Home Equity	199	2	242	2
With an allowance recorded:				
Commercial	1,210	11	446	9
Commercial real estate	14,500	50	19,697	123
Residential real estate	766	12	699	6
Consumer				
Installment loans	106	1	104	2
Home equity	285	2	460	3
<b>Total</b>	<b>\$ 29,406</b>	<b>\$ 129</b>	<b>\$ 31,975</b>	<b>\$ 196</b>

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, 2012	Loans Past Due Over 90 Days Still Accruing	
(000s omitted)	Nonaccrual	
Commercial	\$ 2,186	\$ 0
Commercial real estate	11,174	0
Residential real estate	237	0
Home Equity	168	0
Installment loans	6	0
<b>Total</b>	<b>\$ 13,771</b>	<b>\$ 0</b>
 December 31, 2011		
(000s omitted)	Nonaccrual	Loans Past Due Over 90 Days Still Accruing (1)

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Commercial	\$ 2,837	\$ 449
Commercial real estate	13,918	0
Residential real estate	241	0
Home Equity	88	39
Installment loans	13	0
Total	\$ 17,097	\$ 488

(1)-Includes accrued interest receivable of \$6

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

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

(000s omitted)

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due
March 31, 2012				
Commercial	\$ 1,049	\$ 0	\$ 2,249	\$ 3,298
Commercial real estate	453	0	8,360	8,813
Residential real estate	99	95	196	390
Installment loans	0	230	6	236
Home Equity	7	0	6	13
Total	\$ 1,608	\$ 325	\$ 10,817	\$ 12,750

(000s omitted)

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due (1)	Total Past Due
December 31, 2011				
Commercial	\$ 431	\$ 14	\$ 2,741	\$ 3,186
Commercial real estate:	2,796	0	10,750	13,546
Residential real estate	0	0	198	198
Installment loans	3	1	51	55
Home Equity	73	0	85	158
Total	\$ 3,303	\$ 15	\$ 13,825	\$ 17,143

(1) Includes interest receivable of \$15.

**Modifications:**

A modification of a loan constitutes a troubled debt restructuring ( TDR ) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of concessions when modifying a loan or lease, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Residential real estate loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs through a reduction of interest rate and/or extension of the maturity date. Installment loans modified in a TDR are primarily comprised of loans where the Corporation has lowered monthly payments by extending the term.

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Corporation may have the financial effect of increasing the specific allowance associated with the loan.

The Corporation has identified as TDRs certain loans for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology. Upon identifying these loans as TDRs, the Corporation classified them as impaired. The Corporation's recorded investment in TDRs at March 31, 2012 is \$16,182,000, with a specific valuation allowance of \$2,376,000. This is compared to \$15,005,000, with a specific valuation allowance of \$2,289,000, at December 31, 2011. This specific valuation allowance is an allocated portion

of the total allowance for loan losses. The Corporation has no additional amounts committed to these customers.

**Table of Contents**

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

The following presents by class, information related to loans modified in a TDR during the period ended March 31, 2012.

(000s omitted)	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial real estate	5	\$ 2,565	\$ 2,565
Residential real estate	2	191	191
Home equity	1	38	38
Total	8	\$ 2,794	\$ 2,794

The following presents information on TDRs for which there was a payment default during the period ended March 31, 2012 (i.e. 30 days or more past due following a modification) that had been modified during the 12-month period prior to the default.

(000s omitted)	Loans with payment defaults	
	Number of Contracts	Recorded Investment (as of period end) (1)
Commercial	4	\$ 1,295
Commercial real estate	7	1,554
Installment loans	1	6
Total	12	\$ 2,855

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs are analyzed in the same manner as other impaired loans within their respective loan segment.

The following presents by portfolio loan class, the type of modification made in a TDR from January 1, 2012 through March 31, 2012:

(000s omitted)	Loans modified through reduction of interest rate	
	Number of Loans	Recorded Investment (as of period end) (1)
Commercial real estate	3	\$ 2,264
Residential real estate	1	104
Home equity	1	38
Total	5	\$ 2,406

- (1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

(000s omitted)	<b>Loans modified through extension of term</b>	
	<b>Number of Loans</b>	<b>Recorded Investment (as of period end) <sup>(1)</sup></b>
Commercial real estate	2	\$ 301
Residential real estate	1	87
<b>Total</b>	<b>3</b>	<b>\$ 388</b>

- (1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

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

**Prime.** Loans classified as prime are well seasoned borrowers displaying strong financial condition, consistently superior earning performance, and access to a range of financing alternatives. The borrower's trends and outlook, as well as those of its industry are positive.

**Pass.** Loans classified as pass have a moderate to average risk to established borrowers that display sound financial condition and operating results. The capacity to service debt is stable and demonstrated at a level consistent with or above the industry norms. Borrower and industry trends and outlook are considered good.

**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.

**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.

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, 2012	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 5,160	\$ 24,057	\$ 1,948	\$ 2,315	\$ 33,480
Commercial real estate	396	80,856	8,499	23,654	113,405
<b>Total</b>	<b>\$ 5,556</b>	<b>\$ 104,913</b>	<b>\$ 10,447</b>	<b>\$ 25,969</b>	<b>\$ 146,885</b>

(000s omitted)

December 31, 2011	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 3,411	\$ 25,006	\$ 1,850	\$ 3,832	\$ 34,099
Commercial real estate:	0	79,909	14,583	24,833	119,325
<b>Total</b>	<b>\$ 3,411</b>	<b>\$ 104,915</b>	<b>\$ 16,433</b>	<b>\$ 28,665</b>	<b>\$ 153,424</b>

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:





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

(000s omitted)

	Home Equity	Installment	Residential Real Estate	Total
March 31, 2012				
Performing	\$ 19,098	\$ 5,819	\$ 25,821	\$ 50,738
Non-performing	385	186	1,109	1,680
<b>Total</b>	<b>\$ 19,483</b>	<b>\$ 6,005</b>	<b>\$ 26,930</b>	<b>\$ 52,418</b>

(000s omitted)

	Home Equity	Installment	Residential Real Estate	Total
December 31, 2011				
Performing	\$ 19,162	\$ 6,317	\$ 26,060	\$ 51,539
Non-performing	494	133	844	1,471
<b>Total</b>	<b>\$ 19,656</b>	<b>\$ 6,450</b>	<b>\$ 26,904</b>	<b>\$ 53,010</b>

**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.

**Securities Available for Sale:**

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.

**Table of Contents****NOTE 5 FAIR VALUE** (continued)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. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sale and income data available, which results in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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 Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>March 31, 2012</u>				
<u>Available for sale securities</u>				
US Government and federal agency	\$ 5,905	\$ 0	\$ 5,905	\$ 0
Mortgage-backed residential	15,972	0	15,972	0
Collateralized mortgage obligations-agencies	34,157	0	34,157	0
Collateralized mortgage obligations-private label	1,632	0	1,632	0
Equity securities	2,042	0	1,050	992
	\$ 59,708	\$ 0	\$ 58,716	\$ 992

(000s omitted)	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2011</u>				
<u>Available for sale securities</u>				
US Government and federal agency	\$ 6,165	\$ 0	\$ 6,165	\$ 0
Mortgage-backed residential	15,922	0	15,922	0
Collateralized mortgage obligations-agencies	31,454	0	31,454	0
Collateralized mortgage obligations-private label	3,023	0	3,023	0
Equity securities	2,123	0	1,051	1,072
	\$ 58,687	\$ 0	\$ 57,615	\$ 1,072

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).



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

(000s omitted)	Equity Securities	
	2012	2011
Beginning balance, January 1,	\$ 1,072	\$ 1,147
Included in other comprehensive income (loss)	(80)	13
<b>Ending balance, March 31,</b>	<b>\$ 992</b>	<b>\$ 1,160</b>

**Assets Measured on a Non-Recurring Basis**

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

(000s omitted)	Total	Significant
		Unobservable Inputs (Level 3)
<b>At March 31, 2012</b>		
Impaired loans		
Commercial	\$ 512	\$ 512
Commercial real estate	8,809	8,809
Residential real estate	667	667
Installment	32	32
Home equity	88	88
<b>Total impaired loans</b>	<b>\$ 10,108</b>	<b>\$ 10,108</b>

(000s omitted)	Total	Significant
		Unobservable Inputs (Level 3)
<b>At December 31, 2011</b>		
Impaired loans		
Commercial	\$ 997	\$ 997
Commercial real estate	8,526	8,526
Residential real estate	474	474
Installment	55	55
Home equity	102	102
<b>Total impaired loans</b>	<b>\$ 10,154</b>	<b>\$ 10,154</b>
<b>Other real estate owned</b>		
Commercial real estate	\$ 301	\$ 301
<b>Total other real estate owned</b>	<b>\$ 301</b>	<b>\$ 301</b>

The following represent impairment charges recognized during the period:

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At March 31, 2012, impaired loans, which were measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal amount of \$12,697,000 with a valuation allowance of \$2,589,000. This is compared to December 31, 2011 when the principal amount of impaired loans was \$13,868,000 with a valuation allowance of \$3,714,000.

**Table of Contents**

**NOTE 5 FAIR VALUE** (continued)

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 \$3,006,000, of which none were at fair value at March 31, 2012, as there were no write-downs during the first quarter of 2012. At December 31, 2011, other real estate owned had a net carrying amount of \$1,949,000, of which \$301,000 was at fair value, which resulted from write downs totaling \$24,000.

Quantitative information about Level 3 fair value measurements is as follows:

	Fair Value at March 31, 2012	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Equity Securities <sup>(1)</sup>	\$ 992	Market Average	Price to book multiple of peer group	(67.29%)
Impaired Loans	\$ 10,108			
		Appraisal Value-		10-40%
		Real estate	Discount applied to appraisal	(19.69%)
				25-100%
		Appraisal Value-		(33.59%)
		Accounts receivable	Discount applied to appraisal	20-80%
				(73.78%)
		Appraisal Value-		
		Vehicles/equipment	Discount applied to appraisal	
Total level 3 assets	\$ 11,100			

<sup>(1)</sup> Reasonable modifications made to the price to book multiple are not expected to have a significant impact to the value of the securities.

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

The estimated fair values of financial instruments that are not reported at fair value in their entirety in the Corporation's consolidated balance sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value were as follows:

(000s omitted)	March 31, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets:</b>				
Level 1 inputs:				
Cash and cash equivalents	\$ 30,476	\$ 30,476	\$ 18,634	\$ 18,634
FHLB Stock	661	NA	661	NA
Accrued interest receivable	984	984	1,039	1,039
Level 2 inputs:				
Securities held to maturity	2,963	3,035	2,963	3,053
Loans held for sale	593	593	123	123
Performing loans	188,579	173,446	192,378	178,864
Level 3 inputs:				
Impaired loans	10,108	10,108	10,154	10,154
<b>Liabilities:</b>				
Level 1 inputs:				
Deposits-non-maturing	\$ 189,705	\$ 186,579	\$ 180,051	\$ 178,305
Accrued interest payable	1,692	1,692	1,572	1,572
Level 2 inputs:				
Deposits-with stated maturity	83,949	83,016	85,830	84,815
FHLB advance	923	1,163	923	1,180
Subordinated debentures	14,000	12,647	14,000	12,612

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 consolidated balance sheets for cash and short-term instruments approximate their fair values.

**Securities held to maturity**

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

**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.

**Performing 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.

**FHLB Stock**

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It was not practical to determine the fair value of FHLB stock and therefore the FHLB stock is not included under a specific value methodology.



## **Table of Contents**

### **NOTE 5 FAIR VALUE (continued)**

#### **Accrued interest**

The carrying amount of accrued interest approximates its fair value.

#### **Off-balance-sheet instruments**

The fair value of off-balance sheet items is not considered material.

#### **Deposits**

The fair values disclosed for non-maturing deposits are by definition equal to the amount payable on demand at the reporting date. Fair values for deposits with a stated maturity are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar deposits.

#### **FHLB advance**

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

#### **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**

The provision (benefit) for federal income taxes is computed by applying the statutory federal income tax rate to income (loss) before income taxes as reported in the consolidated financial statements after deducting non-taxable items, principally income on bank-owned life insurance, and deducting credits related to certain investments.

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, 2012 and December 31, 2011. The Corporation's evaluation of taxable events, losses in recent years and the continuing struggles 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, 2012 and December 31, 2011.

An income tax benefit associated with continuing operations in the amount of \$124,000 and \$242,000 was recorded for the periods ending March 31, 2012 and 2011, respectively. In 2011, the benefit recorded considered 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



**Table of Contents****NOTE 6 INCOME TAXES** (continued)

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. For the first quarter of 2012, the income tax benefit was related to the reversal of excess taxes accrued during the fourth quarter of 2011 in relation to estimates of a tax audit.

There were no unrecognized tax benefits at March 31, 2012 or December 31, 2011, 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 2009.

**NOTE 7 EARNINGS PER COMMON SHARE**

The factors in the earnings per share computation follow:

(000s omitted except share and per share data)	Three Months Ended March 31,	
	2012	2011
<b>Basic</b>		
Net (loss) income	\$ (739)	\$ 310
<b>Weighted average common shares outstanding</b>	<b>2,388,893</b>	<b>2,309,912</b>
Basic (loss) income per common share	\$ (0.31)	\$ 0.13
<b>Diluted</b>		
Net (loss) income	\$ (739)	\$ 310
<b>Weighted average common shares outstanding for basic earnings per common share</b>	<b>2,388,893</b>	<b>2,309,912</b>
Add: Dilutive effects of assumed exercises of stock options	0	0
<b>Average shares and dilutive potential common shares</b>	<b>2,388,893</b>	<b>2,309,912</b>
Diluted income per common share	\$ (0.31)	\$ 0.13

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

(000s omitted except share and per share data)	Three Months Ended March 31,	
	2012	2011
<b>Basic</b>		
Net loss of continuing operations	\$ (739)	\$ (132)
<b>Weighted average common shares outstanding</b>	<b>2,388,893</b>	<b>2,309,912</b>
Basic loss per common share from continuing operations	\$ (0.31)	\$ (0.06)

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<b>Diluted</b>		
Net loss of continuing operations	\$ (739)	\$ (132)
<b>Weighted average common shares outstanding for basic earnings</b>		
per common share	2,388,893	2,309,912
Add: Dilutive effects of assumed exercises of stock options	0	0
<b>Average shares and dilutive potential common shares</b>	<b>2,388,893</b>	<b>2,309,912</b>
Diluted loss per common share from continuing operations	\$ (0.31)	\$ (0.06)

**Table of Contents**

**NOTE 7 EARNINGS PER COMMON SHARE** (continued)

Stock options of 11,490 and 16,634 shares of common stock outstanding at March 31, 2012 and March 31, 2011, respectively were not considered in computing diluted earnings per common share for 2012 and 2011, because they were anti-dilutive.

**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.

**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 ( WMCB ). 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 were housed in a newly formed real estate holding company subsidiary of the Corporation, FHLLC. In addition, The State Bank assumed \$2,900,000 of watch rated credits.

As of July 1, 2011, due to a change in management's intent, the remaining balances of the assets described above and previously classified as discontinued operations were reclassified to continuing operations; therefore there are no assets or liabilities presented at December 31, 2011 or March 31, 2012. Corresponding amounts also were reclassified for all periods presented.

A condensed statement of income of discontinued operations is presented for the three months ended March 31, 2011. Due to the sale of West Michigan Community Bank at January 31, 2011, only one month of income and expense is presented for West Michigan Community Bank.

**CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**

(000s omitted)

	Three Months Ended March 31, 2011		
	Assumed Loans and Other Real Estate	WMCB	Total
Interest income	\$ (63)	\$ 515	\$ 452
Interest expense	0	129	129
Net interest income	(63)	386	323
Provision for loan losses	0	(50)	(50)
Net interest income (loss) after provision for loan losses	(63)	436	373
Non-interest income	36	121	157
Non-interest expense	105	415	520
Income (loss) before federal income tax	(132)	142	10
Federal income tax expense	0	37	37

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Gain on sale of subsidiary	0	469	469
Net income (loss)	\$ (132)	\$ 574	\$ 442

**Table of Contents**

**NOTE 9 DISCONTINUED OPERATIONS** (continued)

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.

**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 the Bank 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, 2012 and December 31, 2011, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action.

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, 2012, The State Bank had a Tier 1 capital to average assets ratio of 7.9% and a total capital to risk-weighted assets ratio of 12.6%. The State Bank is not in compliance with the Consent Order requirements, and therefore cannot be considered well capitalized.

The Consent Orders restrict the Bank 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. At March 31, 2012 actions included the injection of \$250,000 of capital into The State Bank resulting from the sale of non-performing assets from the subsidiary of the Corporation. 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 Corporation. 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 expectation that the Corporation maintain sufficient capital levels.

At December 31, 2011 the total capital to risk weighted assets for the Corporation was at 10.1%, which is above the 8% threshold required to be considered adequately capitalized. The ratios for the Corporation are not reported at March 31, 2012, as the total assets of the Corporation were below the \$500,000,000 threshold of reporting requirements. 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.

**Table of Contents**

**NOTE 10 REGULATORY MATTERS (continued)**

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.

	Actual		Purposes		Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(000s omitted)						
<b>As of March 31, 2012</b>						
Total Capital (to Risk Weighted Assets) The State Bank	26,058	12.6%	16,580	8.0%	24,871	12.0%
Tier 1 Capital (to Risk Weighted Assets) The State Bank	23,386	11.4	8,290	4.0	NA	NA
Tier 1 Capital (to Average Assets) The State Bank	23,386	7.9	11,905	4.0	23,810	8.0
(000s omitted)						
<b>As of December 31, 2011</b>						
Total Capital (to Risk Weighted Assets) Consolidated The State Bank	\$ 22,263 26,448	10.1% 12.3	\$ 27,646 17,166	8.0% 8.0	NA \$ 25,749	NA 12.0%
Tier 1 Capital (to Risk Weighted Assets) Consolidated The State Bank	19,515 23,700	8.8 11.0	8,823 8,583	4.0 4.0	NA NA	NA NA
Tier 1 Capital (to Average Assets) Consolidated The State Bank	19,515 23,700	6.5 8.1	11,981 11,654	4.0 4.0	NA 23,307	NA 8.0



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**Table of Contents**

**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 are not limited to, changes in interest rates, in the performance of the economy or in the financial condition of borrowers.

**Results of Operations**

As indicated in the statement of operations, the loss from continuing operations for the first three months ended March 31, 2012 was (\$739,000) compared to (\$132,000) for the same period in 2011. Net interest income in the first quarter of 2012 was \$79,000 below net interest income for the same quarter in 2011. The first quarter of 2012 provision for loan losses increased \$68,000 compared to the first quarter of 2011. Management feels the allowance for loan losses is appropriate and such allowance has decreased \$489,000 when comparing the balance as of March 31, 2012 to the balance as of December 31, 2011. Non interest income for the first quarter of 2012 was \$40,000 below non interest income for the same quarter in 2011. Non interest expense for the first quarter of 2012 was \$332,000 higher than for the same quarter in 2011. These variances from period to period are detailed over the next several pages.

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, 2012, the Corporation's return on average assets (annualized) was (0.97%) compared to 0.09% for the same period in 2011. For the three months ended March 31, 2012, the Corporation's return on average equity (annualized) was (19.5%) compared to 1.86% for the same period in 2011. The net loss per share, basic and diluted, was (\$0.31) in the first quarter of 2012 compared to \$0.13 net income per share basic and diluted for the same period in 2011.

**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, 2012 and 2011 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, 2012 compared to the three month period ended March 31, 2011. 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, 2012, net interest income decreased compared to the same period in 2011. While the volume of loans increased over the past year, the loan yield decreased. This is due to the repricing of fixed rate loans to current market rates as they renew along with new volume of loans being booked at current rates which are lower than rates for the same periods in prior years. These changes resulted in a decrease in loan yield when comparing March 31, 2012 to March 31, 2011. Mitigating 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. In addition, a shift of deposits from interest bearing to non-interest bearing assisted in improving the net interest margin.

**Table of Contents****Table 1**

(000s omitted)	THREE MONTHS ENDED		
	MARCH 31, 2012 COMPARED TO 2011 INCREASE (DECREASE) DUE TO		
	VOLUME	YIELD/ RATE	TOTAL
Taxable securities	\$ 81	\$ (40)	\$ 41
Tax-exempt securities (1)	(21)	(2)	(23)
Federal funds sold	(5)	4	(1)
Total loans (1)	(40)	(249)	(289)
Loans held for sale	1	(1)	0
Total earning assets	16	(288)	(272)
Interest bearing demand deposits	0	0	0
Savings deposits	0	(1)	(1)
Time CD s \$100,000 and over	(83)	(87)	(170)
Other time deposits	(30)	(25)	(55)
Other borrowings	(4)	10	6
Total interest bearing liabilities	(117)	(103)	(220)
Net Interest Income	\$ 133	\$ (185)	\$ (52)

(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, 2012, the Corporation's net interest margin as a percentage of average assets (with consideration of full tax equivalency) was 3.86% compared with 3.76% for the same period in 2011. 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 three month period ended March 31, 2012 to the three month period ended March 31, 2011.

Average earning assets decreased 2.8% or \$7,467,000 comparing the first three months of 2012 to the same time period in 2011. Loans, the highest yielding component of earning assets, represented 77.0% of earning assets in 2012 compared to 73.7% in 2011. Average interest bearing liabilities decreased 7.1% or \$16,759,000 comparing the first three months of 2012 to the same time period in 2011. Non-interest bearing deposits amounted to 25.4% of average earning assets in the first three months of 2012 compared with 21.3% in the same time period of 2011.

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 2012, 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 BALANCE	2012 INCOME/ EXPENSE	YIELD/ RATE	AVERAGE BALANCE	2011 INCOME/ EXPENSE	YIELD/ RATE
<b>ASSETS</b>						
Securities:						
U.S. Treasury and government Agencies	\$ 53,763	\$ 309	2.31%	\$ 40,279	\$ 267	2.67%
State and Political <sup>(1)</sup>	2,963	45	6.11%	4,350	68	6.29%
Other	2,780	11	1.59%	2,804	12	1.72%
Total Securities	59,506	365	2.47%	47,433	347	2.94%
Fed Funds Sold	0	8	0.00%	22,741	9	0.16%
Loans:						
Commercial	147,871	2,051	5.58%	148,538	2,310	6.05%
Tax Free <sup>(1)</sup>	1,535	26	6.81%	2,001	32	6.43%
Real Estate-Mortgage	26,093	320	4.93%	19,393	299	6.12%
Consumer	25,873	360	5.60%	28,350	405	5.75%
Total loans	201,372	2,757	5.51%	198,282	3,046	6.12%
Loans Held for Sale	748	8	4.30%	637	8	5.05%
<b>TOTAL EARNING ASSETS</b>	<b>\$ 261,626</b>	<b>\$ 3,138</b>	<b>4.82%</b>	<b>\$ 269,093</b>	<b>\$ 3,410</b>	<b>5.00%</b>
Cash Due from Banks	28,522			17,934		
Allowance for Loan Losses	(7,687)			(10,129)		
Assets of discontinued operations	0			46,045		
All Other Assets	20,831			26,595		
<b>TOTAL ASSETS</b>	<b>\$ 303,292</b>			<b>\$ 349,538</b>		
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY:</b>						
Deposits:						
Interest Bearing DDA	\$ 48,862	\$ 14	0.12%	\$ 48,157	\$ 14	0.12%
Savings Deposits	67,980	15	0.09%	68,004	16	0.09%
Time CD s \$100,000 and Over	36,258	264	2.93%	46,224	434	3.78%
Other Time CD s	50,296	203	1.62%	57,339	258	1.81%
Total Interest Bearing Deposits	203,396	496	0.98%	219,724	722	1.32%
Other Borrowings	14,923	132	3.56%	15,354	126	3.30%
<b>INTEREST BEARING LIABILITIES</b>	<b>\$ 218,319</b>	<b>628</b>	<b>1.16%</b>	<b>\$ 235,078</b>	<b>848</b>	<b>1.45%</b>
Non-Interest bearing DDA	66,508			57,342		
Liabilities of discontinued operations	0			37,422		
All Other Liabilities	3,596			3,040		
Stockholders Equity	14,869			16,656		
<b>TOTAL LIABILITIES &amp; STOCKHOLDERS EQUITY</b>	<b>\$ 303,292</b>			<b>\$ 349,538</b>		
Net Interest Rate Spread			3.66%			3.60%

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Net Interest Income /Margin	\$ 2,510	3.86%	\$ 2,562	3.76%
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(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

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**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 implemented 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 appropriateness 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 management considers the allowance for loan losses to be appropriate 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 two years. Rolling eight 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 \$508,000 during the quarter as a result of charge offs incurred on loans for which specific allocations were previously recorded.

At March 31, 2012, the allowance was \$7,675,000, or 3.86% of total loans compared to \$8,164,000, or 3.97%, at December 31, 2011, a decrease of \$489,000 during the first three months of 2012. Non performing loan levels, discussed below, decreased during the period while net charge-offs decreased to \$1,352,000 during the first three months of 2012 compared to \$3,004,000 during the first three months of 2011. A majority of the charge-offs relate to loans for which specific allocations were recorded at December 31, 2011.

Table 3 below summarizes loan losses and recoveries for the first three months of 2012 and 2011. During the first three months of 2012, the Corporation experienced net charge-offs of \$1,352,000 or 0.68% of gross loans compared with net charge-offs of \$3,004,000 or 1.53% of gross loans in the first three months of 2011. The provision for loan loss was \$863,000 in the first three months of 2012 and \$795,000 for the same time period in 2011. 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, the use of historical loss rates in estimating the required level of allowance for loan losses continues to require high levels of provision for estimated future loan losses.

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

(000s omitted)	Commercial	Commercial	Residential	Installment Loans	Home Equity	Unallocated	Total
		Real Estate	Real Estate				
Balance January 1, 2012							
Allowance for loan losses	\$ 891	\$ 5,759	\$ 476	\$ 215	\$ 482	\$ 341	\$ 8,164
Provision for loan losses	181	1,068	74	(36)	(87)	(337)	863
Loans charged off	(551)	(680)	(60)	(10)	(104)	0	(1,405)
Loan recoveries	13	29	1	6	4	0	53
Balance March 31, 2012	\$ 534	\$ 6,176	\$ 491	\$ 175	\$ 295	\$ 4	\$ 7,675
Ratio of net charge-offs to gross loans	1.62%	0.57%	0.22%	0.06%	0.51%		0.68%

(000s omitted)	Commercial	Commercial	Residential	Installment Loans	Home Equity	Unallocated	Total
		Real Estate	Real Estate				
Balance January 1, 2011							
Allowance for loan losses	\$ 871	\$ 9,155	\$ 411	\$ 233	\$ 508	\$ 46	\$ 11,224
Provision for loan losses	(158)	888	(4)	(17)	148	(62)	795
Loans charged off	(2)	(3,031)	(11)	(32)	(98)	0	(3,174)
Loan recoveries	6	124	1	6	15	18	170
Balance March 31, 2011	\$ 717	\$ 7,136	\$ 397	\$ 190	\$ 573	\$ 2	\$ 9,015
Ratio of net (recovery) charge-off to gross loans	(0.01%)	2.53%	0.05%	0.33%	0.42%		1.48%

**Non-Interest Income**

Non-interest income decreased slightly during the three months ended March 31, 2012 as compared to the same period in 2011. Overall non-interest income was \$1,119,000 for the three months ended March 31, 2012 compared to \$1,159,000 for the same period in 2011. This represents a decrease of 3.5%.

Service charges on deposit accounts are approximately 21.4% of non-interest income. These fees were \$239,000 in the first quarter of 2012, compared to \$296,000 for the same period of 2011. This represents a decrease of 19.3% from year to year in NSF charges collected.

Trust, investment and financial planning services income decreased \$69,000 or 24.0% in the first quarter of 2012 compared to the same period in the prior year. The decrease is attributable to changes in market value, which resulted in lower fee income.

Gain on the sale of mortgage loans originated by the Banks and sold into the secondary market increased by \$147,000 or 216.2% to \$215,000 in the first quarter of 2012 compared to \$68,000 for the same period in 2011. This was due to decreases in market rates, which resulted in additional volume of loans repricing, resulting in an increase of loans sold into the secondary market. Management believes for the remainder of 2012, mortgage income may slightly decrease as rates continue to change. The Corporation sells the majority of the mortgage loans originated in the secondary market on a servicing released basis.

Other operating income decreased by \$61,000 or 12.0% in the first quarter of 2012 compared to the same time period in 2011. The decreases consist of decreased interchange income from debit cards, a decrease in gain on sale of real estate owned, and decreases in charges related to providing support services to other banks.

**Non-Interest Expense**

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Total non-interest expense increased 10.1% to \$3,606,000 in the three months ended March 31, 2012, compared with \$3,274,000 in the same period of 2011. The increase is comprised of increases in salaries and benefits, FDIC assessment and a cashier's check loss. These increases were partially offset by decreases in occupancy, furniture and equipment, loans and collection and legal expenses.

## Table of Contents

Salary and benefit costs, the Corporation's largest non-interest expense category, were \$1,723,000 in the first quarter of 2012, compared with \$1,673,000, for an increase of \$50,000 or 3.0%, over the same time period in 2011. Salary and benefits expense increased due to higher benefit cost for staff as the cost of health care has risen year-over-year.

Occupancy expenses, at \$269,000, were reduced in the three months ended March 31, 2012 compared to the same period in 2011 with a decrease of \$15,000 or 5.3%. Decreases of occupancy expenses were in property insurance, depreciation, utility costs and reductions in building repairs and maintenance, mostly associated with the sale of a bank facility and consolidation of operations.

During the three months ended March 31, 2012, furniture and equipment expenses were \$253,000 compared to \$292,000 for the same period in 2011, a decrease of 13.4%. The decrease was due to lower depreciation expense, equipment rental expense and furniture and equipment expense in the first quarter of 2012. These decreases can be associated with the sale of a bank facility and consolidation of operations.

Loan and collection expenses, at \$143,000, were down \$18,000 or 11.2% during the three months ended March 31, 2012 compared to the same time period in 2011. 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 increased \$12,000 for the three months ended March 31, 2012 compared to the same period in 2011. For the three months ended March 31, 2012, advertising expenses were \$31,000 compared to \$19,000 for the same period in 2011. The Corporation has resumed advertising campaigns with the goal of attracting new customers for lending and deposit products, while also strengthening our presence in local communities through sponsorship of community events.

Other operating expenses were \$1,187,000 in the three months ended March 31, 2012 compared to \$845,000 in the same time period in 2011, an increase of \$342,000 or 40.5%. Increases year over year include increases in FDIC assessments and a single cashier's check loss of \$271,000. These increases were partially offset by a decrease in legal expenses year over year.

## 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 credit 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 \$306,466,000 at March 31, 2012 compared to total assets of \$298,861,000 at December 31, 2011. Loans comprised 64.8% of total assets at March 31, 2012 compared to 68.9% at December 31, 2011. Loans decreased \$7,080,000 during the first three months of 2012.

Bank premises and equipment decreased \$96,000 to \$10,106,000 at March 31, 2012 compared to \$10,202,000 at December 31, 2011. The decrease was a result of normal depreciation net of acquisitions.

Other assets decreased \$69,000 when comparing March 31, 2012 to December 31, 2011. The decrease is mainly attributable to a decrease in repossessed assets, interest receivable and prepaid expenses.



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**Table of Contents**

On the liability side of the balance sheet, the ratio of non-interest bearing deposits to total deposits was 26.4% at March 31, 2012 and 23.6% at December 31, 2011. Interest bearing deposit liabilities totaled \$201,306,000 at March 31, 2012 compared to \$203,168,000 at December 31, 2011. Total deposits increased \$7,773,000 with non-interest bearing demand deposits increasing \$9,635,000 and interest bearing deposits decreasing \$1,862,000. FHLB advances did not change when comparing the two periods. Other liabilities increased \$322,000 due to an increase of \$121,000 in interest payable on the Trust Preferred and an increase in accounts payable of \$195,000 due to fluctuations in the FDIC assessment liability.

**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, 2012 and December 31, 2011.

Total non-performing assets decreased \$2,228,000 at March 31, 2012 as compared to December 31, 2011. Total non-performing loans decreased by \$3,814,000 at March 31, 2012 as compared to December 31, 2011. Loans past due over 90 days and still accruing interest decreased \$488,000 during the first three months of 2012. Non-accrual loans decreased \$3,326,000 when comparing March 31, 2012 to December 31, 2011. Included in non-accrual loans are \$6,925,000 and \$8,128,000 of modified loans which have not been returned to accrual status at March 31, 2012 and December 31, 2011, respectively.

Modified loans presented in Table 4 are comprised of loans which have performed since modification and have been returned to accrual status. Modified loans increased \$503,000 to \$7,380,000 at March 31, 2012 compared to \$6,877,000 at December 31, 2011. Modified loans are loans for which concessions have been granted to the borrower based on their individual financial situation. These concessions may include modifications to the interest rate, term of the loan or forgiveness of principal or interest.

Other non-performing assets increased \$1,083,000 in the first quarter of 2012. Other Real Estate owned totaled \$3,006,000 at March 31, 2012 compared to \$1,949,000 at December 31, 2011. Other Real Estate in Redemption increased to \$249,000 from \$223,000 at December 31, 2011. The Other Real Estate Owned in Redemption balance is comprised of three commercial and one residential property.

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

(000s omitted)	March 31, 2012	December 31, 2011
<b>Non-Performing Loans:</b>		
Loans past due 90 days or more & still accruing	\$ 0	\$ 488
Non-accrual loans	13,771	17,097
<b>Total non-performing loans</b>	<b>13,771</b>	<b>17,585</b>
<b>Modified loans</b>	<b>7,380</b>	<b>6,877</b>
<b>Total modified loans</b>	<b>7,380</b>	<b>6,877</b>
<b>Other non-performing assets:</b>		
Other real estate	3,006	1,949
Other real estate owned in redemption	249	223
<b>Total other non-performing assets</b>	<b>3,255</b>	<b>2,172</b>
<b>Total Non-Performing assets</b>	<b>\$ 24,406</b>	<b>\$ 26,634</b>
Non-performing loans as a % of total loans	6.93%	8.55%
Non-performing assets as a % of total loans and other real estate	12.10%	12.82%
Allowance for loan losses as a % of non-performing loans	55.73%	46.43%
Accruing loans past due 90 days or more to total loans	0.00%	0.24%
Non-performing assets as a % of total assets	7.96%	8.91%

While total non performing assets decreased from December 31, 2011 to March 31, 2012, the ratio of non-performing loans to the allowance for loan losses increased. This was the result of loans that had previously been specifically reserved for in the allowance for loan losses, and were charged down during the first quarter, thus effectively reducing the amount of available funds remaining versus total non-performing assets.

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.

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. Interest accrued but not collected is reversed against income for the current quarter when a loan is placed on non-accrual status. At March 31, 2012, there were no 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, 2012. 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

## **Table of Contents**

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 Bank's deposit base plus other funding sources (federal funds purchased, short-term borrowings, FHLB advances, other liabilities and stockholders' equity) provided primarily all funding needs in the first three months of 2012. 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.

A source of liquidity that is no longer available to the Bank is brokered deposits. Brokered deposits totaled approximately \$6,015,000 at March 31, 2012 and \$11,015,000 at December 31, 2011. As The State Bank is considered adequately capitalized at March 31, 2012, it is precluded, under prompt corrective action guidelines, from issuing or renewing brokered deposits. Management anticipates repayment of brokered deposits as they mature using fed funds and the Bank's local deposits.

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 \$1,021,000 since December 31, 2011 due to purchases in the available for sale investment portfolio. During the first quarter of 2012, the Corporation sold one private label security at a gross loss of \$178,000. Simultaneously four additional securities were sold at a total gain of \$191,000. The Corporation has re-invested some of the funds as well as 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.

In April 2009, the Corporation, in order to maintain liquidity at the holding company, provided notice to each of The Bank of New York and Wilmington Trust Company, the trustees of the Corporation's junior subordinated debt securities due 2033 ( Fentura Trust I ), and junior subordinated debt securities due 2035 ( Fentura Trust II ), respectively, that the Corporation was exercising its right to defer interest payments for each of the interest payment dates of June 15, 2009, as to the Fentura Trust I, and May 23, 2009, as to the Fentura Trust II to June 15, 2014 and May 23, 2014, respectively, unless the Corporation subsequently gives notice that it has elected to shorten such deferral period. The Corporation has the ability under each of the trust indentures to defer interest payments for up to twenty consecutive quarterly periods (five years), so long as the Corporation is not in default, as defined in the respective indentures. The Corporation is not in default under either of the indentures. Interest on the debt securities continues to accrue during the deferral period and interest on the deferred interest also accrues, both of which must be paid at the end of the deferral period. The total then-estimated annual interest that was payable on the debt securities, if not deferred, was approximately \$1,464,000, based on variable rates at the time of deferral. Management believes the Corporation's liquidity position remains stable as the operating expenses of the Corporation are minimal.

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.

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**Table of Contents**

The Corporation had cash provided by financing activities resulting primarily from the increase of deposits, which increased \$7,773,000 from December 31, 2011. Cash provided by investing activities was \$3,956,000 in first three months of 2012 compared to \$103,803,000 in first three months of 2011. The change in investing activities was due to the sale of a subsidiary bank.

**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 well capitalized institutions as those having total risk-based ratios, tier 1 risk-based capital ratios and tier 1 leverage ratios of at least 10%, 6%, and 5%, respectively. At March 31, 2012 the subsidiary Bank maintained adequately capitalized leverage requirements as defined by federal law; however the Bank was not in compliance with the capital requirements prescribed by the Consent Order.

Total stockholders equity decreased 3.3% to \$14,170,000 at March 31, 2012 compared with \$14,660,000 at December 31, 2011. The decrease was due to the net loss in the first three months of 2012, partially offset by increases in other comprehensive income as noted below. The Corporation's equity to asset ratio was 4.6% at March 31, 2012 and 4.9% at December 31, 2011.

As indicated on the balance sheet at December 31, 2011, the Corporation had accumulated other comprehensive income of \$23,000 compared to accumulated other comprehensive income at March 31, 2012 of \$234,000. The fluctuation in the position is attributable to a combination of the fluctuation of the market price of securities held in the available for sale portfolio along with the sale of the private label CMO during the first quarter.

The information on the Corporation's capital resources is contained on pages 45 through 48 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011 is incorporated herein by reference.

**Regulatory Orders**

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators that contain provisions to foster improvement in The State Bank's earnings, lower 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, 2012, The State Bank had a Tier 1 capital to average assets ratio of 7.9% and a total capital to risk-weighted assets ratio of 12.6%.

The Consent Order restricts the Bank from issuing or renewing brokered deposits. The Consent Order also restricts dividend payments from The State Bank to the Corporation. The Corporation, the Board of Directors and management continue to execute initiatives to comply with the Consent Order. At March 31, 2012 actions included the injection of \$250,000 capital into The State Bank resulting from the sale of non-performing assets from the subsidiary of the Corporation. 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 would cause the 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 Corporation. 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 expectation that the Corporation maintain sufficient capital levels. The board of directors and management continue to execute and monitor initiatives to comply with Federal Reserve restrictions.

## **Table of Contents**

### **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, ORE, securities valuation and income taxes. Actual results could differ from those estimates.

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 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 results.

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.

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. 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 all or part of the benefit would not be realized. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the 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 instead of loan foreclosure. They 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.

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

**Table of Contents**

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, 2012	December 31, 2011
Commitments to make loans (at market rates)	\$ 9,707	\$ 5,725
Unused lines of credit and letters of credit	26,017	28,420

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

The information concerning quantitative and qualitative disclosures about market risk contained on page 70 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, 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 has begun simulation modeling. For the first three months of 2012, 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 2012 compared to 2011.

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 the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011 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, 2012, 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**

(000s omitted)

(000s omitted)	March 31, 2012					Total
	Within Three Months	Three Months to One Year	One to Five Years	After Five Years		
<b>Earning Assets:</b>						
Securities	\$ 11,776	\$ 23,089	\$ 26,245	\$ 1,561		\$ 62,671
Loans	33,142	48,678	78,329	38,538		198,687
Loans held for sale	593	0	0	0		593
FHLB stock	661	0	0	0		661
<b>Total earning assets</b>	<b>\$ 46,172</b>	<b>\$ 71,767</b>	<b>\$ 104,574</b>	<b>\$ 40,099</b>		<b>\$ 262,612</b>
<b>Interest bearing liabilities:</b>						
Interest bearing demand deposits	\$ 46,156	\$ 0	\$ 0	\$ 0		\$ 46,156
Savings deposits	71,202	0	0	0		71,202
Time deposits less than \$100,000	11,952	22,572	15,242	74		49,840
Time deposits greater than \$100,000	10,360	14,764	8,984	0		34,108
Other borrowings	33	0	890	0		923
Subordinated debentures	14,000	0	0	0		14,000
<b>Total interest bearing liabilities</b>	<b>\$ 153,703</b>	<b>\$ 37,336</b>	<b>\$ 25,116</b>	<b>\$ 74</b>		<b>\$ 216,229</b>
<b>Interest rate sensitivity GAP</b>	<b>(\$ 107,531)</b>	<b>\$ 34,431</b>	<b>\$ 79,458</b>	<b>\$ 40,025</b>		<b>\$ 46,383</b>
<b>Cumulative interest rate sensitivity GAP</b>	<b>(\$ 107,531)</b>	<b>(\$ 73,100)</b>	<b>\$ 6,358</b>	<b>\$ 46,383</b>		
<b>Interest rate sensitivity GAP ratio</b>	<b>0.30</b>	<b>1.92</b>	<b>4.16</b>	<b>541.88</b>		
<b>Cumulative interest rate sensitivity GAP ratio</b>	<b>0.30</b>	<b>0.62</b>	<b>1.03</b>	<b>1.21</b>		

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 or our management, are intended to identify 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,

**Table of Contents**

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 Interim Chief Executive Officer and Interim 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. Mine Safety Disclosures** None

**Item 5. Other Information.** None

**Item 6. Exhibits.**

(a) Exhibits

31.1 Certificate of the Interim 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 Interim 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 Interim 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 Interim 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 17, 2012

/s/ Ronald L. Justice  
Ronald L. Justice

Interim President and CEO

Dated: May 17, 2012

/s/ James W. Distelrath  
James W. Distelrath  
Interim Chief Financial Officer and Principal Accounting Officer

**Table of Contents**

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