

**FENTURA FINANCIAL, INC.**

**FINANCIAL STATEMENTS AND REPORT OF  
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
December 31, 2010 and 2009**

**and**

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

FENTURA FINANCIAL, INC.  
Fenton, Michigan  
CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders  
Fentura Financial, Inc.  
Fenton, Michigan

We have audited the accompanying consolidated balance sheets of Fentura Financial, Inc. as of December 31, 2010 and 2009, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the two years in the period ended December 31, 2010. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Fentura Financial, Inc. as of December 31, 2010 and 2009, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2010 in conformity with U.S. generally accepted accounting principles.

As discussed in Note 14, the Corporation's bank subsidiary is not in compliance with revised minimum regulatory capital requirements under a formal regulatory agreement which has imposed limitations on certain operations. Failure to comply with the regulatory agreement may result in additional regulatory enforcement actions.

*Crowe Horwath LLP*

/s/ Crowe Horwath LLP

Grand Rapids, Michigan  
March 9, 2011

FENTURA FINANCIAL, INC.  
CONSOLIDATED BALANCE SHEETS  
December 31, 2010 and 2009  
(000s omitted except share and per share data)

<u>ASSETS</u>	<u>2010</u>	<u>2009</u>
Cash and due from banks	\$ 11,592	\$ 15,490
Federal funds sold	21,900	16,150
Total cash and cash equivalents	33,492	31,640
Securities available for sale, at fair value	41,875	33,939
Securities held to maturity (fair value 2010 - \$4,383; 2009 - \$5,492)	4,350	5,455
Total securities	46,225	39,394
Loans held for sale	850	229
Loans, net of allowance of 2010- \$10,027; 2009- \$8,589	197,948	233,461
Bank premises and equipment	10,335	10,994
Accrued interest receivable	1,050	1,289
Bank owned life insurance	5,800	5,947
Federal Home Loan Bank stock	740	806
Other real estate owned	2,742	3,761
Assets of discontinued operations	122,968	185,273
Other assets	2,078	9,285
Total Assets	<u>\$424,228</u>	<u>\$522,079</u>
<u>LIABILITIES AND STOCKHOLDERS EQUITY</u>		
Deposits:		
Non-interest-bearing deposits	\$ 55,044	\$ 53,113
Interest-bearing deposits	220,933	258,438
Total deposits	275,977	311,551
Short-term borrowings	879	164
Federal Home Loan Bank advances	954	981
Subordinated debentures	14,000	14,000
Liabilities of discontinued operations	113,321	172,077
Accrued taxes, interest and other liabilities	3,042	2,774
Total liabilities	408,173	501,547
Shareholders' equity		
Common stock - \$0 par value, 5,000,000 shares authorized, shares issued and outstanding 2,308,765 – 2010; 2,248,553 – 2009	43,036	42,913
Retained deficit	(27,042)	(21,657)
Accumulated other comprehensive income (loss)	61	(724)
Total shareholders' equity	16,055	20,532
Total liabilities and shareholders' equity	<u>\$424,228</u>	<u>\$522,079</u>

See accompanying notes to consolidated financial statements.

FENTURA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
Years ended December 31, 2010 and 2009  
(000s omitted except share and per share data)

Interest income	<b>2010</b>	<b>2009</b>
Loans, including fees	\$13,874	\$16,239
Securities:		
Taxable	881	1,173
Tax-exempt	295	474
Short-term investments	27	3
Total interest income	<u>15,077</u>	<u>17,889</u>
Interest expense		
Deposits	4,032	6,230
Other borrowings	520	695
Total interest expense	<u>4,552</u>	<u>6,925</u>
Net interest income	10,525	10,964
Provision for loan losses	6,934	11,040
Net interest income after provision for loan losses	<u>3,591</u>	<u>(76)</u>
Non-interest income		
Service charges on deposit accounts	1,445	1,726
Gain on sale of mortgage loans	701	744
Trust and investment services income	915	919
Gain on sale of securities	51	0
Other than temporary loss		
Total impairment	(359)	(288)
Loss recognized in other comprehensive income	52	0
Net impairment loss recognized in earnings	<u>(307)</u>	<u>(288)</u>
Loss on equity investment	0	(1,360)
Other income and fees	1,968	1,649
Total non-interest income	<u>4,773</u>	<u>3,390</u>
Non-interest expense		
Salaries and employee benefits	6,387	6,650
Occupancy	1,225	1,326
Furniture and equipment	1,265	1,339
Loan and collection	1,279	2,559
Advertising and promotional	101	121
Telephone and communication services	247	251
Other professional services	294	179
Other general and administrative	2,289	2,286
Total non-interest expense	<u>13,087</u>	<u>14,711</u>
Income/(loss) from continuing operations before income tax	(4,723)	(11,397)
Federal income tax expense/(benefit)	(202)	2,283
Income/(loss) from continuing operations	<u>(4,521)</u>	<u>(13,680)</u>
Net income/(loss) from discontinued operations, net of tax	<u>(864)</u>	<u>(3,300)</u>
Net income (loss)	<u>\$ (5,385)</u>	<u>\$ (16,980)</u>
Net income/(loss) per share from continuing operations:		
Basic and diluted	\$ (1.99)	\$ (6.20)
Net income/(loss) per share from discontinued operations:		
Basic and diluted	\$ (0.38)	\$ (1.50)
Net income/(loss) per share		
Basic and diluted	\$ (2.37)	\$ (7.70)
Cash dividends declared	<u>\$ 0</u>	<u>\$ 0</u>

See accompanying notes to consolidated financial statements.

FENTURA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
Years ended December 31, 2010 and 2009  
(000s omitted except share and per share data)

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	<u>2010</u>	<u>2009</u>
Net loss	\$ (5,385)	\$ (16,980)
Other comprehensive income (loss), net of tax:		
Unrealized holding gains arising during period	731	1,622
Impairment loss recognized in income	307	288
Reclassification adjustments from losses realized in net loss from discontinued operations	202	0
Reclassification adjustment for gains realized in income	(51)	(12)
Tax effect	(404)	(645)
Other comprehensive income	<u>785</u>	<u>1,253</u>
Comprehensive loss	<u>\$ (4,600)</u>	<u>\$ (15,727)</u>

See accompanying notes to consolidated financial statements.

FENTURA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Years ended December 31, 2010 and 2009  
(000s omitted except share and per share data)

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balance, January 1, 2009</b>	\$42,778	\$ (4,677)	\$ (1,977)	\$36,124
Net loss	0	(16,980)	0	(16,980)
Issuance of shares under stock purchase and dividend reinvestment plans (62,788 shares)	135	0	0	135
Other comprehensive loss (net of tax)	0	0	1,253	1,253
<b>Balance, December 31, 2009</b>	\$42,913	\$ (21,657)	\$ (724)	\$20,532
Net loss	0	(5,385)	0	(5,385)
Issuance of shares under stock purchase and dividend reinvestment plans (60,212 shares)	123	0	0	123
Other comprehensive income (net of tax)	0	0	785	785
<b>Balance, December 31, 2010</b>	<u>\$43,036</u>	<u>\$ (27,042)</u>	<u>\$ 61</u>	<u>\$ 16,055</u>

FENTURA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years ended December 31, 2010 and 2009  
(000s omitted except share and per share data)

<b>OPERATING ACTIVITIES:</b>	<b><u>2010</u></b>	<b><u>2009</u></b>
Net loss	\$(5,385)	\$(16,980)
Adjustments to reconcile net loss to cash		
Provided by Operating Activities:		
Depreciation, amortization and accretion	613	682
Establishment of deferred tax asset valuation allowance	0	6,464
Deferred income taxes	(339)	(785)
Provision for loan losses	6,934	11,040
Loans originated for sale	(44,315)	(58,580)
Proceeds from the sale of loans	44,395	59,785
Gain on sales of loans	(701)	(744)
Gain on sale of securities	(51)	0
(Gain) loss on sale of other real estate owned	(363)	28
Write downs on other real estate owned	342	1,184
Loss on equity investment	0	1,360
Loss on security impairment	307	288
Earnings from bank owned life insurance	(150)	(65)
Net (increase) decrease in interest receivable & other assets	7,381	(7,519)
Net increase (decrease) in interest payable & other liabilities	268	1,004
Net change in discontinued operations operating activities	2,201	4,428
Total Adjustments	16,522	18,570
Net cash provided by (used in) operating activities	11,137	1,590
<b>Cash Flows From Investing Activities:</b>		
Proceeds from maturities of securities – HTM	725	1,303
Proceeds from maturities of securities – AFS	10,301	9,746
Proceeds from calls of securities – HTM	380	0
Proceeds from calls of securities – AFS	4,700	2,500
Proceeds from sales of securities – AFS	8,677	0
Purchases of securities – AFS	(30,515)	(8,340)
Proceeds from sales of equity securities	6	9
Net decrease (increase) in loans	26,299	34,806
Proceeds from FHLB stock repurchase	66	0
Proceeds from bank owned life insurance	297	203
Sales of other real estate owned	3,320	1,380
Acquisition of premises and equipment, net	(126)	(130)
Net change in discontinued operations investing activities	21,441	23,230
Net cash provided by (used in) investing activities	45,571	64,707
<b>Cash Flows From Financing Activities:</b>		
Net decrease in deposits	(35,574)	(20,441)
Net increase (decrease) in short-term borrowings	715	(1,336)
Proceeds from/(repayment) of notes payable	0	(1,000)
Repayments of advances from FHLB	(27)	(26)
Net proceeds from stock issuance and repurchase	123	135
Cash dividends	0	0
Net change in discontinued operations financing activities	(24,790)	(19,936)
Net cash provided by (used in) financing activities	(59,553)	(42,604)
Net change in cash and cash equivalents	(2,845)	23,693
Cash and cash equivalents-Beginning	\$ 44,646	\$ 20,953
Cash and cash equivalents at year end	41,801	44,646
Less cash and cash equivalents of discontinued operations	8,309	13,006
Cash and cash equivalents of continuing operations at year end	\$ 33,492	\$31,640
Cash paid for (received from):		
Interest	\$ 4,147	\$ 7,073
Income taxes	\$ (361)	\$ (519)
Non-cash disclosures:		
Transfers from loans to other real estate	\$ 2,459	\$ 4,255
Loans provided for sales of other real estate owned	\$ 179	\$ 0

See accompanying notes to consolidated financial statements.

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Nature of Operations and Principles of Consolidation: The consolidated financial statements include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiary, The State Bank in Fenton, Michigan; and reported as discontinued operations, West Michigan Community Bank in Hudsonville, Michigan and the other subsidiaries of the Banks. Intercompany transactions and balances are eliminated in consolidation.

In 2009, the Corporation entered into an agreement to sell one of its bank subsidiaries, Davison State Bank, to a private, nonaffiliated investor group. This sale closed on April 30, 2010. Additionally, the Corporation entered into an agreement to sell West Michigan Community Bank to a bank holding company. This sale closed on January 31, 2011. As a result of these sale agreements, both subsidiaries are reported as discontinued operations. See Note 13 for further discussion.

The Corporation provides banking and trust services principally to individuals, small businesses and governmental entities through its nine community banking offices in Genesee, Livingston, and Oakland Counties in southeastern Michigan. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Commercial real estate and construction loans are 56.0% of total loans and other commercial business loans are 20.9% of total loans at December 31, 2010. For the year ended December 31, 2009, the loan portfolio was composed as follows: commercial real estate and construction loans 64.0%, of total loans and other commercial business loans 12.8% of total loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets and real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by both residential and commercial real estate. The Corporation's exposure to credit risk is substantially affected by the economy in the Corporation's market area and by changes in commercial real estate values. While the loan portfolio is substantially commercial based, the Corporation is not dependent on any single borrower. Other financial instruments which potentially represent concentrations of credit risk include deposit accounts in other financial institutions and federal funds sold.

The principal source of liquidity of the Corporation is dividends from its bank subsidiaries and deposits in the subsidiary banks. The Corporation's access to liquidity from its banking subsidiaries is subject to regulatory restrictions, as a result of the Consent Orders entered into with various banking regulators further described in Note 14. The Banks are currently subject to restrictions on their ability to make dividend payments without prior regulatory approval. The Corporation currently believes that it has cash on hand to cover its financial obligations and expenses for the foreseeable future and is not reliant on new capital funding to meet such obligations. The Banks' primary sources of liquidity are deposits that consist of non-maturing and maturing time deposits. At December 31, 2010 maturing time deposits consist of brokered deposits equaling 8.0% of total deposits and other time deposits equaling 29.7% of total deposits. Details regarding deposits are further described in Note 7 of the Financial Statements.

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

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

Cash Flows: Cash and cash equivalents, includes cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions and short-term borrowings.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary (OTTI) impairment 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.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loans held for sale are reported at the lower of cost or fair value, on an aggregate basis and are sold with servicing rights released.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Interest

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

income is not reported when full loan repayment is in doubt, typically when the loan is impaired or payments are past due over 90 days (180 days for residential mortgages).

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

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and 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 over the most recent three years. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential mortgage, installment loans and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loans effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral.

Other Real Estate Owned and Foreclosed Assets: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 15 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years.

Federal Home Loan Bank (FHLB) stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

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

Bank Owned Life Insurance: The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

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

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

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

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense. There was no such interest or penalties in 2010 or 2009.

Loan Commitments and Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Earnings (loss) Per Common Share: Basic earnings or loss per common share are net income or net loss divided by the weighted average number of common shares outstanding during the period. Employee Stock Ownership Plan (ESOP) shares are considered outstanding for this calculation unless unearned. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options.

Comprehensive Income: Comprehensive income consists of net income (loss) and other comprehensive income (loss). Other comprehensive income includes unrealized gains and losses on securities available for sale, which are also recognized as separate components of equity.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of \$25,000 and \$60,000 was required to meet regulatory reserve and clearing requirements at year-end 2010 and 2009 respectively.

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. West Michigan Community Bank and The State Bank have been restricted from dividend payments due to the signing of Consent Orders with the Federal Deposit Insurance Corporation (FDIC). The Holding Company has been placed under restrictions by The Federal Reserve regarding the declaration or payment of any dividends and the receipt of dividends from subsidiary Banks.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

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.

New Accounting Pronouncements:

In June 2009, the FASB amended previous guidance relating to transfers of financial assets and eliminates the concept of a qualifying special purpose entity. This guidance must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. This guidance must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities should be evaluated for

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued)

consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. The disclosure provisions were also amended and apply to transfers that occurred both before and after the effective date of this guidance. The effect of adopting this new guidance was not material to the Corporation.

In June 2009, the FASB amended guidance for consolidation of variable interest entity guidance by replacing the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. Additional disclosures about an enterprise's involvement in variable interest entities are also required. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is prohibited. The effect of adopting this new guidance was not material to the Corporation.

In July 2010, the FASB issued an Accounting Standards Update, "Receivables: Disclosure About the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The objective of this ASU is for an entity to provide disclosures that facilitate financial statement users' evaluation of the nature of credit risk inherent in the entity's portfolio of financing receivables, how that risk is analyzed and assessed in arriving at the allowance for credit losses, and the changes and reasons for those changes in the allowance for credit losses. An entity should provide disclosure on a disaggregated basis on two defined levels: (1) portfolio segment; and (2) class of financing receivable. The update makes changes to existing disclosure requirements and includes additional disclosure requirements about financing receivables, including credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables, the aging of past due financing receivables at the end of the reporting period by class of financing receivables and their effect on the allowance for credit losses. The Corporation adopted this update as of December 31, 2010 and the adoption had no impact on its operations.

**NOTE 2 - EARNINGS PER SHARE**

The factors in the earnings per share computation follow.

(000s omitted except share and per share data)	<u>2010</u>	<u>2009</u>
<b>Basic</b>		
Net income (loss)	\$ (5,385)	\$ (16,980)
Weighted average common shares outstanding	<u>2,272,065</u>	<u>2,205,419</u>
Basic earnings (loss) per common share	<u>\$ (2.37)</u>	<u>\$ (7.70)</u>
<b>Diluted</b>		
Net income (loss)	\$ (5,385)	\$ (16,980)
Weighted average common shares outstanding for basic earnings per common share	2,272,065	2,205,419
Add: Dilutive effects of assumed exercises of stock options	<u>0</u>	<u>0</u>
Average shares and dilutive potential common shares	<u>2,272,065</u>	<u>2,205,419</u>
Diluted earnings (loss) per common share	<u>\$ (2.37)</u>	<u>\$ (7.70)</u>

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**NOTE 2 - EARNINGS PER SHARE** (continued)

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

(000s omitted except share and per share data)	<u>2010</u>	<u>2009</u>
<b>Basic</b>		
Net income (loss) of continuing operations	\$ (4,521)	\$ (13,680)
Weighted average common shares outstanding	<u>2,272,065</u>	<u>2,205,419</u>
Basic earnings (loss) per common share from continuing operations	<u>\$ (1.99)</u>	<u>\$ (6.20)</u>
<b>Diluted</b>		
Net income (loss) of continuing operations	\$ (4,521)	\$ (13,680)
Weighted average common shares outstanding for basic earnings per common share	2,272,065	2,205,419
Add: Dilutive effects of assumed exercises of stock options	<u>0</u>	<u>0</u>
Average shares and dilutive potential common shares	<u>2,272,065</u>	<u>2,205,419</u>
Diluted earnings (loss) per common share from continuing operations	<u>\$ (1.99)</u>	<u>\$ (6.20)</u>

Stock options for 18,872, and 20,297 shares of common stock were not considered in computing diluted earnings per common share for 2010 and 2009 respectively, because they were antidilutive.

**NOTE 3 – SECURITIES**

Year-end securities were as follows:

<b>Available for Sale</b> (000s omitted)	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<u>2010</u>				
U.S. Government & federal agency	\$ 4,005	\$ 6	\$ (11)	\$ 4,000
Mortgage-backed residential	7,342	126	(36)	7,432
Collateralized mortgage obligations-agencies	24,758	258	(114)	24,902
Collateralized mortgage obligations-private label	4,215	0	(344)	3,871
Equity securities	<u>1,655</u>	<u>49</u>	<u>(34)</u>	<u>1,670</u>
	<u>\$ 41,975</u>	<u>\$ 439</u>	<u>\$ (539)</u>	<u>\$ 41,875</u>
<u>2009</u>				
U.S. Government & federal agency	\$ 5,542	\$ 38	\$ (67)	\$ 5,513
State and municipal	5,788	81	(41)	5,828
Mortgage-backed residential	10,560	242	0	10,802
Collateralized mortgage obligations-agencies	5,272	123	0	5,395
Collateralized mortgage obligations-private label	5,750	0	(878)	4,872
Equity securities	<u>1,971</u>	<u>21</u>	<u>(463)</u>	<u>1,529</u>
	<u>\$ 34,883</u>	<u>\$ 505</u>	<u>\$ (1,449)</u>	<u>\$ 33,939</u>

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**NOTE 3 – SECURITIES** (continued)

<b>Held to Maturity</b> (000s omitted)	Amortized <u>Cost</u>	Gross Unrecognized <u>Gains</u>	Gross Unrecognized <u>Losses</u>	<u>Fair Value</u>
<u>2010</u>				
State and municipal	\$ 4,350	\$ 41	\$ (8)	\$ 4,383
	<u>\$ 4,350</u>	<u>\$ 41</u>	<u>\$ (8)</u>	<u>\$ 4,383</u>
<u>2009</u>				
State and municipal	\$ 5,455	\$ 55	\$ (18)	\$ 5,492
	<u>\$ 5,455</u>	<u>\$ 55</u>	<u>\$ (18)</u>	<u>\$ 5,492</u>

The other-than-temporary impairment recognized in accumulated other comprehensive income was \$0 and \$97,000 for securities at December 31, 2010 and 2009.

Sales of available for sale securities were as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
Proceeds	\$ 8,683	\$ 9
Gross gains	215	0
Gross losses	(164)	0

Contractual maturities of securities at year-end 2010 were as follows. Securities not due at a single maturity date, mortgage-backed, collateralized mortgage obligations and equity securities are shown separately.

(000s omitted)	<u>Available for Sale</u>		<u>Held to Maturity</u>	
	Amortized	Fair	Amortized	Fair
	<u>Cost</u>	<u>Value</u>	<u>Cost</u>	<u>Value</u>
Due in one year or less	\$ 4,005	\$ 4,000	\$ 1,146	\$ 1,157
Due from one to five years	0	0	1,957	1,969
Due from five to ten years	0	0	879	892
Due after ten years	0	0	368	365
Mortgage-backed residential	7,342	7,432	0	0
Collateralized mortgage obligations-agencies	24,758	24,902	0	0
Collateralized mortgage obligations-private label	4,215	3,871	0	0
Equity securities	<u>1,655</u>	<u>1,670</u>	<u>0</u>	<u>0</u>
	<u>\$ 41,975</u>	<u>\$ 41,875</u>	<u>\$ 4,350</u>	<u>\$ 4,383</u>

Securities pledged at year-end 2010 and 2009 had a carrying amount of \$8,707,000 and \$18,878,000 and were pledged to secure public deposits and borrowings.

At year-end 2010 two holdings totaling \$3,871,000 in securities issued by Wells Fargo and Bear Stearns exceeded 10% of shareholder's equity. At year-end 2009 holdings totaling \$2,406,000 in securities issued by Wells Fargo exceed 10% of shareholders' equity.

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**NOTE 3 – SECURITIES** (continued)

Securities with unrealized losses at year-end 2010 and 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

(000s omitted) Description of Securities	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
US Gov't & federal agencies	\$ 1,989	\$ (11)	\$ 0	\$ 0	\$ 1,989	\$ (11)
State & municipal	365	(3)	245	(5)	610	(8)
Mortgage backed residential Collateralized Mortgage Obligations-agencies	2,062	(36)	0	0	2,062	(36)
Collateralized Mortgage Obligations-agencies	6,085	(114)	0	0	6,085	(114)
Collateralized Mortgage Obligations-private label	0	0	3,871	(344)	3,871	(344)
Equity securities	<u>186</u>	<u>(14)</u>	<u>439</u>	<u>(20)</u>	<u>625</u>	<u>(34)</u>
Total temporarily impaired	<u>\$ 10,687</u>	<u>\$ (178)</u>	<u>\$ 4,555</u>	<u>\$ (369)</u>	<u>\$ 15,242</u>	<u>\$ (547)</u>

(000s omitted) Description of Securities	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
US Gov't & federal agencies	\$ 3,475	\$ (67)	\$ 0	\$ 0	\$ 3,475	\$ (67)
State & municipal	497	(18)	659	(41)	1,156	(59)
Collateralized Mortgage Obligations-private label			4,872	(878)	4,872	(878)
Equity securities	<u>0</u>	<u>0</u>	<u>1,009</u>	<u>(463)</u>	<u>1,009</u>	<u>(463)</u>
Total temporarily impaired	<u>\$ 3,972</u>	<u>\$ (85)</u>	<u>\$ 6,540</u>	<u>\$ (1,382)</u>	<u>\$ 10,512</u>	<u>\$ (1,467)</u>

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.

The table below presents a roll forward of the credit losses recognized in earnings on debt securities for which a portion of OTTI was recognized in other comprehensive income for the period ended December 31, 2010:

(000s omitted)	<u>2010</u>	<u>2009</u>
Beginning balance, January 1,	\$ 288	\$ 0
Additions for credit losses on securities for which no previous other-than-temporary impairment was recognized	298	288
Increases to credit losses on securities for which other-than-temporary impairment was previously recognized	9	0
Reduction for previous credit losses realized on securities sold during the period	(88)	0
Ending balance, December 31,	<u>\$ 507</u>	<u>\$ 288</u>

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**NOTE 3 – SECURITIES** (continued)

As of December 31, 2010, the Corporation's security portfolio consisted of 87 securities, 13 of which were in an unrealized loss position. The majority of unrealized losses are related to the Corporation's collateralized mortgage obligations (CMOs) as discussed below.

In 2010, the Corporation recognized other-than-temporary impairments totaling \$307,000 on four individual investments. Three of the impairments, totaling \$298,000 were recognized on equity securities as a result of analysis of the declining performance of the individual institutions. The fourth totaling \$9,000 was on a single collateralized mortgage obligation instrument and was recognized due to the deterioration of the underlying loans. In 2009, the Corporation recognized other-than-temporary impairments totaling \$288,000 on four individual investments. Three of the impairments, totaling \$209,000 were recognized on equity securities as a result of analysis of the declining performance of the individual institutions. The fourth totaling \$79,000 was on the previously mentioned collateralized mortgage obligation.

Collateralized Mortgage Obligations

The decline in fair value of the Corporation's private label collateralized mortgage obligations is primarily attributable to the lack of liquidity and the financial crisis affecting these markets and not necessarily the expected cash flows of the individual securities. The ratings held on the private label securities are AA and A-. The underlying collateral of these CMOs is comprised largely of 1-4 family residences. In each of these securities, the Corporation holds the senior tranche and receives payments before other tranches. For private label securities, management completes an analysis to review the recent performance of the mortgage pools underlying the instruments. At December 31, 2010, two of the private label securities with an amortized cost of \$3,900,000 have an unrealized loss of \$344,000.

The Corporation has also been closely monitoring the performance of the CMO and MBS portfolios. In 2009, there were several CMOs that were downgraded in the market. Management continued to monitor items such as payment streams and underlying default rates, and did not determine a severe change in these items. On a quarterly basis, management uses multiple assumptions to project the expected future cash flows of the private label CMO's 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 are adjusted when appropriate after considering characteristics of the underlying loans collateralizing the private label CMO security. As a result of its review, the Corporation recognized a \$9,000 other-than-temporary impairment as a result of incurred credit losses which has been reflected in the income statement. The security with the credit loss was the Corporation's sole CCC rated security. The Corporation sold this security during the fourth quarter of 2010 and recognized an additional loss of \$136,000.

The Corporation has three agency collateralized mortgage obligations with an unrealized loss of \$114,000. 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 into non-public bank holding companies within Michigan. These securities receive a multi-faceted review utilizing call report data. Management reviews such performance indicators as earnings, ROE, ROA, non-performing assets,

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**NOTE 3 - SECURITIES** (continued)

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 fourth quarter, management performed its review and determined that no additional other-than-temporary impairment was necessary on the equity securities in the portfolio.

During 2010 OTTI totaling \$298,000 was recognized on the Corporation's equity securities in bank holding companies. The impairment was recognized as a result of the length of time these securities have been at an unrealized loss position.

US Government and federal agencies and state and municipal

Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Corporation does not have the intent to sell these mortgage-backed securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at December 31, 2010.

**NOTE 4 – LOANS**

Major categories of loans at December 31, are as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
Commercial	\$ 43,395	\$ 31,066
Real estate – commercial	106,784	133,097
Real estate – construction	9,597	21,904
Real estate – residential	19,046	23,681
Consumer	<u>29,153</u>	<u>32,302</u>
	207,975	242,050
Less allowance for loan losses	<u>10,027</u>	<u>8,589</u>
	<u>\$ 197,948</u>	<u>\$ 233,461</u>

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

Certain directors and executive officers of the Corporation, including their affiliates are loan customers of the Bank. These amounts are reflective of directors and executive officers of continuing operations only.

(000s omitted)	<u>2010</u>	<u>2009</u>
Beginning balance, January 1,	\$4,223	\$10,142
New loans	247	0
Repayments	(339)	(115)
Change in related parties	<u>(1,033)</u>	<u>(5,804)</u>
Ending balance, December 31,	<u>\$3,098</u>	<u>\$4,223</u>

FENTURA FINANCIAL, INC.  
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**NOTE 4 – LOANS** (continued)

Activity in the allowance for loan losses for the years is as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
Balance, beginning of year	\$ 8,589	\$ 7,328
Provision for loan losses	6,934	11,040
Loans charged off	(6,417)	(9,996)
Loan recoveries	<u>921</u>	<u>217</u>
Balance, end of year	<u>\$ 10,027</u>	<u>\$ 8,589</u>

FENTURA FINANCIAL, INC.  
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**NOTE 4 – LOANS** (continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method at December 31, 2010:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loans	Home Equity	Unallocated	Total
Allowance for loan losses:							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	\$ 184	\$ 5,962	\$ 95	\$ 69	\$ 160	\$ 18	\$ 6,488
Collectively evaluated for impairment	685	1,980	316	164	348	46	3,539
Total ending allowance balance	\$ 869	\$ 7,942	\$ 411	\$ 233	\$ 508	\$ 64	\$ 10,027
Loans:							
Loans individually evaluated for impairment	\$ 1,183	\$ 25,602	\$ 1,069	\$ 228	\$ 357	\$ 0	\$ 28,439
Loans collectively evaluated for impairment	42,212	90,779	17,977	7,798	20,770	0	179,536
Total ending loans balance	\$ 43,395	\$ 116,381	\$ 19,046	\$ 8,026	\$ 21,127	\$ 0	\$ 207,975
Accrued interest receivable	357	429	76	55	58	0	975
Total recorded investment in loans	\$ 43,752	\$ 116,810	\$ 19,122	\$ 8,081	\$ 21,185	\$ 0	\$ 208,950

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**NOTE 4 – LOANS** (continued)

Loan impairment is measured by estimating the expected future cash flows and discounting them at the respective effective interest rate or by valuing the underlying collateral. The recorded investment in impaired loans is as follows at December 31:

(000s omitted)	<u>2010</u>	<u>2009</u>
Year end loans not requiring allocation	\$ 5,407	\$ 7,937
Year end loans requiring allocation	<u>23,032</u>	<u>19,947</u>
	<u>\$ 28,439</u>	<u>\$ 27,884</u>
Amount of the allowance for loan losses allocated	\$ 6,488	\$ 5,248

	<u>2010</u>	<u>2009</u>
Average of individually impaired loans during the year	\$ 27,612	\$ 25,129
Cash basis interest income recognized during impairment	1,262	1,057

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2010:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
With no related allowances recorded:			
Commercial	\$ 490	\$ 490	\$ 0
Commercial Real Estate			
Construction	149	149	0
Other	4,034	4,036	0
Residential real estate	544	544	0
Consumer			
Installment Loans	116	116	0
Home Equity	74	75	0
With an allowance recorded:			
Commercial	693	696	184
Commercial real estate:			
Construction	348	348	101
Other	21,071	21,161	5,879
Residential real estate	525	529	95
Consumer			
Installment loans	112	112	69
Home equity	283	284	160
Total	<u>\$28,439</u>	<u>\$28,540</u>	<u>\$6,488</u>

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**NOTE 4 – LOANS** (continued)

Non-accrual loans and loans past due 90 days still on accrual were as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
Loans past due over 90 days still on accrual	\$ 133	\$ 319
Renegotiated loans	3,654	1,454
Non-accrual loans	12,496	11,429

Non-accrual 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 December 31, 2010:

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

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

The following table presents the aging of the recorded investment in past due loans at December 31, 2010 by class of loans:

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

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

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**NOTE 4 – LOANS** (continued)

**Troubled Debt Restructurings:**

The Corporation allocated \$598,000 and \$40,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructuring as of December 31, 2010 and 2009. Renegotiated loans above are also included with impaired loans. The Corporation has no additional amounts committed to these customers.

**Loans to be acquired from discontinued operations:**

As part of the terms of the sale of West Michigan Community Bank, selected non performing assets will be acquired by a newly formed holding company. The holding company will acquire \$1,100,000 of substandard loans, \$4,400,000 of non-accrual loans and \$800,000 of real estate in redemption. These loans have a \$1,277,000 of allowance for loan losses allocated as of December 31, 2010.

Additionally, The State Bank will acquire \$2,900,000 of watch credit grade loans. The total of all loans to be acquired is \$9,200,000.

**Credit Quality Indicators:**

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

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

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

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection nor 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.

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**NOTE 4 – LOANS** (continued)

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be prime or pass rated loans. At December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(000s omitted)	<u>Prime</u>	<u>Pass</u>	<u>Watch</u>	<u>Substandard</u>	<u>Total</u>
Commercial	\$3,174	\$33,871	\$3,530	\$3,177	\$ 43,752
Commercial real estate:					
Construction	0	755	1,414	6,979	9,148
Other	0	81,739	9,863	16,060	107,662
Total	<u>\$3,174</u>	<u>\$116,365</u>	<u>\$14,807</u>	<u>\$26,216</u>	<u>\$ 160,562</u>

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 December 31, 2010:

(000s omitted)	<u>Consumer</u>		<u>Residential</u>	<u>Total</u>
	<u>Home Equity</u>	<u>Installment</u>	<u>Traditional</u>	
Performing	\$21,128	\$7,553	\$18,053	\$ 46,734
Non-performing	57	528	1,069	1,654
Total	<u>\$21,185</u>	<u>\$8,081</u>	<u>\$19,122</u>	<u>\$ 48,388</u>

**NOTE 5 – OTHER REAL ESTATE OWNED**

Other real estate owned at December 31, included in continuing operations, was:

(000s omitted)	<u>2010</u>	<u>2009</u>
Beginning balance	\$ 3,761	\$2,099
Transfers into other real estate	2,459	4,255
Sales of other real estate owned	(3,136)	(1,409)
Write downs of other real estate owned	(342)	(1,184)
Ending balance	<u>\$ 2,742</u>	<u>\$ 3,761</u>

Net gains (losses) on sales of other real estate were \$363,000 in 2010 and (\$28,000) in 2009. Due to declining real estate values, the Corporation experienced write-downs of other real estate owned of \$342,000 in 2010 and \$1,184,000 in 2009. Carrying costs associated with other real estate owned totaled \$482,000 in 2010 and \$823,000 in 2009.

As part of the terms of the sale of West Michigan Community Bank, \$3,900,000 other real estate owned, included in discontinued operations, will be retained by a newly formed real estate holding company.

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**NOTE 5 – OTHER REAL ESTATE OWNED (continued)**

Other real estate owned at December 31, included in discontinued operations, was:

(000s omitted)	<u>2010</u>	<u>2009</u>
Beginning balance	\$ 4,206	\$3,885
Transfers into other real estate	1,714	1,294
Sales of other real estate owned	(2,003)	(746)
Write downs of other real estate owned	(63)	(227)
Ending balance	<u>\$ 3,854</u>	<u>\$ 4,206</u>

**NOTE 6 - PREMISES AND EQUIPMENT, NET**

Bank premises and equipment is comprised of the following at December 31:

(000s omitted)	<u>2010</u>	<u>2009</u>
Land and land improvements	\$ 2,305	\$ 2,305
Building and building improvements	11,421	11,385
Furniture and equipment	5,802	5,979
Construction in progress	0	8
	<u>19,528</u>	<u>19,677</u>
Less accumulated depreciation	9,193	8,683
	<u>\$10,335</u>	<u>\$ 10,994</u>

Depreciation expense, of continuing operations, was \$785,000 and \$848,000 for 2010 and 2009.

The Corporation leases property for certain branches and ATM locations. Rent expense of continuing operations were \$96,000 for 2010 and \$100,800 for 2009. Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that generally are present (000s omitted):

2011	\$ 71
2012	52
2013	52
2014	52
2015	26
	<u>\$253</u>

**NOTE 7 – DEPOSITS**

The following is a summary of deposits of continuing operations at December 31:

(000s omitted)	<u>2010</u>	<u>2009</u>
Noninterest-bearing:		
Demand	\$ 55,044	\$ 53,113
Interest-bearing:		
Savings	64,133	60,663
Money market demand	52,723	57,123
Time, \$100,000 and over	45,296	71,419
Time, \$100,000 and under	58,781	69,233
	<u>\$ 275,977</u>	<u>\$ 311,551</u>

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**NOTE 7 – DEPOSITS** (continued)

Scheduled maturities of time deposits at December 31, were as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
In one year	\$ 50,519	\$ 79,103
In two years	36,361	28,404
In three years	9,500	22,600
In four years	4,839	5,525
In five years	2,770	4,895
Thereafter	88	125
	<u>\$ 104,077</u>	<u>\$ 140,652</u>

Brokered deposits totaled approximately \$21,995,000 and \$34,398,000 at December 31, 2010 and 2009. At December 31, 2010 and 2009, brokered deposits had interest rates ranging from 4.90% to 5.30% and 4.80% to 5.30%, respectively, and maturities ranging from five months to twenty-two months. Brokered deposits mature as follows: \$11,005,000 in 2011 and \$10,990,000 in 2012.

The State Bank is considered adequately capitalized at December 31, 2010 as a result; 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 Banks' local deposits.

Deposits from principal officers, directors, and affiliates of continuing operations at year-end December 31, 2010 and 2009 were \$4,528,000 and \$2,083,000.

**NOTE 8 - BORROWINGS**

Short-Term Borrowings

Short-term borrowings consist of term federal funds purchased and treasury tax and loan deposits and generally are repaid within one to 120 days from the transaction date.

Federal Home Loan Bank Advance

At year-end, advances of continuing operations, from the FHLB were as follows:

(000s omitted)

<u>Principal Terms</u>	<u>Advance Amount</u>	<u>Maturity Date</u>
<u>December 31, 2010</u>		
Single maturity fixed rate advance with rate of 7.34%	<u>\$ 954</u>	May 2016
<u>December 31, 2009</u>		
Single Maturity fixed rate advance, with rate of 7.34%	<u>\$ 981</u>	May 2016

The advance is payable at its maturity date, a prepayment penalty is assessed with early payoffs of advances. The advance was collateralized by securities totaling \$6,700,000 and \$11,136,000 at December 31, 2010 and 2009.

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**NOTE 8 – BORROWINGS** (continued)

Maturities over the next five years are (000s omitted):

2011	30
2012	33
2013	35
2014	39
2015	42
Thereafter	<u>775</u>
	<u>\$ 954</u>

Subordinated Debenture and Trust Preferred Securities

A trust formed by the Corporation issued \$12,000,000 of trust preferred securities in 2003 as part of a pooled offering of such securities. The interest rate is a floating rate (LIBOR plus 3.00%) and the current rate at December 31, 2010 is 3.29%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2008 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2033.

A trust formed by the Corporation issued \$2,000,000 of trust preferred securities in 2005 as part of a pooled offering of such securities. The interest rate is a floating rate (LIBOR plus 1.60%) and the current rate at December 31, 2010 is 1.88%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2010 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2035.

The Corporation is not considered the primary beneficiary of these trusts, therefore the trusts are not consolidated in the Corporations' financial statements but rather the subordinated debentures are shown as a liability.

As the subsidiary banks are working to preserve capital and withholding the payment of dividends to the holding company, the Corporation elected in the first quarter of 2009 to defer interest payments for five years on \$14,000,000 of subordinated debentures. The reason for the interest deferral is to maintain liquidity at the holding company and the Bank subsidiaries. Accrued interest payable on the subordinated debentures was \$1,027,000 at December 31, 2010 compared to \$577,000 at December 31, 2009. The Corporation is not in default under either of the indentures. During this five year period, the Corporation is precluded from paying dividends on its outstanding common stock. The Corporation subsequently may give notice that it elects to shorten the deferral period, pay accrued interest and return to the normal course of dividend payments.

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**NOTE 9 - INCOME TAXES**

The provision (benefit) for income taxes reflected in the consolidated statements of income for the years ended December 31 consists of the following:

(000s omitted)	<u>2010</u>	<u>2009</u>
Current expense (benefit) of continuing operations	\$ 137	\$ (3,396)
Deferred expense (benefit) of continuing operations	(339)	(785)
Establishment of valuation allowance	0	6,464
Net tax from continuing operations	<u>(202)</u>	<u>2,283</u>
Net tax expense (benefit) of discontinued operations	0	(1,564)
	<u>\$ (202)</u>	<u>\$ 719</u>

Income tax expense (benefit) for continuing operations was less than the amount computed by applying the statutory federal income tax rate to income (loss) before income taxes. The reasons for the difference are as follows:

(000s omitted)	<u>2010</u>	<u>2009</u>
Income tax at statutory rate	\$ (1,431)	\$ (3,876)
Valuation allowance	1,251	6,598
Tax exempt income	(124)	(181)
Other	102	(258)
	<u>\$ (202)</u>	<u>\$ 2,283</u>

The net deferred tax asset recorded includes the following amounts of deferred tax assets and liabilities:

(000s omitted)	<u>2010</u>	<u>2009</u>
Deferred tax assets		
Allowance for loan losses	\$ 4,614	\$ 3,877
Alternative minimum tax credit	563	622
Unrealized loss on securities available for sale	0	372
Compensation	443	415
Net operating loss	1,216	0
Non-accrual interest	248	173
Capital loss	1,393	1,390
ORE write downs	556	418
Other	256	408
	<u>9,289</u>	<u>7,675</u>
Deferred tax liabilities		
Depreciation	(512)	(578)
Purchase accounting adjustments	(220)	(253)
Unrealized gain on securities available for sale	(31)	0
Other	(83)	(93)
	<u>(846)</u>	<u>(924)</u>
Valuation allowance	<u>(8,443)</u>	<u>(6,751)</u>
	<u>\$ 0</u>	<u>\$ 0</u>

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**NOTE 9 - INCOME TAXES** (continued)

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 December 31, 2010 and 2009. In 2009 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. As a result, during the second quarter of 2009, the Corporation recognized a valuation allowance. During the fourth quarter of 2009, new tax laws were enacted which allowed the Corporation to exercise the option to carry the current year loss back over a five year taxable income period. In 2010 the Corporation evaluated the deferred tax position and found there to be no change at this time. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the related deferred income tax assets are realized or the valuation allowance is otherwise no longer required. Management will continue to monitor our deferred tax assets quarterly for changes affecting their realizability.

There were no unrecognized tax benefits at December 31, 2010 or 2009, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Corporation and its subsidiaries are subject to U.S federal income taxes as well as income tax of the state of Michigan. The Corporation is no longer subject to examination by taxing authorities for years before 2007.

**NOTE 10 - BENEFIT PLANS**

The Corporation has a noncontributory discretionary employee stock ownership plan (Plan) covering substantially all of its employees. It is a requirement of the plan to invest principally in the Corporation's common stock. No contributions were made to the Plan in 2010 or 2009.

The Corporation has also established a 401(k) Plan in which 50% of the employees' contribution can be matched with a discretionary contribution by the Corporation up to a maximum of 6% of gross wages. In 2009 the Corporation elected to eliminate its contribution to the 401(k) Plan during the first quarter. This election was maintained in 2010. Therefore there were no contributions to the plan in 2010 and the reduced contributions in 2009 totaled \$59,000.

The Corporation entered into Supplemental Executive Retirement Agreements (SERP Agreements) with certain executives. The SERP Agreements are designed to encourage executives to remain long term employees of the Corporation, and to provide specified benefits to certain key executives who contribute materially to the continued growth, development and future business success of the Corporation. The retirement benefits are an unsecured obligation of the Corporation. The Corporation and the Affiliate Bank has established other Non-Qualified Deferred Compensation arrangements for employees not covered under the SERP. The arrangements are designed to encourage certain officers to remain long term employees of the Corporation and the Banks, and to provide the officers with supplemental retirement income. At year end 2010 and 2009, accumulated liability for these plans totaled \$671,246 and \$585,030. The Corporation's contributions to the plans in 2010 and 2009 were \$0 and \$99,367, respectively.

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**NOTE 11 - STOCK PURCHASE AND OPTION PLANS**

Director and Employee Plans

The Directors Stock Purchase Plan permits directors of the Corporation to purchase shares of common stock made available for purchase under the plan at the fair market value on the fifteenth day prior to the annual issuance date. The total number of shares issuable under this plan is limited to 9,600 shares in any calendar year.

The Retainer Stock Plan allows directors to elect to receive shares of common stock in full or partial payment of the director's retainer fees and fees for attending meetings. The number of shares is determined by dividing the dollar amount of fees to be paid in shares by the market value of the stock on the first business day prior to the payment date.

The Executive Stock Bonus Plan permits the administrator of the plan to grant shares of the Corporation's common stock to eligible employees. Any executive or managerial level employee is eligible to receive grants under the plan. The Board of Directors administers the plan and the numbers of shares issued are at the sole discretion of the Board of Directors. No shares were granted under this plan during 2010 or 2009.

Dividend Investment Plan

The Automatic Dividend Reinvestment Plan ("DRIP") permits enrolled shareholders to automatically use dividends paid on common stock to purchase additional shares of the Corporation's common stock at the fair market value on the investment date. Any shareholder who is the beneficial or record owner of not more than 9.9% of the issued and outstanding shares of the Corporation's common stock is eligible to participate in the plan.

Pursuant to a separate agreement with a family who collectively holds more than 9.9% of the Corporation's stock on or prior to January 31 of each year beginning January 31, 1997, the Corporation is to advise the family, in a written notice, of the number of shares sold under the DRIP. Each family member will have the option, until February 28 of the same year, to purchase from the Corporation one-third of the total number of shares that would be sufficient to prevent the dilution to all family members as a group that result solely as a result of the DRIP shares. The purchase price under this agreement is the fair market value on December 31 of the year immediately preceding the year in which the written notice is given. Similarly, a reverse agreement exists which allows the Corporation to redeem family shares to maintain the family ownership percentage in the event that stock repurchase activity more than offsets the shares available because of the DRIP.

The following summarizes shares issued under the various plans:

	<u>2010</u>	<u>2009</u>
Automatic dividend reinvestment plan	0	0
Director stock purchase & retainer stock	54,090	59,360
Stock options	0	0
Other issuance of stock	<u>6,122</u>	<u>3,428</u>
	<u>60,212</u>	<u>62,788</u>

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**NOTE 11 - STOCK PURCHASE AND OPTION PLANS** (continued)

Stock Option Plans

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 2010 or 2009.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the Plan. No options were granted in 2010 or 2009.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

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, 2010	20,297	\$29.55		
Options forfeited 2010	<u>(1,425)</u>	<u>32.64</u>		
Options outstanding at December 31, 2010	<u>18,872</u>	<u>\$29.32</u>	<u>2.59</u>	<u>\$0</u>
Exercisable at December 31, 2010	<u>18,872</u>	<u>\$29.32</u>	<u>2.59</u>	<u>\$0</u>

No options were exercised during 2010 or 2009. As of December 31, 2010, there was no unrecognized compensation cost related to non-vested stock options granted under the Plan.

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**NOTE 12 - 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 and asset or liability.

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

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

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

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**NOTE 12 - FAIR VALUE** (continued)

Assets Measured on a Recurring Basis

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

(000s omitted)

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

(000s omitted)

	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2009				
<u>Available for sale securities</u>				
US Government and agency	\$ 5,513	\$ 0	\$ 5,513	\$ 0
State and municipal	5,828	0	5,828	0
Mortgage-backed residential	10,802	0	10,802	0
Collateralized mortgage obligations- agency	5,395	0	5,395	0
Collateralized mortgage obligations- private label	4,872	0	4,872	0
Equity securities	<u>1,529</u>	<u>17</u>	<u>1,512</u>	<u>0</u>
	<u>\$33,939</u>	<u>\$ 17</u>	<u>\$33,922</u>	<u>\$ 0</u>

At June 30, 2009, \$1,385,000 of equity securities were transferred from level 3 inputs to level 2 inputs due to the existence of observable trades in markets that are not active.

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

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**NOTE 12 - FAIR VALUE** (continued)

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

(000s omitted)	<u>Equity Securities</u>	
	2010	2009
Beginning balance, Jan. 1,	\$ 0	\$ 1,229
Total gains or losses (realized / unrealized)		
Included in earnings	0	7
Loss on security impairment	(298)	(208)
Included in other comprehensive income	0	357
Purchases, issuances and settlements		
Transfers in and / or out of Level 3	1,445	(1,385)
Ending balance, December 31,	<u>\$ 1,147</u>	<u>\$ 0</u>

Assets Measured on a Non-Recurring Basis

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

(000s omitted)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>At December 31, 2010</u>				
Impaired loans				
Commercial	\$ 599	\$ 0	\$ 0	\$ 599
Commercial real estate	7,066	0	0	7,066
Residential real estate	716	0	0	716
Consumer	355	0	0	355
Total impaired loans	<u>\$ 8,736</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 8,736</u>
Other real estate owned				
Commercial real estate	\$ 235	\$ 0	\$ 0	\$ 235
Residential real estate	60	0	0	60
Total other real estate owned	<u>\$ 295</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 295</u>
<u>At December 31, 2009</u>				
Impaired loans	\$14,700	\$ 0	\$ 0	\$14,700
Other real estate owned	470	0	0	470

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**NOTE 12 - FAIR VALUE** (continued)

The following represent impairment charges recognized during the period:

Impaired loans, that are measured for impairment using the fair value of the collateral had a carrying amount of \$12,500,000, with a valuation allowance of \$3,764,000, resulting in an additional provision for loan losses of \$700,000 at December 31, 2010. At December 31, 2009 impaired loans had a carrying amount of \$19,947,000, with a valuation allowance of \$5,247,000, which resulted in additional provision for loan losses of \$1,959,000.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,742,000, of which \$295,000 was at fair value at December 31, 2010, which resulted from write-downs totaling \$352,000. At December 31, 2009 other real estate owned had a net carrying amount of \$1,274,000, of which \$470,000 was at fair value, which resulted from write-downs totaling \$123,000.

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

(000s omitted)	<u>2 0 1 0</u>		<u>2 0 0 9</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
<b>Assets:</b>				
Cash and cash equivalents	\$33,492	\$33,492	\$31,640	\$31,640
Securities - held to maturity	4,350	4,383	5,455	5,492
FHLB stock	740	n/a	806	n/a
Loans held for sale	850	850	229	229
Loans (including impaired loans)	197,948	194,925	233,461	258,506
Accrued interest receivable	1,050	1,050	1,289	1,289
<b>Liabilities:</b>				
Deposits	\$275,977	\$272,223	\$311,551	\$297,608
Short-term borrowings	879	879	164	164
FHLB advances	954	1,369	981	1,257
Subordinated debentures	14,000	12,613	14,000	12,656
Accrued interest payable	1,166	1,166	758	758

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

Cash and cash equivalents

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

Securities

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

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**NOTE 12 - FAIR VALUE** (continued)

FHLB Stock

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

Loans held for sale

The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

Loans

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

Off-balance-sheet instruments

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

Deposit liabilities

The fair values disclosed for demand deposits are, by definition equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using discounted cash flow calculation that applies interest rates currently being offered on similar certificates. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings

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

FHLB advances

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

Subordinated Debentures

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

Limitations

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

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**NOTE 13-DISCONTINUED OPERATIONS**

On March 17, 2009, The Corporation entered into an agreement to sell all of the stock of one of its bank subsidiaries, Davison State Bank, to a private, non-affiliated, investor group. The Corporation recorded an estimated loss on the sale of Davison State Bank of \$700,000 in the first quarter of 2009 which is recorded in net loss from discontinued operations. As a result of the amended sales agreement, the estimated loss of \$700,000 was reversed in the first quarter of 2010. Condensed balance sheets and statements of income of discontinued operations are presented below. As of April 30, 2010, Davison State Bank was sold to an independent financial group. As a result, there is no balance sheet for presentation at December 31, 2010.

**DAVISON STATE BANK  
CONDENSED BALANCE SHEET OF DISCONTINUED OPERATIONS**

(000s omitted)	<u>Dec 31,</u> <u>2009</u>
<b>ASSETS</b>	
Cash and cash equivalents	\$ 2,537
Securities - available for sale	7,082
Securities - held to maturity	405
Loans, net of allowance (\$678)	24,396
Other assets	3,499
Total assets	<u>\$ 37,919</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>	
Deposits:	
Non-interest bearing	\$ 9,012
Interest bearing	26,265
Total deposits	<u>35,277</u>
Accrued taxes, interest and other liabilities	(60)
Shareholders' equity	<u>2,702</u>
Total liabilities and shareholders' equity	<u>\$ 37,919</u>

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank. The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium to book). As a condition of the sale, the Corporation acquired non-performing assets of West Michigan Community Bank which totaled \$10,100,000. The assets will be housed in a newly formed real estate holding company subsidiary of the Corporation. In addition, The State Bank acquired \$2,900,000 of watch rated credits into its loan portfolio.

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 13-DISCONTINUED OPERATIONS** (continued)

A condensed balance sheet of discontinued operations is presented below at December 31, 2010 and 2009.

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

(000s omitted)	<u>Dec 31,</u> <u>2010</u>	<u>Dec 31,</u> <u>2009</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 8,309	\$ 10,469
Securities - available for sale	15,080	9,669
Loans, net of allowance (\$3,543-2010, \$2,137-2009)	86,353	111,844
Other assets	13,226	15,372
Total assets	<u>\$ 122,968</u>	<u>\$ 147,354</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 13,751	\$ 11,739
Interest bearing	93,546	117,804
Total deposits	107,297	129,543
Federal Home Loan Bank advances	5,000	7,000
Accrued taxes, interest and other liabilities	1,024	317
Shareholders' equity	9,647	10,494
Total liabilities and shareholders' equity	<u>\$ 122,968</u>	<u>\$ 147,354</u>

**TOTAL DISCONTINUED OPERATIONS  
CONDENSED BALANCE SHEET OF DISCONTINUED OPERATIONS**

(000s omitted)	<u>Dec 31,</u> <u>2010</u>	<u>Dec 31,</u> <u>2009</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 8,309	\$ 13,006
Securities - available for sale	15,080	16,751
Securities - held to maturity	0	405
Loans, net of allowance (\$3,543-2010, \$2,815-2009)	86,353	136,240
Other assets	13,226	18,871
Total assets	<u>\$ 122,968</u>	<u>\$ 185,273</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 13,751	\$ 20,751
Interest bearing	93,546	144,069
Total deposits	107,297	164,820
Federal Home Loan Bank advances	5,000	7,000
Accrued taxes, interest and other liabilities	1,024	257
Shareholders' equity	9,647	13,196
Total liabilities and shareholders' equity	<u>\$ 122,968</u>	<u>\$ 185,273</u>

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 13-DISCONTINUED OPERATIONS** (continued)

A condensed statement of income of discontinued operations is presented for the twelve months ended December 31, 2010 and December 31, 2009.

**DAVISON STATE BANK  
CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**

(000s omitted)	Years Ended December 31	
	2010	2009
Interest income	\$ 607	\$ 2,023
Interest expense	116	642
Net interest income	491	1,381
Provision for loan losses	(5)	505
Net interest income after provision for loan losses	496	876
Non-interest income	178	563
Non-interest expense	121	2,700
Income (loss) before federal income tax	553	(1,261)
Federal income tax expense/(benefit)	181	275
Net income (loss)	\$ 372	\$ (986)

**WEST MICHIGAN COMMUNITY BANK  
CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**

(000s omitted)	Years Ended December 31	
	2010	2009
Interest income	\$ 6,865	\$ 8,260
Interest expense	2,349	3,661
Net interest income	4,516	4,599
Provision for loan losses	1,955	3,683
Net interest income after provision for loan losses	2,561	916
Non-interest income	1,007	1,266
Non-interest expense	4,985	5,785
Income (loss) before federal income tax	(1,417)	(3,603)
Federal income tax expense (benefit)	(181)	(1,289)
Net income (loss)	\$ (1,236)	\$ (2,314)

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 13-DISCONTINUED OPERATIONS** (continued)

**TOTAL DISCONTINUED OPERATIONS  
CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS**

(000s omitted)	Years Ended December 31	
	2010	2009
Interest income	\$ 7,472	\$ 10,283
Interest expense	2,465	4,303
Net interest income	5,007	5,980
Provision for loan losses	1,950	4,188
Net interest income after provision for loan losses	3,057	1,792
Non-interest income	1,185	1,829
Non-interest expense	5,106	8,485
Income (loss) before federal income tax	(864)	(4,864)
Federal income tax expense (benefit)	0	(1,564)
Net income (loss)	\$ (864)	\$ (3,300)

**NOTE 14 - REGULATORY MATTERS**

The Corporation (on a consolidated basis) and its Bank subsidiaries are subject to various regulatory capital requirements administered by the federal banking 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's financial statements. 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 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 Banks to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2010 and 2009, the most recent notifications from Federal Deposit Insurance Corporation categorized the Banks as adequately capitalized under the regulatory framework for prompt corrective action.

West Michigan Community Bank was placed under a Consent Order with federal and state banking regulators that contain provisions to foster improvement in West Michigan Community Bank's earnings, lower non performing loan levels, and increase capital. The Consent Order required West Michigan Community Bank to retain a Tier 1 capital to average assets ratio of a minimum of 8.0%. As of December 31, 2010, West Michigan Community Bank had a Tier 1 capital to average assets ratio of 7.5%, as compared to a Tier 1 capital to average asset ratio of 6.9% at December 31, 2009. West Michigan Community Bank was not in compliance with the Consent Order requirements. As previously mentioned, West Michigan Community Bank was sold on January 31, 2011.

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 14 - REGULATORY MATTERS** (continued)

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 December 31, 2010, The State Bank had a Tier 1 capital to average assets ratio of 6.5% and a total capital to risk-weighted assets ratio of 10.0%. The State Bank is not in compliance with the Consent Order requirements, and therefore cannot be considered well capitalized.

The Consent Orders restrict the Banks from issuing or renewing brokered deposits. Refer to Note 8 for further details. The Consent Orders also restrict dividend payments from The State Bank and West Michigan Community 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 which includes the injection of capital into The State Bank resulting from the sale of West Michigan Community Bank. The sale is projected to provide an additional \$3.5 million of capital that may be allocated to The State Bank. While below the compliance level required by the Orders, both Banks maintain capital levels that would be considered well capitalized by regular prompt corrective action regulatory standards. Non-compliance with Consent Order requirements may cause banks to be subject to further enforcement actions by the FDIC.

Effective in November 2010, the Corporation received a notice from The Federal Reserve which defined restrictions being placed upon the holding company. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an expectation that the Corporation "maintain sufficient capital" levels.

As illustrated in the table below, at December 31, 2010, the Consolidated Corporation's total capital to risk weighted assets ratio indicates that it is under capitalized. The Corporation's total capital to risk weighted assets ratio of 7.8% at December 31, 2010 was below the minimum requirement of 8.0%. This is compared to December 31, 2009 when the total capital to risk weighted assets for the Corporation was at 7.8%. With the current capital levels, the Corporation is required to obtain written approval prior to payments of any dividends or for any increase or decrease to outstanding debt.

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

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 14 - REGULATORY MATTERS** (continued)

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

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 14 - REGULATORY MATTERS** (continued)

(000s omitted)	Actual		For Capital Adequacy Purposes		Regulatory Agreement Requirements	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>As of December 31, 2009</u>						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 33,661	7.8%	\$ 34,636	8.0%	NA	NA
The State Bank	24,334	8.9	21,961	8.0	\$ 32,810	12.0% (1)
Davison State Bank	3,328	9.9	2,692	8.0	NA	NA
West Michigan Community Bank	11,841	9.4	10,063	8.0	NA	NA
Tier 1 Capital (to Risk Weighted Assets)						
Consolidated	28,164	6.5	17,318	4.0	NA	NA
The State Bank	20,830	7.6	10,981	4.0	NA	NA
Davison State Bank	2,904	8.6	1,346	4.0	NA	NA
West Michigan Community Bank	10,262	8.2	5,031	4.0	NA	NA
Tier 1 Capital (to Average Assets)						
Consolidated	28,164	5.0	22,491	4.0	NA	NA
The State Bank	20,830	6.2	13,535	4.0	27,069	8.0
Davison State Bank	2,904	7.2	1,620	4.0	3,240	8.0
West Michigan Community Bank	10,262	6.9	5,923	4.0	11,845	8.0

(1) Effective April 10, 2010

Management believes they have responded fully to the provisions of the Consent Orders except for the capital requirements. In order to be considered well capitalized and comply with the capital requirements of the Orders, The State Bank would have needed a capital injection of approximately \$4.3 million as of December 31, 2010. While below the compliance level required by the Orders, the bank maintains capital levels considered adequate by regulatory standards. Non-compliance with Consent Order requirements may cause the bank to be subject to further enforcement actions by the FDIC.

The bank has achieved improved capital ratios since falling below the well capitalized level in June of 2009. Management has initiated multiple strategies to meet the capital requirements including shrinking assets of the Bank as much as feasible without weakening the liquidity position, reducing operating costs by reducing overhead and curtailing spending, and raising additional capital through the sale of Fentura subsidiary, Davison State Bank. Management has successfully reduced assets of The State Bank by \$31.1 million during 2010 and efforts to shrink assets further are continuing. The sale of Davison State Bank generated \$3.0 million in proceeds which were used to strengthen the capital position of The State Bank.

The January 2011 sale of West Michigan Community Bank generated \$900,000 of cash which is available to be injected into The State Bank. The Corporation will also receive cash from future principal payments on loans acquired from the sale of West Michigan Community bank and from proceeds of other real estate sold, to strengthen the capital position of The State Bank, subject to regulatory approval.

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

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**NOTE 15 - LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES**

Off-balance-sheet risk

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

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

(000s omitted)	<u>2010</u>	<u>2009</u>
Commitments to make loans (at market rates)	\$ 8,403	\$ 2,847
Unused lines of credit and letters of credit	29,746	34,213

Commitments to make loans are generally made for periods of 90 days or less. At December 31, 2010, loan commitments and unused line of credit had interest rates ranging from 3.63% to 6.25% and maturities ranging from 9 months to 30 years.

**NOTE 16 - PARENT ONLY CONDENSED FINANCIAL INFORMATION**

The condensed financial information that follows presents the financial condition of Fentura Financial, Inc. (parent company only), along with the results of its operations and its cash flows.

CONDENSED BALANCE SHEETS  
Years ended December 31,  
(000s omitted)

	<u>2010</u>	<u>2009</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 863	\$ 319
Securities available for sale, at fair value	1,148	1,009
Other assets	188	448
Investment in subsidiaries	29,317	33,001
Total Assets	<u>\$ 31,516</u>	<u>\$ 34,777</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$ 1,461	\$ 245
Subordinated debt	14,000	14,000
Shareholders' equity	16,055	20,532
Total liabilities and shareholders' equity	<u>\$ 31,516</u>	<u>\$ 34,777</u>

FENTURA FINANCIAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2010 and 2009

**NOTE 16 - PARENT ONLY CONDENSED FINANCIAL INFORMATION** (continued)

**CONDENSED STATEMENTS OF INCOME**

Years ended December 31,  
(000s omitted)

	<u>2010</u>	<u>2009</u>
Loss on equity investment	\$ 0	\$ (1,360)
Other income	704	0
Dividends from subsidiaries	0	750
Interest expense	(450)	(620)
Operating expenses	(727)	(1,408)
Equity in undistributed net loss of subsidiaries	(3,780)	(15,069)
Net loss before income taxes	(4,253)	(17,707)
Federal income tax expense (benefit)	1,132	(727)
Net loss	\$ (5,385)	\$ (16,980)

**CONDENSED STATEMENTS OF CASH FLOWS**

Years ended December 31,  
(000s omitted)

	<u>2010</u>	<u>2009</u>
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ (5,385)	\$ (16,980)
Change in other assets	938	(86)
Change in other liabilities	45	81
Equity in undistributed net loss of subsidiaries	3,780	15,069
Loss on security impairment	203	908
Net loss of equity investment	0	1,360
Net cash from (used in) operating activities	(419)	352
<b>Cash flows provided by investing activities</b>		
Sale of equity security	0	383
Proceeds from sale of subsidiary	2,800	0
Loss on sale of subsidiary	(59)	0
Investment in subsidiary	(1,900)	(365)
Net cash from (used in) investing activities	841	18
<b>Cash flows used in financing activities</b>		
Issuance of subordinated debt	0	0
Net short-term borrowings	0	(1,000)
Dividends paid	0	0
Stock repurchase	0	0
Proceeds from stock issuance	122	135
Net cash from (used in) financing activities	122	(865)
Change in cash and cash equivalents	544	(495)
Cash and cash equivalents at beginning of year	319	814
<b>Cash and cash equivalents at end of year</b>	\$ 863	\$ 319

## Management's Discussion and Analysis of Financial Condition and Results of Operations

This section provides a narrative discussion and analysis of the consolidated financial condition and results of operations of Fentura Financial, Inc. (the Corporation), together with its subsidiaries, The State Bank (the Bank), as well as Fentura Mortgage Company, for the years ended December 31, 2010, 2009, 2008, 2007 and 2006. Davison State Bank, and West Michigan Community Bank, and West Michigan Mortgage Company, LLC have been reclassified into Discontinued Operations in all periods. The supplemental financial data included throughout this discussion should be read in conjunction with the primary financial statements presented on pages 1 through 44 of this report. It provides a more detailed and comprehensive review of operating results and financial position than could be obtained from a reading of the financial statements alone.

**TABLE 1** **Selected Financial Data**

<i>000s omitted except per share data and ratios</i>	2010	2009	2008	2007	2006
Summary of Consolidated Statements of Income:					
Interest income	\$ 15,077	\$ 17,889	\$ 20,627	\$ 24,716	\$ 24,712
Interest expense	4,552	6,925	9,307	11,382	10,274
Net interest income	10,525	10,964	11,320	13,334	14,438
Provision for loan losses	6,934	11,040	5,610	5,395	720
Net interest income after provision	3,591	(76)	5,710	7,939	13,718
Total other operating income	4,773	3,390	3,060	5,308	5,482
Total other operating expense	13,087	14,711	14,455	13,854	14,622
Income (loss) before income taxes	(4,723)	(11,397)	(5,685)	(607)	4,578
Federal income taxes (benefit)	(202)	2,283	(2,149)	(435)	1,427
Income (loss) from continuing operations	(4,521)	(13,680)	(3,536)	(172)	3,151
Discontinued operations, net of tax	(864)	(3,300)	(8,629)	(295)	2,157
Net income (loss)	\$ (5,385)	\$ (16,980)	\$ (12,165)	\$ (467)	\$ 5,308
Earnings per share – basic*	\$(2.37)	\$(7.70)	\$(5.60)	\$(0.22)	\$2.48
Earnings per share – diluted*	\$(2.37)	\$(7.70)	\$(5.60)	\$(0.22)	\$2.47
Summary of Consolidated Balance Sheets:					
Assets	\$424,228	\$522,079	\$578,604	\$628,019	\$622,298
Securities, including FHLB stock	46,965	40,200	44,999	59,682	83,060
Loans, including loans held for sale	198,798	233,690	284,252	293,873	283,441
Assets of discontinued operations	122,968	185,273	208,737	225,405	221,343
Deposits	275,977	311,551	331,992	354,303	345,576
Borrowings	15,833	15,145	17,507	20,679	26,552
Liabilities of discontinued operations	113,321	172,077	191,116	199,757	194,322
Shareholders' equity	16,055	20,532	36,124	49,496	51,318
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets	6.50%	6.50%	10.20%	10.40%	11.30%
Total capital to risk weighted assets	7.80%	7.80%	11.40%	11.60%	12.50%
Tier 1 capital to average assets	4.90%	5.00%	8.80%	9.00%	8.60%
Total cash dividends	\$0	\$0	\$0	\$2,163	\$2,069
Book value per share*	\$6.95	\$9.13	\$16.53	\$22.88	\$24.08
Cash dividends paid per share*	\$0.00	\$0.00	\$0.00	\$1.00	\$0.94
Period end market price per share*	\$1.75	\$1.36	\$6.75	\$22.00	\$32.55
Dividend pay-out ratio	0.00%	0.00%	0.00%	-463.17%	38.98%
Return on average shareholders' equity	-28.52%	-61.18%	-25.13%	-0.89%	10.82%
Return on average assets	-1.15%	-3.02%	-2.03%	-0.08%	0.85%
Net interest margin	3.72%	3.50%	3.33%	3.66%	4.11%
Total equity to assets at period end	3.78%	3.93%	6.24%	7.88%	8.25%

\* Per Share data calculated using average shares outstanding in each period. Per share amounts and average shares outstanding have been adjusted to reflect a 10% stock dividend paid on August 4, 2006.

## **RESULTS OF OPERATIONS**

The Corporation posted a net loss of \$5,385,000 for the twelve months ended December 31, 2010, compared to a net loss of \$16,980,000 for the same period in 2009. In 2010, the loss was driven by ongoing proportionately high provision for loan losses although net interest income had stabilized when compared to 2009. Net-interest income declined \$439,000, in 2010 due to a reduction in interest income of \$2,812,000 versus a reduction of \$2,373,000 in interest expense. Interest income declined primarily due to decreases in volume of loans. Non-interest income increased in 2010 by \$1,383,000 or 41.0% from the non-interest income in the prior year. This was due to the write off of a DeNovo bank equity investment which resulted in a loss of \$1,360,000. Non-interest expense decreased by \$1,624,000 or 11.0%, primarily due to decreases in loan and collection expenses.

Standard performance indicators used in the banking industry help management evaluate the Corporation's performance. Two of these performance indicators are return on average assets and return on average equity. For 2010 and 2009 respectively, the Corporation posted a return on average assets of (1.15%) and (3.02%). Return on average equity was (28.52%) in 2010 and (61.18%) in 2009. The Corporation's capital position experienced a decrease in equity of \$4.5 million or 21.8% in 2010. Total assets decreased \$97.9 million in 2010 and decreased \$56.5 million in 2009. The large decrease in 2010 was the largely the result of the sale of a subsidiary bank during the second quarter of 2010. Diluted loss per share was (\$2.37) in 2010 and (\$7.70) in 2009.

The markets in which The Corporation operates continue to be effected by the economic challenges in the State of Michigan. The economic conditions continue to place pressure on its customers and their ability to repay loans. This has driven up the level of troubled assets and has resulted in increased related loan expenses and provision for loan losses. The Corporation continues to monitor troubled assets and the capital levels of its Banks.

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank. The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium to book). Regulatory approval was received for the sale of West Michigan Community Bank and for the Corporation to acquire approximately \$10,100,000 of non-performing assets. As the non-performing assets are converted to performing loans or liquidated, the proceeds will be available to strengthen the capital position of The State Bank.

## **NET INTEREST INCOME**

Net interest income, the principal source of income, is the amount of interest income generated by earning assets (principally securities and loans) less interest expense paid on interest bearing liabilities (largely deposits and other borrowings).

A critical task of management is to price assets and liabilities so that the spread between the interest earned on assets and the interest paid on liabilities is maximized without unacceptable risk. While interest rates on interest earning assets and interest bearing liabilities are subject to market forces, in general, the Corporation can exert more control over deposit costs than earning asset rates. Deposit costs are somewhat limited though due to the timing of repricing of time deposits. Loan products carry either fixed rates of interest or rates tied to market indices which are determined independently. The Corporation sets its own rates on deposits, providing management with some flexibility in determining the timing and proportion of rate changes for the cost of its deposits.

Table 2 summarizes the changes in net interest income resulting from changes in volume and rates for the years ended December 31, 2010 and 2009. Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the last three years are shown in Table 3. Tax equivalent net interest income decreased by \$538,000 in 2010 or 4.8% and

decreased by \$347,000 or 3.0% in 2009. In both 2010 and 2009 investment security balances decreased, loan volume decreased and non-performing loans increased slightly.

As indicated in Table 3, for the year ended December 31, 2010, the Corporation's net interest margin was 3.72% compared with 3.50% in 2009. The improvement in 2010 is primarily attributable to stabilization in the loan portfolio as fewer loans were placed into non-accrual status than in the prior year. In addition, the average interest bearing liability rate continued to decrease, as management continued to re-price the core deposit products along with time deposit portfolio as they matured. The increase in 2009 was attributed to a larger decline in interest bearing liability rates over the decline in earning asset yields.

Average earning assets decreased 10.3% in 2010 and decreased 7.7% in 2009. Average earning assets were reduced through lower total average securities and loans when comparing 2010 to 2009. Loan balances, including loans held for sale, the highest yielding component of earning assets, represent 78.9% of earning assets in 2010, compared to 84.9% in 2009. Average interest bearing liabilities decreased 13.2% in 2010 and decreased 3.4% in 2009. Non-interest bearing deposits amounted to 19.2% of average earning assets in 2010 compared with 16.8% in 2009.

**Table 2**

Changes in Net Interest Income due to changes in average volume and interest rates  
Years ended December 31,

(000s omitted)	INCREASE /(DECREASE) DUE TO					
	2010			2009		
	VOL	YIELD/ RATE	TOTAL	VOL	YIELD/ RATE	TOTAL
Taxable securities	\$ 10	\$ (302)	\$(292)	\$ (216)	\$ (86)	\$ (302)
Tax-exempt securities (1)	(284)	13	(271)	(51)	51	0
Federal funds sold	18	6	24	14	(135)	(121)
Total loans (1)	(2,757)	407	(2,350)	(1,210)	(1,119)	(2,329)
Loans held for sale	(19)	(3)	(22)	32	(9)	23
Total earning assets	(3,032)	121	(2,911)	(1,431)	(1,298)	(2,729)
Interest bearing demand deposits	(13)	(154)	(167)	4	(255)	(251)
Savings deposits	(5)	(166)	(171)	(6)	(340)	(346)
Time CDs \$100,000 and over	(751)	(150)	(901)	(216)	(421)	(637)
Other time deposits	(410)	(549)	(959)	(9)	(671)	(680)
Other borrowings	(25)	(150)	(175)	(244)	(224)	(468)
Total interest bearing liabilities	(1,204)	(1,169)	(2,373)	(471)	(1,911)	(2,382)
Net Interest Income	\$ (1,828)	\$ 1,290	\$(538)	\$ (960)	\$ 613	\$(347)

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

**TABLE 3**  
**(000s omitted)**

**Summary of Net Interest Income**  
**Years Ended December 31,**

	2010			2009			2008		
	AVG BAL	INC/ EXP	YIELD	AVG BAL	INC/ EXP	YIELD	AVG BAL	INC/ EXP	YIELD
<b>ASSETS</b>									
Securities:									
U.S. Treasury and Government Agencies	\$29,135	\$849	2.91%	\$28,346	\$1,126	3.97%	\$32,773	\$1,422	4.34%
State and Political (1)	7,310	447	6.11%	11,961	718	6.00%	12,846	718	5.59%
Other	1,846	32	1.73%	3,067	47	1.53%	6,123	53	0.87%
Total Securities	38,291	1,328	3.47%	43,374	1,891	4.36%	51,742	2,193	4.24%
Fed Funds Sold	22,550	27	0.12%	5,089	3	0.06%	4,508	124	2.75%
Loans:									
Commercial	172,488	10,671	6.19%	206,691	12,379	5.99%	221,631	14,041	6.34%
Tax Free (1)	2,228	144	6.46%	2,616	167	6.38%	2,093	139	6.64%
Real Estate-Mortgage	21,491	1,315	6.12%	28,268	1,723	6.10%	30,583	1,950	6.38%
Consumer	30,654	1,745	5.69%	34,382	1,956	5.69%	37,350	2,424	6.49%
Total loans	226,861	13,875	6.12%	271,957	16,225	5.97%	291,657	18,554	6.36%
Allowance for Loan Loss	(10,104)			(8,883)			(6,098)		
Net Loans	216,757	13,875	6.40%	263,074	16,225	6.17%	285,559	18,554	6.50%
Loans Held for Sale	986	48	4.87%	1,373	70	5.10%	769	47	6.11%
<b>TOTAL EARNING ASSETS</b>	<b>288,688</b>	<b>15,278</b>	<b>5.29%</b>	<b>321,793</b>	<b>18,189</b>	<b>5.65%</b>	<b>348,676</b>	<b>20,918</b>	<b>6.00%</b>
Cash Due from Banks	13,361			20,255			9,823		
Assets of discontinued operations	150,441			201,534			220,573		
All Other Assets	27,753			27,426			27,681		
<b>TOTAL ASSETS</b>	<b>\$470,139</b>			<b>\$562,125</b>			<b>\$600,655</b>		
<b>LIABILITIES &amp; SHAREHOLDERS' EQUITY:</b>									
Deposits:									
Interest bearing – DDA	\$ 48,988	\$ 94	0.19%	\$51,657	\$261	0.51%	\$51,234	\$512	1.00%
Savings Deposits	64,562	77	0.12%	66,056	248	0.38%	66,778	594	0.89%
Time CD's \$100,000 and Over	60,770	2,436	3.97%	80,055	3,337	4.17%	84,834	3,974	4.68%
Other Time CD's	63,392	1,425	2.27%	77,943	2,384	3.06%	78,165	3,064	3.92%
Total Interest Bearing Deposits	237,712	4,032	1.70%	275,711	6,230	2.26%	281,011	8,144	2.90%
Other Borrowings	15,332	520	3.39%	15,916	695	4.37%	20,844	1,163	5.58%
<b>INTEREST BEARING LIABILITIES</b>	<b>253,044</b>	<b>4,552</b>	<b>1.80%</b>	<b>291,627</b>	<b>6,925</b>	<b>2.37%</b>	<b>301,855</b>	<b>9,307</b>	<b>3.08%</b>
Non-interest bearing - DDA	55,286			53,941			53,043		
Liabilities of discontinued operations	139,647			186,063			194,752		
All Other Liabilities	3,281			2,741			2,601		
Shareholders Equity	18,881			27,753			48,404		
<b>TOTAL LIABILITIES and S/H EQUITY</b>	<b>\$470,139</b>			<b>\$562,125</b>			<b>\$600,655</b>		
Net Interest Rate Spread			3.48%			3.28%			2.92%
Impact of Non-Interest Bearing Funds on Margin			0.24%			0.22%			0.41%
Net Interest Income/Margin		\$10,726	3.72%		\$11,264	3.50%		\$11,611	3.33%

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

## **ALLOWANCE AND PROVISION FOR LOAN LOSSES**

The allowance for loan losses reflects management's judgment as to the level considered appropriate to absorb probable incurred losses in the loan portfolio. The Corporation's methodology in determining the adequacy of the allowance is based on ongoing quarterly assessments and relies on several key elements, which include specific allowances for identified problem loans and a formula based risk allocated allowance for the remainder of the portfolio. This includes a review of individual loans, size and composition of the loan portfolio, historical loss experience, current economic conditions, financial condition of borrowers, the level and composition of non-performing loans, portfolio trends, estimated net charge-offs, and other pertinent factors. Although reserves have been allocated to various portfolio segments, the allowance is general in nature and is available for the portfolio in its entirety. At December 31, 2010, the allowance for loan losses was \$10,027,000 or 4.82% of total loans. This compares with \$8,589,000 or 3.55% at December 31, 2009. Management believes the allowance for loan losses at December 31, 2010 of \$10,027,000 was sufficient to cover all probable incurred losses in the loan portfolio at that time.

The provision for loan losses was \$6,934,000 in 2010 and \$11,040,000 in 2009. Provision for 2010 decreased from the 2009 level by \$4,106,000. The decrease in 2010 is related to the declining size of the loan portfolio along with improving economic indicators which partially drive the loan loss calculations. The amount of provision taken for the year is a direct output of the calculation of loan loss adequacy performed on a quarterly basis. The Corporation has a methodology that provides for formula based allowances on homogeneous pools of general loans, as well as specific allocations for impaired loans. During 2010 specific reserves for impaired loans increased compared to 2009 due to the continued decline of the underlying collateral value of the impaired loans. Reserves for the homogeneous pools of loans decreased from 2010 to 2009 due to the reduction in the loan portfolio and a change in the mix of loan concentrations. The Bank experienced gross charge-offs of non-performing assets of \$6,417,000 for 2010, compared to \$9,996,000 for 2009.

In 2010, the Corporation reduced the size of the commercial loan portfolio. Commercial loans decreased \$13,984,000 from 2009 year end. Real estate construction and mortgage loans decreased \$16,942,000 from year end 2009. The decline in real estate construction and mortgage loans was primarily due to management efforts to continue to reduce exposure to this sector. Charge-offs of commercial loans totaled \$5,618,000 in 2010 compared to \$8,423,000 in 2009. Non-performing loans increased slightly in 2010 when compared to 2009.

Table 4 summarizes loan losses and recoveries from 2006 through 2010. During 2010, the Corporation experienced net charge-offs of \$5,496,000, compared with net charge-offs of \$9,779,000 in 2009. The year to year decrease in charge offs was primarily due to a decrease in commercial loan charge-offs by \$2,806,000 year over year. Also, mortgage loan charge-offs decreased by \$419,000 and consumer charge-offs decreased by \$354,000. Total recoveries increased by \$704,000 comparing 2010 with 2009. The net charge-off ratio is the difference of charged-off loans minus the recoveries from loans divided by gross loans. Accordingly, the net charge-off ratio for 2010 was 2.64% compared to 4.04% at the end of 2009. As charge-offs have occurred, the Bank reviews the remaining loan concentration and believes that the level of losses have decreased compared to prior years.

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is adequate to meet normal credit risks in the loan portfolio. The Corporation has identified a concentration level connected with construction and land development loans. Specific strategies were developed to reduce the concentration level and limit exposure to this type of lending. The Corporation has been successful in reducing this concentration in 2009 and 2010. The Corporation's loan portfolio has no exposure in foreign loans. The Corporation has not extended credit to finance highly leveraged transactions nor does it intend to do so 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. At December 31, 2010, the local economy of the Bank continues to struggle. Unemployment remains high, collateral values on real estate have

stabilized on 1-4 family property, yet commercial property values continue to decline. Loan demand in commercial and consumer types continues to be low. Management continues to identify and devote attention to credits that may not be performing as agreed. Non-performing loans are discussed further in the section titled “Non-Performing Assets”.

**TABLE 4**

**Analysis of the Allowance for Loan Losses**

**Years Ended December 31,**

(000s omitted)	2010	2009	2008	2007	2006
Balance Beginning of Period	\$ 8,589	\$ 7,328	\$ 4,882	\$ 4,088	\$3,916
Charge-offs:					
Commercial, Financial and Agricultural	(5,618)	(8,424)	(2,994)	(4,032)	(419)
Real Estate-Mortgage	(264)	(683)	(203)	(177)	0
Installment Loans to Individuals	(535)	(889)	(366)	(588)	(221)
Total Charge-offs	(6,417)	(9,996)	(3,563)	(4,797)	(640)
Recoveries:					
Commercial and Financial	812	152	222	140	31
Real Estate-Mortgage	41	4	23	0	0
Installment Loans to Individuals	68	61	154	56	61
Total Recoveries	921	217	399	196	92
Net Charge-offs	(5,496)	(9,779)	(3,164)	(4,601)	(548)
Provision for loan losses	6,934	11,040	5,610	5,395	720
Balance at End of Period	\$10,027	\$ 8,589	\$ 7,328	\$ 4,882	\$ 4,088
Ratio of Net Charge-Offs During the Period	2.64%	4.04%	1.13%	1.54%	0.19%

**NON-INTEREST INCOME**

Non-interest income was \$4,773,000 in 2010 and \$3,390,000 in 2009. These amounts represent an increase of 40.8% in 2010 compared to 2009.

The most significant category of non-interest income is service charges on deposit accounts, which were \$1,445,000 in 2010, compared to \$1,726,000 in 2009. This was a decrease of \$281,000 or 16.3% in 2010. The decrease in 2010 was in all categories of service charges, with the largest declining component being NSF and overdraft privilege fees.

Gains on the sale of mortgage loans originated by the Bank and sold in the secondary market were \$701,000 in 2010 and \$744,000 in 2009. The decrease of 5.8% in 2010 is due to the slowing of refinancing activity, as mortgage rates have risen, along with lower volumes of customers eligible for refinancing and new mortgages. The Corporation sells the majority of the mortgage loans originated in the secondary market on a servicing released basis.

Trust and investment income decreased \$4,000 in 2010 to \$915,000; compared with \$919,000 in 2009. The market value of the trust and investment portfolios has steadied.

Other income and fees includes income from the sale of checks, safe deposit box rent, merchant account income, ATM income, gain on sale of real estate owned and other miscellaneous income items. Other income and fees were \$1,968,000 for 2010, compared to \$1,649,000 in 2009. The largest improvement was in gain on sale of other real estate owned. For the year ended December 31, 2010, the gain on sale of real estate owned was \$392,000, compared to a loss on sale of real estate owned of \$28,000.

Throughout 2010, the Corporation performed a quarterly review of bank equity stocks owned. As a result of this review, the Corporation acknowledged other-than-temporary impairment on one investment.

During the third quarter of 2010, the Bank recognized impairment of \$307,000 on one bank stock. The remaining amortized cost for bank stocks owned is \$1,655,000 and has an unrealized net gain of \$15,000 at December 31, 2010. This is compared to other-than-temporary impairment realized totaling \$288,000 for the year ended December 31, 2009.

For the year ended December 31, 2009, the Corporation recognized a loss on equity investment of \$1,360,000. This transaction did not recur in 2010.

### **NON-INTEREST EXPENSE**

Total non-interest expense was \$13,087,000 in 2010 compared to \$14,711,000 in 2009. This was a decrease of 11.0% in 2010.

Salaries and employee benefits, the Corporation's largest operating expense category, were \$6,387,000 in 2010, compared with \$6,650,000 in 2009. The decrease between 2010 and 2009 was primarily a result of personnel reductions, through attrition.

Occupancy expenses associated with the Corporation's facilities were \$1,225,000 in 2010 compared to \$1,326,000 in 2009 for a decrease of 7.6%. In 2010, the benefits of restructuring building cleaning services to in-house and the renegotiation of multiple property maintenance contracts, which began in 2009, were recognized.

In 2010, equipment expenses were \$1,265,000 compared to \$1,339,000 in 2009 for a decrease of 5.5% in 2010. In 2010, the Corporation experienced a decrease of \$53,000 in depreciation expense. In addition in rental expenses were up \$7,000, and maintenance expenses were down \$21,000.

Loan and collection expenses were \$1,279,000 in 2010 compared to \$2,559,000 in 2009. The decrease was related to other real estate owned (ORE) held by the Corporation. In 2010, ORE carrying costs and related expenses totaled \$482,000 compared to \$823,000 for 2009. Multiple properties being held in ORE required negative valuation adjustments totaling \$342,000 in 2010 compared to \$1,184,000 in 2009. These adjustments were made as a result of the continuing decline in real estate values in Michigan. The decreases from 2009 to 2010 were in the categories of increased filing and recording costs, appraisal expense, collection expenses and other loan related expenses. It is anticipated that in 2011, loan and collection expenses will remain similar to 2010 or have a slight decline.

Advertising expenses were \$101,000 in 2010 compared to \$121,000 in 2009. When comparing 2010 to 2009, the Corporation reduced media expenses and other promotional expenses by 16.5%. The Bank continues to maintain presence in the local markets through continued sponsorship of local activities and community groups. The Corporation continues to remain focused on targeted advertising.

Other professional service fees include audit fees, consulting fees, legal fees, and various other professional services. Other professional services were \$294,000 in 2010 compared to \$179,000 in 2009. In 2010, the Corporation and the Bank had decreases of \$161,000 of legal expenses, mostly in relation to troubled loans. The Corporation saw flattening of audit and state exam fees during 2010, as well as decreases totaling \$141,000 in other professional services.

Other general and administrative expenses, including telephone and communication services, were \$2,289,000 in 2010, or an increase of 0.1%, compared to \$2,286,000 in 2009. Increases were in expenses such as operating insurances, other losses and other operating expenses. Partially offsetting these increases was a decrease in the FDIC assessment of \$50,000 or 4.5% from 2009 to 2010. Other small decreases, on an individual basis, were in business development expenses, subscriptions, and education expenses.

## **FINANCIAL CONDITION**

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

The Corporation's total assets averaged \$470,139,000 for 2010 declining from the 2009 average of \$562,125,000 by \$91,986,000 or 16.4%. Average loans comprised 78.9% of total average earning assets during 2010 compared to 84.9% in 2009. Loans declined \$45,483,000, on average, from year end 2009 to year end 2010, with commercial loans having the largest decline of \$34,591,000 or 16.5%. The ratio of average non-interest bearing deposits to total deposits was 18.9% in 2010 compared to 16.4% in 2009. Interest bearing deposits comprised 93.9% of total average interest bearing liabilities during 2010, down from 94.5% during 2009. This was primarily due to the decrease in interest bearing checking accounts and time deposits. The Corporation's year-end total assets were \$424,228,000 for 2010 down from \$522,079,000 in 2009. The decrease was mainly due to the sale of a subsidiary bank during 2010, along with the ongoing strategic shrinkage of the loan portfolio.

## **SECURITIES PORTFOLIO**

Securities of continuing operations totaled \$46,225,000 at December 31, 2010 compared to \$39,394,000 at December 31, 2009. This was an increase of \$6,831,000 or 17.3%. At December 31, 2010, these securities comprised 16.7% of earning assets, up from 13.2% at December 31, 2009. The Corporation's present policies, with respect to the classification of securities, are discussed in Note 1 to the Consolidated Financial Statements. The Corporation considers all of its securities as available for sale except for Michigan tax-exempt securities which are classified as held to maturity.

As of December 31, 2010, the estimated aggregate fair value of the Corporation's securities portfolio was \$67,000 below amortized cost. At December 31, 2010, gross unrealized gains were \$480,000 and gross unrealized losses were \$547,000. A summary of estimated fair values and unrealized gains and losses for the major components of the securities portfolio is provided in Item 1 of the Form 10-K. As of year end 2010, the Corporation continues to receive a favorable rate of return on the securities.

With regard to equity investments held by the Corporation, management regularly reviews the performance of each institution that is not publicly traded. The majority of the equity securities are investments in Michigan bank holding companies. On a quarterly basis, management reviews the Corporation's investment in these equity securities. Management reviews current market prices on publicly traded equity securities and compares the current price to the book price. Any difference is adjusted as a temporary valuation difference, unless other resources provide other information. Equity securities that are not publicly traded 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. As a result of the September 30, 2010 review, OTTI totaling \$298,000 was recognized during the quarter on the Corporation's equity securities in bank holding companies. The impairment was recognized as a result of the length of time these securities have been at an unrealized loss position.

The Corporation has also been closely monitoring the performance of the CMO and MBS portfolios. In 2009, there were several CMOs that were downgraded in the market. Management continued to monitor items such as payment streams and underlying default rates, and did not determine a severe change in these items. On a quarterly basis, management uses multiple assumptions to project the expected future

cash flows of the private label CMOs with prepayment speeds, projected default rates and loss severity rates. The cash flows are then discounted using the effective rate on the securities determined at acquisition. Recent historical experience is the base for determining the cash flow assumptions and are adjusted when appropriate after considering characteristics of the underlying loans collateralizing the private label CMO security. As a result of its review, the Corporation recognized a \$9,000 other-than-temporary impairment as a result of incurred credit losses which has been reflected in the income statement. The security with the credit loss was the Corporation's sole CCC rated security. The Corporation sold this security during the fourth quarter of 2010.

**TABLE 5**  
**Analysis and Maturities of Securities**

(000s omitted)	Amortized Cost	Fair Value	Yield <sup>(1)</sup>
<b>AVAILABLE FOR SALE</b>			
U.S. Agencies			
One year or less	\$ 0	\$ 0	0.00%
Over one through five years	0	0	0.00%
Over five through ten years	4,005	4,000	2.38%
Over ten years	0	0	0.00%
Total	4,005	4,000	
Mortgage-Backed			
One year or less	\$ 0	\$ 0	0.00%
Over one through five years	0	0	0.00%
Over five through ten years	0	0	0.00%
Over ten years	36,315	36,205	3.61%
Total	36,315	36,205	
Equity Securities	\$ 1,655	\$ 1,670	
<b>HELD TO MATURITY</b>			
State and Political			
One year or less	\$ 1,146	\$ 1,157	4.28%
Over one through five years	1,957	1,970	4.17%
Over five through ten years	879	892	4.17%
Over ten years	368	364	4.25%
Total	4,350	4,383	
Total Securities	\$ 46,325	\$ 46,258	

<sup>(1)</sup>Tax equivalent yield

### **LOAN PORTFOLIO**

The Corporation extends credit primarily within in its local markets in Genesee, Oakland, and Livingston, counties. The Corporation's commercial loan portfolio is widely diversified but includes a concentration in commercial real estate, as discussed previously and in the following paragraph. The Corporation's loan portfolio balances are summarized in Table 6.

Total loans, of continuing operations, decreased \$34,075,000 for the year ended December 31, 2010, with total loans comprising 75.1% of earning assets as compared to 81.3% of December 31, 2009 earning assets. The economic challenges experienced in the State of Michigan that began in 2007 have continued

to linger in 2010. Continued employment and economic declines, primarily in the automotive industry, contributed to steepening unemployment rates and a declining population. With these burdening challenges as well as by management strategy, the Corporation achieved a commercial loan reduction during the year. In 2010, commercial loans decreased \$13,984,000 or 8.5% to \$150,179,000. Real estate construction and mortgage loans also decreased by \$16,942,000 or 37.2% in 2010. The decline was primarily in the real estate construction portfolio as management focused efforts on reducing the concentration. Consumer loans decreased \$3,149,000 or 9.7% in 2010. In 2009, commercial loan totals decreased \$11,430,000 to \$164,163,000 or declined by 6.5%. In addition, real estate construction and mortgage loans decreased \$23,281,000 or 33.8% to \$45,585,000 at December 31, 2009. Consumer loans decreased \$3,217,000 or 9.1% in 2009.

**TABLE 6**  
**Loan Portfolio**

December 31,  
(000s omitted)

	2010	2009	2008	2007	2006
Commercial	\$ 150,179	\$ 164,163	\$ 175,593	\$ 193,647	\$ 168,276
Real estate – construction	9,597	21,904	37,358	35,479	46,880
Real estate – residential	19,046	23,681	31,508	31,142	29,234
Consumer	29,153	32,302	35,519	37,695	40,913
Total	\$ 207,975	\$ 242,050	\$ 279,978	\$ 297,963	\$ 285,303

The Corporation originates primarily residential and commercial real estate loans, commercial, construction, and consumer loans. The Corporation estimates that the majority of the loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the general economic conditions in the markets we serve.

**TABLE 7**  
**Maturities of the Loan Portfolio by Loan Type**

(000s omitted)

December 31, 2010

	Within One <u>Year</u>	One- Five <u>Years</u>	After Five <u>Years</u>	<u>Total</u>
Commercial	\$ 74,388	\$ 67,313	\$ 8,478	\$ 150,179
Real estate – construction	9,079	344	174	9,597
Real estate – residential	694	3,151	15,201	19,046
Consumer	4,800	18,491	5,862	29,153
	\$ 88,961	\$ 89,299	\$ 29,715	\$ 207,975

**TABLE 8**  
**Maturities of the Loan Portfolio by Rate Categories**

(000s omitted)

December 31, 2010

	Within One <u>Year</u>	One- Five <u>Years</u>	After Five <u>Years</u>	<u>Total</u>
Loans:				
Fixed Rate	\$ 61,868	\$ 73,698	\$ 19,652	\$ 155,218
Variable Rate	27,093	15,601	10,063	52,757
	\$ 88,961	\$ 89,299	\$ 29,715	\$ 207,975

Credit risk is managed via specific credit approvals and monitoring procedures. Management has implemented conservative lending guidelines in terms of loan-to-value (LTV) ratios and has implemented limits regarding the concentration of loan types. The Corporation's outside loan review function examines the loan portfolio on a quarterly basis for compliance with credit policies and to assess the overall quality of the loan portfolio. These procedures provide management with information on an ongoing basis for setting appropriate direction and taking corrective action as needed.

The Corporation closely monitors its construction and commercial mortgage loan portfolios. Construction loans at December 31, 2010, which comprised 4.6% of total loans, totaled \$9,597,000 as compared to \$21,904,000 at the end of 2009.

The construction and commercial real estate loan properties are located principally in the Corporation's local markets. Included are loans to various individual, industrial, commercial, professional and small business borrowers. The Corporation believes that the portfolio is reasonably well diversified.

### **NON-PERFORMING ASSETS**

Non-performing assets include loans on which interest accruals have ceased, real estate acquired through foreclosure, loans past due 90 days or more and still accruing and renegotiated loans. Table 9 represents the levels of these assets at December 31, 2006 through 2010. Non-performing assets decreased \$147,000 at December 31, 2010 as compared to 2009. Other Real Estate Owned decreased \$1,019,000 in 2010. Other Real Estate owned totaled \$2,742,000 at December 31, 2010. Other Real Estate in Redemption decreased to \$828,000 at the end of 2010 from \$2,733,000 at the end of 2009. The Other Real Estate Owned in Redemption balance is comprised of seven commercial and two residential properties. Non-performing loans at December 31, 2010, increased by \$3,071,000 as compared to December 31, 2009. This was largely due to the increase in renegotiated loans as of December 31, 2010. Renegotiated 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. Loans past due over 90 days and still accruing interest decreased \$186,000 during this period. Non-accrual loans increased \$1,067,000 when comparing December 31, 2010 to December 31, 2009.

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank. The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium to book). As a condition of the sale, the Corporation acquired non-performing assets of West Michigan Community Bank which totaled \$10,100,000. The assets will be housed in a newly formed real estate holding company subsidiary of the Corporation. In addition, The State Bank acquired \$2,900,000 of watch rated credits into its loan portfolio.

The level and composition of non-performing assets are both 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, thereby 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 9**  
**Non-Performing Assets and Past Due Loans**

(000s omitted)	December 31,				
	2010	2009	2008	2007	2006
<b>Non-Performing Loans:</b>					
Loans Past Due 90 Days or More & Still					
Accruing	\$ 133	\$ 319	\$ 656	\$ 54	\$ 348
Non-Accrual Loans	12,496	11,429	20,272	9,662	1,094
Renegotiated Loans	3,654	1,464	942	431	437
Total Non-Performing Loans	16,283	13,212	21,870	10,147	1,879
<b>Other Non-Performing Assets:</b>					
Other Real Estate	2,742	3,761	2,098	128	0
Other Real Estate Owned in Redemption	828	2,733	73	1,460	0
Other Non-Performing Assets	0	0	25	49	18
Total Other Non-Performing Assets	3,570	6,494	2,196	1,637	18
<b>Total Non-Performing Assets</b>	<b>\$19,853</b>	<b>\$19,706</b>	<b>\$24,066</b>	<b>\$ 11,784</b>	<b>\$ 1,897</b>
<b>Non-Performing Loans as a % of</b>					
Total Loans	7.83%	5.46%	7.52%	3.41%	0.45%
<b>Non-Performing Assets as a % of</b>					
Total Loans and Other Real Estate	9.42%	8.02%	8.21%	3.95%	0.45%
<b>Allowance for Loan Losses as a % of</b>					
Non-Performing Loans	61.58%	65.01%	33.51%	48.11%	326.66%
<b>Accruing Loans Past Due 90 Days or</b>					
More to Total Loans	0.06%	0.13%	0.23%	0.02%	0.08%
<b>Non-performing Assets as a % of</b>					
Total Assets	4.68%	3.77%	4.16%	1.87%	0.30%

Table 10 reflects the allocation of the allowance for loan losses and is based upon ranges of estimates and is not intended to imply either limitations on the usage of the allowance or precision of the specific amounts. The entire allowance is available to absorb any future losses without regard to the category or categories in which the charged-off loans are classified. Table 10 also reflects the percentage ratio of outstanding loans by category to total loans at the end of each of the respective years.

**TABLE 10**  
**Allocation of the Allowance for Loan Losses**

December 31, (000s omitted)	2010		2009		2008		2007		2006	
	Amount	Loan %	Amount	Loan %	Amount	Loan %	Amount	Loan %	Amount	Loan %
Commercial and construction	\$8,830	76.82%	\$7,440	76.87%	\$ 6,343	76.06%	\$4,159	76.90%	\$3,292	75.33%
Real estate mortgage	413	9.16%	521	9.78%	231	11.25%	208	10.45%	239	10.28%
Consumer	738	14.02%	622	13.35%	747	12.69%	513	12.65%	545	14.39%
Unallocated	46		5		7		1		11	
<b>Total</b>	<b>\$10,027</b>	<b>100.00%</b>	<b>\$ 8,588</b>	<b>100.00%</b>	<b>\$ 7,328</b>	<b>100.00%</b>	<b>\$4,881</b>	<b>100.00%</b>	<b>\$4,087</b>	<b>100.00%</b>

As discussed earlier under “Allowance and Provision for Loan Losses,” the Corporation has a methodology that provides for formula based allowances as well as specific allocations for impaired loans. A loan is considered impaired when management determines it is probable that the principal and interest due under the contractual terms of the loan will not be collected. In most instances, impairment is measured based on the fair value of the underlying collateral. Impairment may also be measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate. Interest income on impaired non-accrual loans is recognized on a cash basis. Interest income on all other impaired loans is recorded on an accrual basis.

The Corporation's non-performing loans included in Table 9 are considered impaired. The Corporation measures impairment on all large balance non-accrual commercial loans. Certain large balance accruing loans rated watch or lower are also measured for impairment. Impairment losses are believed to be adequately covered by the provision for loan losses. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment and include certain smaller balance commercial loans, consumer loans, and residential real estate loans, and are not included in the impaired loan data in the following paragraphs.

Impaired loans totaled \$28,439,000 at December 31, 2010 compared to \$27,884,000 at December 31, 2009. Specific allowances for loan losses on impaired loans totaled \$6,470,000 and \$5,248,000 at December 31, 2010 and 2009, respectively. The increase from 2010 to 2009 was due an increase in non-accrual loans. Additional information on impaired loans is described in Note 4 of the financial statements.

The Corporation maintains policies and procedures to identify and monitor non-accrual loans. A loan is placed on non-accrual status 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 the loan is placed on non-accrual status.

## **DEPOSITS**

### **TABLE 11**

#### **Average Deposits**

Years Ended December 31

(000s omitted)	<u>2010</u>		<u>2009</u>		<u>2008</u>		<u>2007</u>		<u>2006</u>	
	Average		Average		Average		Average		Average	
	Balance	Rate	Balance	Rate	Balance	Rate	Balance	Rate	Balance	Rate
Non-int. bearing demand	\$ 55,286		\$ 53,941		\$ 53,043		\$ 55,618		\$ 55,664	
Interest-bearing demand	48,988	0.19%	51,657	0.50%	51,234	1.00%	56,993	1.69%	62,060	1.78%
Savings	64,563	0.12%	66,056	0.37%	66,778	0.89%	70,093	1.35%	79,208	1.30%
Time	124,162	3.11%	157,998	3.62%	162,999	4.32%	165,495	4.73%	146,641	4.34%
Total	\$292,998	1.70%	\$329,652	2.26%	\$334,054	2.90%	\$348,199	3.33%	\$343,573	2.95%

The Corporation's average deposit balances, of continuing operations, and rates for the past five years are summarized in Table 11. Total average deposits were 11.1% lower in 2010 as compared to 2009. In 2010, non-interest bearing demand deposits increased \$1.3 million, while all other categories of deposits experienced declining averages in 2010. Despite the changes, the proportion each category held of total deposits remained fairly flat from year to year. Interest-bearing demand average deposits comprised 16.7% of total average deposits, savings average deposits comprised 22.0% of total average deposits, and time average deposits comprised 42.4% of total average deposits.

Brokered deposits, included in time deposits, totaled approximately \$21,995,000 and \$34,398,000 at December 31, 2010 and 2009. At December 31, 2010 and 2009, brokered deposits had interest rates ranging from 4.90% to 5.30% and 4.80% to 5.30%, respectively, and maturities ranging from five months to twenty-two months. Brokered deposits mature as follows: \$11,005,000 in 2011 and \$10,990,000 in 2012.

The State Bank is considered adequately capitalized at December 31, 2010, and is precluded, under prompt corrective action guidelines, from issuing or renewing brokered deposits. Management anticipates repayment of brokered deposits as they mature. These repayments are anticipated to be made from fed funds and the Bank's local deposits.

As of December 31, 2010, certificates of deposit of \$100,000 or more accounted for approximately 16.4% of total deposits compared to 22.9% at December 31, 2009. The maturities of these deposits are summarized in Table 12.

**TABLE 12**  
**Maturity of Time Certificates of Deposit of \$100,000 or More**

(000s omitted)	December 31,	
	2010	2009
Three months or less	\$ 4,638	\$ 7,552
Over three through six months	7,612	11,396
Over six through twelve months	11,012	17,227
Over twelve months	22,034	35,244
Total	<u>\$ 45,296</u>	<u>\$ 71,419</u>

### **FEDERAL INCOME TAXES**

The Corporation's effective tax rate, of continuing operations, was .43% for 2010 and 20.0% for 2009. The principal difference between the effective tax rates and the statutory tax rate of 34% is the Corporation's investments in certain tax-exempt securities and loans as well as its valuation allowance against its tax assets.

During 2010 and 2009, the Corporation evaluated its deferred tax position. 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. In 2009, the Corporation's evaluation of taxable events and the losses in recent years led management to conclude that it was more likely than not that all or part of the benefit would not be realized. As a result, during the second quarter of 2009, the Corporation recognized a valuation allowance. During the fourth quarter of 2009, new tax laws were enacted which allowed the Corporation to exercise the option to take the current year loss and carry it back over a five year taxable income period. This exercise provided the Corporation with a tax benefit of \$5,046,000 during the fourth quarter of 2009. Additional information relating to federal income taxes is included in Note 10 to the Consolidated Financial Statements.

### **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 liquidity. The ALCO, which is comprised of key members of senior management, meets regularly to review financial performance and soundness, including interest rate risk and liquidity exposure in relation to present and prospective markets, business conditions, and product lines. Accordingly, the committee adopts funding and balance sheet management strategies that are intended to maintain earnings, liquidity, and growth rates consistent with policy and prudent business standards. 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. The Corporation's deposit base plus other funding sources (federal funds purchased, other liabilities and shareholders' equity) provided primarily all funding needs in 2010 and 2009. 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 and market conditions.

A source of liquidity that is no longer available to the Bank is brokered deposits. Brokered deposits totaled approximately \$21,995,000 and \$34,398,000 at December 31, 2010 and 2009. As The State Bank is considered adequately capitalized at December 31, 2010, 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 security portfolio provides secondary liquidity along with FHLB advances. As of December 31, 2010, the Corporation had federal funds sold of \$21,900,000 as compared to \$16,150,000 federal funds sold at the end of 2009. In 2010, loan balances continued to decrease substantially. These decreases were partially accompanied by decreases in the deposit portfolio. However, the remaining differential allowed for the Corporation to be positioned into fed funds sold at year end. 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 announced that in order to maintain liquidity at the holding company, it 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 \$1,027,000, based on variable rates at the time of deferral. The management of the holding company liquidity position remains stable as the operating expenses of the holding company 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 analyses of those factors impacting interest rate risk. Factors include maturity and re-pricing frequency of balance sheet components, impact of rate changes on interest margin and prepayment speeds, market value impacts of rate changes, and other issues. Both actual and projected performance, are reviewed, analyzed, and compared to policy and objectives to assure present and future financial viability.

The Corporation had cash flows from financing activities resulting primarily from the outflow of time deposits. In 2010, total deposits decreased \$35,574,000. Cash provided by investing activities was \$45,571,000 in 2010 compared to \$65,707,000 in 2009. The change in investing activities was due to increased calls and sales of investments, which were partially offset by purchases of investments. A continued decrease in loan volume from 2009 to 2010, which was management’s strategy, also played a key role in the investing activities. Sales of other real estate owned increased \$1,940,000 when comparing 2010 to 2009.

The following table discloses information on the maturity of the Corporation’s contractual long-term obligations:

**Table 13**

(000s omitted)	Total	Less than 1			More than
		year	1-3 years	3-5 years	5 years
Time Deposits	\$ 104,077	\$ 50,519	\$ 45,861	\$ 7,609	\$ 88
Short-term borrowings	879	879	0	0	0
FHLB advances	954	30	68	81	775
Subordinated debt	14,000	0	0	0	14,000
Operating leases	253	71	104	78	0
Total	<u>\$ 120,163</u>	<u>\$ 51,499</u>	<u>\$ 46,033</u>	<u>\$ 7,768</u>	<u>\$ 14,863</u>

## **CAPITAL RESOURCES**

Management closely monitors 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 December 31, 2010 the subsidiary Banks maintained adequately capitalized leverage requirements as defined by federal law.

At December 31, 2010, the Corporation’s tier 1 and total risk-based capital ratios were 6.5% and 7.8%, respectively, compared with 6.5% and 7.8% in 2009. The Corporation’s tier 1 leverage ratio was 4.9% at December 31, 2010 compared with 5.0% at December 31, 2009. Although the Corporation experienced a decline in equity from year to year, the Corporation was also able to reduce the size of the balance sheet and maintain risk-based ratios at similar levels to last year.

Total shareholders’ equity declined 21.8% to \$16,055,000 at December 31, 2010, compared with \$20,532,000 at December 31, 2009. The Corporation’s equity to asset ratio was 3.8% at December 31, 2010, compared to 3.9% at December 31, 2009. The decrease in equity in 2010 resulted from negative earnings. The Corporation did not pay dividends in either 2009 or 2010 in order to conserve capital.

Additional information regarding the capital levels of the Corporation and the Bank is in Note 14 to the Financial Statements, for a discussion of capital requirements imposed by regulatory agreements.

## **REGULATORY ORDERS**

In December 2009, The State Bank entered into a formal enforcement action with federal and state banking regulators that contain provisions to foster improvement in The State Bank’s earnings, reduce nonperforming loan levels, increase capital, and require revisions to various policies.

The stipulation and consent to the issuance of a consent order (the “Stipulation and Consent”) among The State Bank, the FDIC and the Michigan Office of Financial and Insurance Regulation (“OFIR”) contains several provisions which pertain to The State Bank’s asset quality. Specifically, The State Bank is required to maintain an adequate allowance for loan losses and to adopt a plan to reduce The State Bank’s risk position in each asset in excess of \$500,000 which was then classified as substandard or doubtful. In addition, while the Stipulation and Consent is in effect, The State Bank may not extend additional credit to any borrower who is already obligated on any extension of credit that has been charged-off so long as the credit remains uncollected. Likewise, The State Bank may not extend any additional credit to any borrower whose loan has been classified as substandard or doubtful and is uncollected, unless approved by The State Bank’s board of directors.

The Stipulation and Consent also requires The State Bank to implement or improve certain plans. Specifically, The State Bank must implement a plan and 2011 budget to improve The State Bank’s overall earnings. The State Bank must also adopt a written contingency funding plan identifying sources of liquid assets to meet contingency funding needs over the near term.

With respect to capital and management generally, The State Bank is required to have and maintain its level of Tier 1 capital as a percentage of its total assets at a minimum of 8%, its total capital to total risk-adjusted assets as a minimum of 12%, and not pay or declare any dividends without the prior consent of the FDIC and the OFIR. The State Bank must also retain qualified management and obtain approval of the FDIC and the OFIR of any changes in The State Bank’s directors or senior executive officers.

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

The Corporation and Bank has addressed substantially all of the requirements of the enforcement action with the exception of the minimum capital ratios set forth above. Refer to Note 14 to the financial statements for additional information.

### **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 adequate to absorb probable losses identified and inherent in the loan portfolio. Our evaluation of the adequacy 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 future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance for loan losses. In either instance unanticipated changes could have a significant impact on operating earnings.

The allowance for loan losses is increased through a provision charged to operating expense. Uncollectible loans are charged-off against 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 let 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. See Note 5 to the financial statements for additional information regarding other real estate owned.

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 ITEMS**

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment. The amounts of commitments are included in Note 15 to the consolidated financial statements.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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. Throughout 2010 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 substantially influenced 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 were managed in 2010 compared to 2009.

The Corporation's market risk exposure is mainly comprised of its vulnerability to interest rate risk. Prevailing interest rates and interest rate relationships in the future will be primarily determined by market factors, which are outside of the Corporation's control. All information provided in this section consists of forward-looking statements. Reference is made to the section captioned "Forward Looking Statements" in this annual report for a discussion of the limitations on the Corporation's responsibility for such statements. The following table provides information about the Corporation's financial instruments that are sensitive to changes in interest rates as of December 31, 2010. The table shows expected cash flows from market sensitive instruments for each of the next five years and thereafter. The expected maturity date values for loans and securities (at amortized cost) were calculated without adjusting the instruments' contractual maturity dates for expected prepayments. Maturity date values for interest bearing core deposits were not based on estimates of the period over which the deposits would be outstanding, but rather the opportunity for re-pricing. The Corporation believes that re-pricing dates, as opposed to expected maturity dates, may be more relevant in analyzing the value of such instruments and are reported as such in the following table.

**TABLE 14****Rate Sensitivity of Financial Instruments**

(000s omitted)	2011	2012	2013	2014	2015	Thereafter	Total	Fair Value
Rate Sensitive Assets:								
Fixed interest rate loans	\$63,427	\$34,089	\$27,962	\$6,668	\$4,977	\$18,801	\$155,924	\$144,532
Average interest rate	5.76%	6.75%	6.64%	6.82%	7.32%	6.55%	6.47%	
Variable interest rate loans	\$27,236	\$3,767	\$4,647	\$4,793	\$2,394	\$10,063	\$52,900	\$ 51,244
Average interest rate	4.94%	4.28%	4.46%	4.78%	5.20%	5.05%	4.90%	
Fixed interest rate securities	\$8,669	\$2,170	\$2,228	\$2,554	\$1,690	\$18,003	\$35,314	\$ 35,346
Average interest rate	2.79%	2.90%	2.91%	2.88%	2.59%	3.20%	3.00%	
Variable Interest rate securities	\$11,781	\$230	\$244	\$258	\$250	\$8,049	\$20,812	\$ 10,912
Average interest rate	0.10%	5.50%	5.60%	5.60%	6.20%	4.58%	2.09%	
FHLB Stock	\$740						\$740	\$ 740
Average interest rate	5.00%						5.00%	
Other interest bearing assets	\$21,900						\$21,900	\$ 21,900
Average interest rate	0.10%						0.10%	
Total rate sensitive assets	\$133,753	\$40,256	\$35,081	\$14,273	\$9,311	\$54,916	\$287,590	\$264,674
Rate Sensitive Liabilities:								
Interest-bearing checking	\$51,623						\$51,623	\$ 51,623
Average interest rate	0.17%						0.17%	
Savings	\$64,133						\$64,133	\$ 64,133
Average interest rate	0.10%						0.10%	
Time	\$50,519	\$36,361	\$9,500	\$4,839	\$2,770	\$86	\$104,075	\$102,640
Average interest rate	2.36%	3.07%	2.93%	2.64%	2.06%	1.80%	2.76%	
Short term borrowings	\$879						\$879	\$ 879
Average interest rate	0.00%						0.00%	
FHLB advances	\$30	\$33	\$35	\$39	\$42	\$775	\$954	\$ 1,369
Average interest rate	7.34%	7.34%	7.34%	7.34%	7.34%	7.34%	7.34%	
Subordinated debt	\$14,000						\$14,000	\$ 12,613
Average interest rate	3.09%							
Total rate sensitive liabilities	\$181,184	\$36,394	\$9,535	\$4,878	\$2,812	\$861	\$235,664	\$233,257

**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 its interest rate sensitive assets and interest rate sensitive liabilities, and is referred to as "GAP".

Table 15 sets forth the distribution of re-pricing of the Corporation's earning assets and interest bearing liabilities as of December 31, 2010, 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 15**  
(000s omitted)

	<b>Gap Analysis</b>				
	<b>December 31, 2010</b>				
	Within Three Months	Three Months- One Year	One to Five Years	After Five Years	Total
Federal Funds sold	\$ 21,900	\$ 0	\$ 0	\$ 0	\$ 21,900
Securities	6,132	4,417	9,622	26,054	46,225
Loans	50,048	38,914	89,299	29,714	207,975
Loans Held for Sale	850	0	0	0	850
FHLB Stock	740	0	0	0	740
<b>Total Earning Assets</b>	<b>\$ 79,670</b>	<b>\$ 43,331</b>	<b>\$ 98,921</b>	<b>\$ 55,768</b>	<b>\$ 277,690</b>
<b>Interest Bearing Liabilities:</b>					
Interest Bearing Demand Deposits	\$ 52,723	\$ 0	\$ 0	\$ 0	\$ 52,723
Savings Deposits	64,133	0	0	0	64,133
Time Deposits Less than \$100,000	10,576	16,681	31,435	89	58,781
Time Deposits Greater than \$100,000	4,638	18,624	22,034	0	45,296
Short-term Borrowings	879	0	0	0	879
FHLB Advances	0	30	149	775	954
Subordinated Debt	14,000	0	0	0	14,000
<b>Total Interest Bearing Liabilities</b>	<b>\$ 146,949</b>	<b>\$ 35,335</b>	<b>\$ 53,618</b>	<b>\$ 864</b>	<b>\$ 236,766</b>
Interest Rate Sensitivity GAP	(\$67,279)	\$ 7,996	\$ 45,303	\$ 54,904	\$ 40,924
Cumulative Interest Rate Sensitivity GAP	(\$67,279)	(\$59,283)	(\$ 13,980)	\$ 40,924	
Interest Rate Sensitivity GAP	0.54	1.23	1.84	64.55	
Cumulative Interest Rate Sensitivity GAP Ratio	0.54	0.67	0.94	1.17	

As indicated in Table 15, 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 interest rates decrease, this negative gap position could have a short-term positive impact on interest margin. 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. In 2010, market driven rates, such as the Prime Rate remained steady throughout the year. 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 in 2010. The Bank was also able to re-price maturing time deposits, 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 yields on loans increased comparing 2010 to 2009. 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 discussion and analysis of financial condition and results of operations, and other sections of the Consolidated Financial Statements and this annual report, contain forward looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and about the Corporation itself. Words such as "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "is likely," "plans," "projects," variations of such words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("Future Factors"), which are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecast in such forward looking statements. The Corporation undertakes no obligation to update, amend or clarify forward looking statements as a result of new information, future events, or otherwise.

Future factors that could cause a difference between an ultimate actual outcome and a preceding forward looking statement include, but are not limited to, changes in interest rate and interest rate relationships, demands for products and services, the degree of competition by traditional and non-traditional competitors, changes in banking laws or regulations, changes in tax laws, change in prices, the impact of technological advances, government and regulatory policy changes, the outcome of pending and future litigation and contingencies, trends in customer behavior as well as their ability to repay loans, and the local and national economy.

## **FENTURA FINANCIAL, INC. COMMON STOCK**

The Corporation's shares are quoted on the OTC Bulletin Board. Table 16 sets forth the high and low market information for each quarter of 2009 through 2010. These quotations reflect inter-dealer prices, without retail mark-up, markdown, or commission and may not represent actual transactions. As of February 1, 2011, there were 707 shareholders of record, not including participants in the Corporation's employee stock option program.

**TABLE 16**  
**Common Stock Data**

<u>Years</u>	<u>Quarter</u>	<u>Market Information</u>		<u>Dividends Paid Per Share (1)</u>
		<u>High</u>	<u>Low</u>	
2009	First Quarter	\$ 7.50	\$ 2.50	\$0.000
	Second Quarter	6.00	4.25	0.000
	Third Quarter	5.00	2.00	0.000
	Fourth Quarter	2.40	0.90	0.000
				\$0.000
2010	First Quarter	\$ 1.75	\$ 1.10	\$0.000
	Second Quarter	4.25	3.20	0.000
	Third Quarter	3.00	1.90	0.000
	Fourth Quarter	1.75	1.45	0.000
				\$0.000

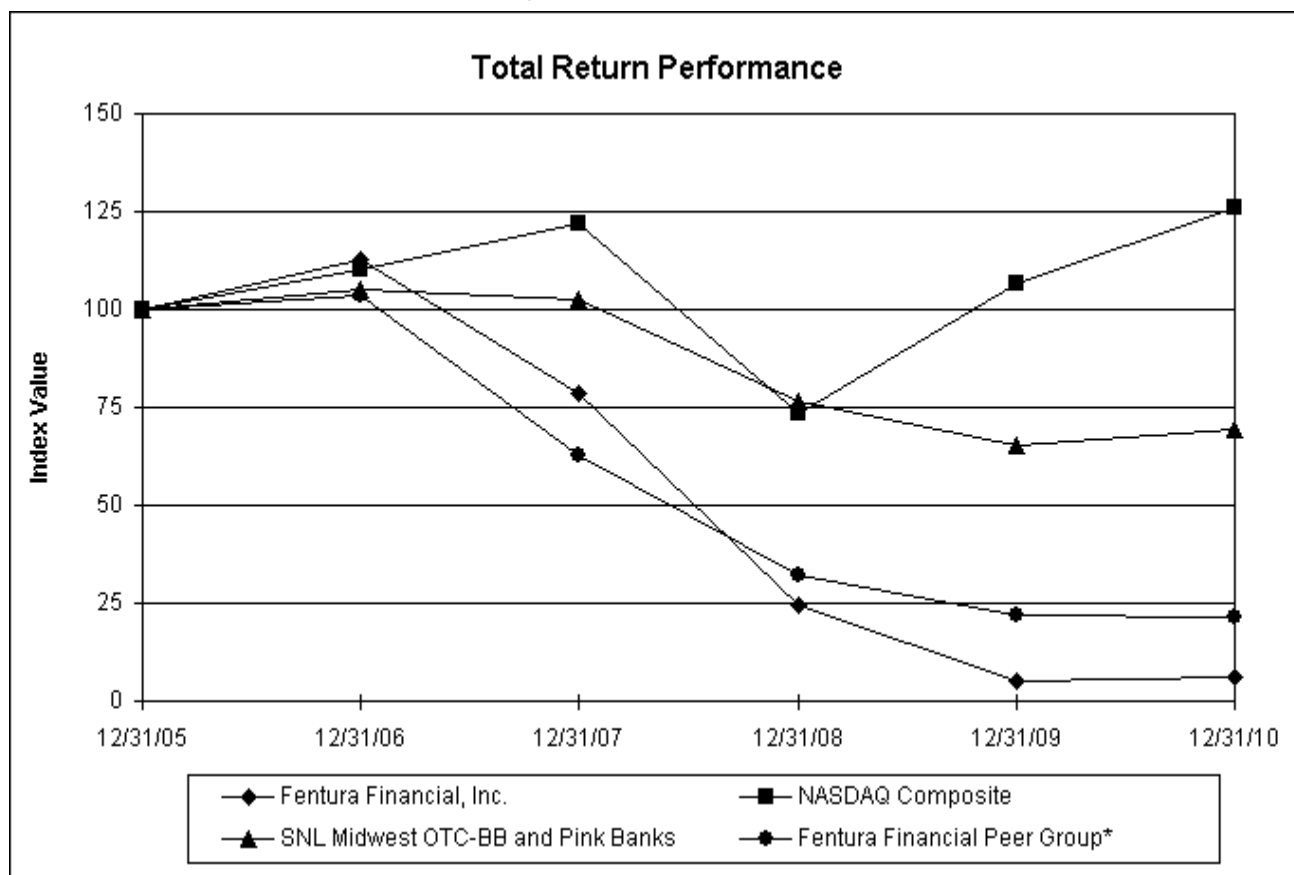
- (1) Refer to Note 1 to the Financial Statements "Dividend Restrictions" for a discussion of limitations on the Corporation's ability to pay dividends.

## SHAREHOLDER RETURN PERFORMANCE GRAPH

The graph compares the cumulative total shareholder return on the Corporation's common stock for the last five years with the cumulative total return of the Midwest Quadrant Pink Bank Index, published by SNL Financial L.C., and the NASDAQ Market Index assuming a \$100 investment at the end of 2003. The NASDAQ Market Index is a broad equity market index. The Midwest Quadrant Pink Bank Index is composed of 101 banks and bank holding companies located in the Midwest and whose shares primarily trade on the Over-the-Counter Bulletin Board.

Cumulative total return is measured by dividing (i) the sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period. The graph assumes the investment of \$100 in the Corporation's common stock, the NASDAQ Market Index, and the Midwest Quadrant Pink Bank Index at the market close on December 31, 2005 and the reinvestment of all dividends through the period ending December 31, 2010.

### COMPARE 5-YEAR CUMULATIVE TOTAL RETURN AMONG FENTURA FINANCIAL, INC., NASDAQ MARKET INDEX, AND MIDWEST QUADRANT PINK BANK INDEX



<i>Index</i>	<i>Period Ending</i>					
	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Fentura Financial, Inc.	100.00	112.60	78.69	24.42	4.92	6.33
NASDAQ Composite	100.00	110.39	122.15	73.32	106.57	125.91
SNL Midwest OTC-BB and Pink Banks	100.00	105.31	102.80	76.62	65.37	69.39
Fentura Financial Peer Group*	100.00	103.50	62.65	32.31	21.84	21.51

Source: SNL Financial LC, Charlottesville, VA \*Fentura Financial Peer Group consists of Banks in Michigan (MI)