Mercantile®
Bank Corporation

2020 ANNUAL REPORT

MISSION STATEMENT

The mission of Mercantile Bank Corporation is to provide financial value
in a highly professional and personalized manner.

We recognize that our most important partners are our **CUSTOMERS**.
We will satisfy our customers' need for security
and achievement of their goals and dreams
by delivering top-quality service
that distinguishes us from our competitors.

Our **EMPLOYEES** are our most valuable asset.
Our exceptional team members are committed to cultivating
an environment of unique ideas, skills and backgrounds.
We also place a high value on
personal growth, development, equity and inclusion.

We recognize the importance of being strong supporters
of the diverse **COMMUNITIES** in which we live and serve.
We pledge to help make them stronger
through investments of time and resources.

We believe that by fulfilling our mission
to our customers, employees and communities,
we will provide our **SHAREHOLDERS** with an excellent return
on their investment in Mercantile Bank Corporation.

LETTER TO OUR SHAREHOLDERS

Mercantile and the financial services industry filled an important role in helping businesses and consumers in their efforts to survive the economic challenges of 2020. Mercantile's strong preparedness plans provided a solid framework for addressing the many issues and concerns that emerged throughout the year, and helped to keep our employees and customers safe.

As reports of a contagious virus overseas first started to surface in late January and early February, Mercantile's Pandemic Response Team was activated and began monitoring available information and developed specific plans and responses.

As the magnitude of the seriousness of the virus became more known, and with the eventual declaration of the situation as a pandemic, the Mercantile team reacted purposefully to position our organization as a source of strength and assistance for the communities we serve and to protect the safety and soundness of all of our stakeholders.

In mid-March, we closed our lobbies for in-person customer service in compliance with local requirements and Centers For Disease Control guidance. At the same time, our Operations and Information Systems teams implemented remote working for the bulk of our staff. By the end of March, we had at least 85% of our employees working from home each day.

Mercantile's prior investments and focus on alternative banking channels, including digital methods, allowed a smooth transition to the new safety measures which restricted in-person service.

Our Virtual Banking Team was able to meet complex customer needs by utilizing our Video Banking Machines (we call them "Live ATM Bankers"), which had been introduced in recent years at several of our locations. Our customers adapted very quickly to these new banking methods.

Mercantile was proactive in its outreach and communication regarding COVID-19 related relief with its customers, as recommended by the federal and state governments and our regulatory agencies. We provided initial payment relief for customers currently in good standing who were concerned about the effects of the crisis on their cash flow.

During the early weeks of the pandemic and associated mandatory business closures, Mercantile provided payment relief on over $700 million in outstanding business and personal loans.

The Paycheck Protection Program ("PPP"), as authorized under the CARES Act, afforded a significant opportunity to quickly deliver additional relief to our business customers. The Mercantile team sped into action, developing an effective process to offer a path to assistance through PPP for customers who wanted to apply. The government rolled out the PPP quickly, and as a result, guidance was very limited and circumstances forced the specific rules governing the program to be rapidly developed. Financial institutions played a critical role in providing information on the nuances of the program to customers, many of whom had never participated in a government lending opportunity of any kind.

Over the course of the next month we funded loans to over 2,000 businesses totaling over $550 million, providing them with the funding needed to allow the continued remittance of payroll to their employees.

Additionally, the Mercantile team performed in its characteristic customer-centric manner, fulfilling the role of a trusted advisor for our clients as they managed through the array of challenges brought about by the pandemic.

Although our team devoted a significant amount of time assisting both new and existing customers in meeting pandemic-related challenges, we still identified and attracted new client relationships and continued to meet the traditional needs of all our customers. Additionally, numerous new commercial relationships were developed as a result of our team's outstanding work assisting some non-customers with PPP loan requests where those clients experienced slow responses from incumbent banks.

The Mercantile trusted advisor approach to its client relationships is clearly effective in any type of economic climate or market condition.

As 2020 drew to a close, there was new focus on PPP as we continued to work with customers to facilitate the submission of their forgiveness applications to the United States Small Business Administration for first draw loans funded earlier in the year. Additionally, the approval of a new stimulus package by the federal government introduced a new round of PPP lending that would provide needed relief to business customers continuing to experience the impact of the pandemic as the calendar turned to 2021.

As COVID-19 gained a foothold in the United States in March, the Federal Open Market Committee ("FOMC") reduced interest rates to historic lows to support the economy. The low interest rates prompted a massive rush of individuals seeking to refinance their existing home mortgages or obtain new loans for the purchase of homes.

Mercantile produced a record number of mortgages in 2020.

Over the last five years, Mercantile had rebuilt its mortgage banking operation with the installment of new leadership, improved processes and procedures, and a new platform. Proven and experienced mortgage lenders were also added to our teams in most of our markets. These strategic initiatives were developed and implemented to create a significant retail revenue stream to complement Mercantile's traditionally strong focus on the commercial segment. In 2020, we opened mortgage production offices in Midland, Michigan and in our first venture outside of the state of Michigan in Cincinnati, Ohio. The combination of all these initiatives and the low interest rate environment allowed us to generate a record amount of real estate mortgage production volume for our bank. For 2020, Mercantile had mortgage production of 4,131 units totaling $865 million for consumers throughout our markets. Of that total, 2,851 units equaling $567 million were for refinancing and 1,280 units equaling $298 million were for the purpose of home purchase.

In addition to the great work done with our mortgage production, development continued in all areas of opportunity for noninterest income.

The pandemic, however, dampened some revenues during the peak period of the mandated business closures in the late winter and spring months. Revenue from customer card usage dropped during March, April and May from the same months in 2019, but rebounded nicely from the summer months through the end of the year to demonstrate year over year growth in that revenue category. Our MercForce Human Capital Management Department also experienced some challenges with revenues in 2020, as payroll reductions by employers and temporary business closures caused a reduction in payroll processing activities. But once again by the end of the year, those revenues had rebounded as many employers returned to full staffing.

While the federal government, through the FOMC moved quickly to try to support a suddenly struggling economy with dramatic cuts in short term interest rates in March, net interest margins of financial institutions including Mercantile came under significant pressure. As the asset sensitive composition of our balance sheet caused a reduction in revenue, the large amount of excess liquidity we carried due to increasing customer deposits, stemming from stimulus program disbursements and reduced customer investing and spending, resulted in additional net interest margin pressures. These factors will also be present in 2021, and we will continue to diligently work to lessen that impact.

As economic uncertainty increased with disruptions created by the pandemic, Mercantile embarked on a process to build its Allowance for Loan and Lease Losses ("ALLL"), and by the end of the year, the reserve increased to 1.18% of total loans.

While the performance of Mercantile's loan portfolio remained remarkably strong, we believed an increase in the loan loss reserve was warranted in light of the challenging economic conditions.

Over the course of 2020, we increased the ALLL by over $14 million, with the vast majority of the increase occurring as a result of changes to certain environmental factors within our incurred loss model. As permitted under the CARES Act, Mercantile elected to postpone the adoption of the Current Expected Credit Loss ("CECL") accounting standard, which had an original effective date of January 1, 2020 per Financial Accounting Standards Board guidance. With the composition of Mercantile's loan portfolio weighted to shorter duration commercial loans, we believed retention of the time tested and proven incurred loan loss reserve model would provide the best opportunity for us to prudently build our reserve in view of the possibility the economy would display weakness for an extended period of time, as the United States struggled to get the pandemic under control. The Consolidated Appropriations Act, 2021 which was signed into law on December 27, 2020 extended the deferment of CECL until January 1, 2022 for financial institutions. While CECL adoption continues to be deferred by our company, the loan loss reserve calculation under that framework is being run in tandem with the incurred loan loss reserve model to ensure that when adoption does occur, Mercantile will be ready.

Throughout all of 2020, Mercantile's asset quality remained extremely strong. Past due loans, nonperforming assets and loan losses all remained at peer-leading levels during the year, despite the challenging environment.

This is a demonstration of the disciplined approach to credit underwriting and loan administration by our lending teams, and it also reflects the strength and resiliency of our clients. By the end of the year, the vast majority of loans that were granted temporary relief through payment deferrals had returned to contractual terms.

Our strategic initiatives in 2020 demonstrated an ongoing focus on our people and reinforced our commitment to the pursuit of best practices in environmental, social and governance matters with particular emphasis on the social component. Our Board of Directors, our management team, and all of our employees remain committed to fulfilling continually evolving roles as purposeful and dedicated community leaders.

Our 2020 Board included introductions of Directors (for our Company and the Bank) with diverse business experience and perspectives.

During the year, as we worked to manage through all the economic effects of the pandemic, events around the country regarding racial justice also impacted our company. Many Mercantile employees were deeply affected by these events, and desired to increase their understanding of what was happening and why. Mercantile's Diversity, Equity and Inclusion team worked to create plans for conversations among groups of employees to ask questions, express opinions and share experiences with one another about racial tensions in our country and in our communities. These conversations were fostered several times throughout our company to ensure broad participation, despite the remote work environment for many employees. We also scheduled what we refer to as "Lead & Learn" sessions, where local and regional guest speakers were introduced virtually to host talks with groups of our team members about various aspects of Diversity, Equity and Inclusion.

For 2021, we will be using the foundations built during the past year as a platform to continue our growth and the growth of those in our communities in knowledge, appreciation, respect and celebration of the differences in each other.

As the needs of our customers and the methods of engagement with them evolved during the year, we continued to identify opportunities to optimize our branch network. During 2020, Mercantile replaced three locations with more effective facilities in the same markets and opened two locations in new markets. As the choices of consumers and businesses increase with the entrance of new players into the market, we fully understand that we must add value to our clients as they seek the fulfillment of their financial needs. In order to best serve our clients as trusted financial advisors, we seek to transform our branch locations into relationship centers. In these forums, the evolving primary focus of our branch teams will be to engage clients and potential clients with the development of strategies to identify and fulfill current and future financial needs. We believe that digital channels will continue to evolve into the most efficient and convenient method of conducting traditional banking transactions for many of our customers.

Another challenge created by the pandemic was the limitation on our team's community involvement. Volunteer hours by our staff were reduced to 12,420, offered to 523 non-profit organizations in 2020. Limits on in-person meetings plus social distancing requirements dampened the direct impact that we could make. Mercantile bankers were still able to make a difference in our communities, however, as our team members helped lead and volunteer with these non-profits to navigate the pandemic's obstacles. Additionally, in late 2020 our team decided that we needed to take some bold action to help address the food and shelter crises in our communities. As a result, we partnered with local non-profit agencies to invest $100,000 as direct donations for the purchase of items to help support these basic human needs across our markets.

For all of 2020, Mercantile donated over $800,000 in support of non-profit organizations and other needs throughout the communities we serve.

We challenge ourselves as an organization and as individuals for continual improvement and progress. We set a high bar as we engage our diverse relationships in all facets of our work. We are incredibly proud of our team's efforts in 2020 throughout all areas of our operation, as we have built solid foundations to sustain and continue the development of these initiatives toward the collective future success of all our constituents.

Finally, we congratulate Mr. Ed Grant and Ms. Susan Jones on their retirement from board service to our company in 2020. Mr. Grant was a long-time member of the Boards of Mercantile Bank Corporation and Mercantile Bank of Michigan. He joined the Board of Firstbank Corporation in 1988 and served in that capacity for 26 years until the merger with Mercantile in 2014 where he continued as a Director until his retirement. Ms. Jones was a long-time Director of Mercantile Bank of Michigan, joining the Board in 1998 and serving until her retirement in 2020 as well. We thank Ed and Susan for their many years of dedicated support and guidance to our organization, and we wish them all the best in the years ahead.

ROBERT B. KAMINSKI, JR.
PRESIDENT AND CHIEF EXECUTIVE OFFICER

IN 2020

Mercantile and its staff were bestowed the following awards:

- 101 Best & Brightest Companies to Work For® (16 years in a row)
- Corp! Magazine Salute to Diversity Award — Diversity Focused Company
- Q2 Software Customer of the Year (Bank)
- Greater Ottawa County United Way — Community Builder Award
- Heart of West Michigan United Way — Gold Award (3 years in a row)
- Michigan Bankers Association Financial Literacy Award

BOARD OF DIRECTORS

David M.Cassard
Retired
Real Estate Executive

Edward J. Clark
Chairman and Chief Executive Officer
American Seating Company

Michael S. Davenport
Owner
Jireh Metal Products, Inc.

Michelle L. Eldridge
Co-Owner
Clear Ridge Wealth Management

Jeff A. Gardner, CPM
Owner
Gardner Group

Robert B. Kaminski, Jr.
President and Chief Executive Officer

Michael H. Price
Chairman of the Board
Retired
Banking Executive

David B. Ramaker
Retired
Banking Executive

EXECUTIVE OFFICERS

Charles E. Christmas
Executive Vice President
Chief Financial Officer and Treasurer

Robert B. Kaminski, Jr.
President
and Chief Executive Officer

Raymond E. Reitsma
Executive Vice President
President of Mercantile Bank of Michigan

Lonna L. Wiersma
Senior Vice President
Human Resource Director
of Mercantile Bank of Michigan

Robert T. Worthington
Senior Vice President
Chief Operating Officer, General Counsel and Secretary

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Mercantile Bank Corporation does not discriminate on the basis of race, color, age, religion, sex, sexual orientation, gender identity, national origin, disability or veteran status in employment or the provision of services.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2020
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________________ to __________________

Commission file number 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

Michigan	**38-3360865**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
310 Leonard Street NW, Grand Rapids, Michigan	**49504**
(Address of principal executive offices)	(Zip Code)

(616) 406-3000
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock	MBWM	The Nasdaq Stock Market LLC

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes _X_ No ___

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ___	Accelerated filer _X_	Emerging growth company ___
Non-accelerated filer ___	Smaller reporting company ___	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ___

Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes Oxley Act (15 USC.7262(b)) by the registered public accounting firm that prepared or issued its audit report. Yes _X_ No ___

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

The aggregate value of the common equity held by non-affiliates (persons other than directors and executive officers) of the registrant, computed by reference to the closing price of the common stock as of the last business day of the registrant's most recently completed second fiscal quarter, was approximately $356 million. As of February 26, 2021, there were issued and outstanding 16,258,947 shares of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's proxy statement for the Annual Meeting of Shareholders to be held May 27, 2021 are incorporated by reference into Part III of this report. Such proxy statement will be filed with the Securities and Exchange Commission within 120 days of the registrant's fiscal year ended December 31, 2020.

PART I

Item 1. Business.

The Company

Mercantile Bank Corporation is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the "Bank Holding Company Act"). Unless the text clearly suggests otherwise, references to "us," "we," "our," or "the company" include Mercantile Bank Corporation and its wholly-owned subsidiaries. As a bank holding company, we are subject to regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). We were organized on July 15, 1997, under the laws of the State of Michigan, primarily for the purpose of holding all of the stock of Mercantile Bank of Michigan ("our bank"), and of such other subsidiaries as we may acquire or establish. Our bank commenced business on December 15, 1997. During the third quarter of 2013, we filed an election to become a financial holding company, which election became effective April 14, 2014.

Mercantile Insurance Center, Inc. ("our insurance company"), a subsidiary of our bank, commenced operations during 2002 to offer insurance products. Mercantile Bank Real Estate Co., L.L.C., ("our real estate company"), a subsidiary of our bank, was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids which serves as our bank's main office and Mercantile Bank Corporation's headquarters.

Our expenses have generally been paid using cash dividends from our bank. Our principal source of future operating funds is expected to be dividends from our bank.

Our Bank

Our bank is a state banking company that operates under the laws of the State of Michigan, pursuant to a charter issued by the Michigan Department of Insurance and Financial Services. Our bank's deposits are insured to the maximum extent permitted by law by the Federal Deposit Insurance Corporation ("FDIC"). Our bank, through its 44 office locations, provides commercial banking services primarily to small- to medium-sized businesses and retail banking services. Our bank's main office is located in Grand Rapids, and our operations are centered around the West and Central portions of Michigan. We also have a banking office located in the metropolitan Detroit, Michigan area, and during 2020 we opened residential mortgage loan production offices in Midland, Michigan and in the Cincinnati, Ohio metropolitan area. As part of our bank's branch rationalization efforts, we recently announced that our bank and Lake Trust Credit Union have entered into an agreement for the sale of our banking office located in Hastings, Michigan, with the sale expected to be consummated by March 31, 2021. Further, in late 2020 we closed banking offices located in the Lakeview, Alma and Ionia downtown areas, consolidating the banking services with nearby banking office locations.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns 27 automated teller machines ("ATM") and 13 video banking machines at a majority of our office locations that participate in the ACCEL/EXCHANGE and PLUS regional network systems, as well as other ATM networks throughout the country. Our bank also enables customers to conduct certain loan and deposit transactions by personal computer and through mobile applications. Courier service is provided to certain commercial customers, and safe deposit facilities are available at a vast majority of our office locations. Our bank does not have trust powers.

Our Insurance Company

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent. To date, we have not provided the insurance products noted above and currently have no plans to do so.

Our Real Estate Company

Our real estate company was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids that serves as our bank's main office and Mercantile Bank Corporation's headquarters. This facility was placed into service during the second quarter of 2005. The facility was transferred to our bank and our real estate company was dissolved on December 18, 2020. Our real estate company was 99% owned by our bank and 1% owned by our insurance company.

Our Trusts

We have five business trusts that are wholly-owned subsidiaries of Mercantile Bank Corporation. Each of the trusts was formed to issue preferred securities that were sold in private sales, as well as selling common securities to Mercantile Bank Corporation. The proceeds from the preferred and common securities sales were used by the trusts to purchase floating rate notes issued by Mercantile Bank Corporation. The rates of interest, interest payment dates, call features and maturity dates of each floating rate note are identical to its respective preferred securities. The net proceeds from the issuance of the floating rate notes were used for a variety of purposes, including contributions to our bank as capital to provide support for asset growth and the funding of stock repurchase programs and certain acquisitions. The only significant assets of our trusts are the floating rate notes, and the only significant liabilities of our trusts are the preferred securities. The floating rate notes are categorized on our Consolidated Balance Sheets as subordinated debentures, and the interest expense is recorded on our Consolidated Statements of Income under interest expense on other borrowings.

Effect of Government Monetary Policies

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States Government, its agencies, and the Federal Reserve Board. The Federal Reserve Board's monetary policies have had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order to, among other things, curb inflation, maintain or encourage employment, and mitigate economic recessions. The policies of the Federal Reserve Board have a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States Government securities, and through its regulation of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. Our bank maintains reserves directly with the Federal Reserve Bank of Chicago to the extent required by law. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

Regulation and Supervision

Banks and bank holding companies, among other financial institutions, are regulated under federal and state law. These include, among others, minimum capital requirements, state usury laws, state laws relating to fiduciaries, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"), the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Expedited Funds Availability Act, the Community Reinvestment Act, the Real Estate Settlement Procedures Act, the USA PATRIOT Act, the FACT Act, the Gramm-Leach-Bliley Act, the Sarbanes Oxley Act, the Bank Secrecy Act, electronic funds transfer laws, redlining laws, predatory lending laws, antitrust laws, environmental laws, money laundering laws and privacy laws. Our growth and earnings performance may be impacted by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. Those regulatory authorities include, but are not limited to, the Federal Reserve Board, the FDIC, the Michigan Department of Insurance and Financial Services, the Internal Revenue Service and state taxing authorities. The effect of such statutes, regulations and policies, and any changes thereto, can be significant and cannot necessarily be predicted.

As a registered bank holding company under the Bank Holding Company Act, we are required to file an annual report with the Federal Reserve Board and such additional information as the Federal Reserve Board may require. We are also subject to examination by the Federal Reserve Board.

The Bank Holding Company Act limits the activities of bank holding companies to banking and the management of banking organizations, and to certain non-banking activities. The permitted non-banking activities include those limited activities that the Federal Reserve Board found, by order or regulation as of the day prior to enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking as to be a proper incident to banking. These permitted non-banking activities include, among other things: operating a mortgage company, finance company, or factoring company; performing certain data processing operations; providing certain investment and financial advice; acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, nonoperating basis; and providing discount securities brokerage services for customers. Neither we nor any of our subsidiaries engage in any of the non-banking activities listed above.

On April 14, 2014, our election to become a financial holding company, as permitted by the Bank Holding Company Act, as amended by Title I of the Gramm-Leach-Bliley Act, was accepted by the Federal Reserve Board. In order to continue as a financial holding company, we and our bank must satisfy statutory requirements regarding capitalization, management and compliance with the Community Reinvestment Act. As a financial holding company, we are permitted to engage in a broader range of activities under the Bank Holding Company Act than are permitted to bank holding companies. Those expanded activities include any activity which the Federal Reserve Board (in certain instances in consultation with the Department of the Treasury) determines, by order or by regulation, to be financial in nature or incidental to such financial activity, or to be complementary to a financial activity, and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Such expanded activities include, among others: insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or issuing annuities, and acting as principal, agent or broker for such purposes; providing financial, investment or economic advisory services, including advising a mutual fund; and underwriting, dealing in, or making a market in securities. While our insurance company is permitted to engage in the insurance agency activities described above by virtue of our financial holding company status, neither we nor any of our subsidiaries currently engage in the expanded activities.

Our bank is subject to restrictions imposed by federal and state laws and regulations. Among other things, these restrictions apply to any extension of credit to us or to our other subsidiaries, to securities borrowing or lending, derivatives, and repurchase transactions with us or our other subsidiaries, to investments in stock or other securities that we issue, to the taking of such stock or securities as collateral for loans to any borrower, and to acquisitions of assets or services from, and sales of certain types of assets to, us or our other subsidiaries. Michigan banking laws place restrictions on various aspects of banking, including branching, payment of dividends, loan interest rates and capital and surplus requirements. Federal law restricts our ability to borrow from our bank by limiting the aggregate amount we may borrow and by requiring that all loans to us be secured in designated amounts by specified forms of collateral.

With respect to the acquisition of banking organizations, we are generally required to obtain the prior approval of the Federal Reserve Board before we can acquire all or substantially all of the assets of any bank, or acquire ownership or control of any voting shares of any bank or bank holding company, if, after the acquisition, we would own or control more than 5% of the voting shares of the bank or bank holding company. Acquisitions of banking organizations across state lines are subject to restrictions imposed by federal and state laws and regulations.

The scope of regulations and supervision of various aspects of our business have expanded as a result of the adoption in July, 2010 of the Dodd-Frank Act, and may continue to expand as the result of implementing regulations being adopted by federal regulators. However, on May 24, 2018, EGRRCPA amended certain provisions of the Dodd-Frank Act to tailor them to the specific circumstances of various categories of financial institutions and transactions. For additional information on this legislation and its potential impact, refer to the Risk Factor entitled “The effect of financial services legislation and regulations remains uncertain” in Item 1A- Risk Factors in this Annual Report.

Employees

As of December 31, 2020, we employed 577 full-time and 88 part-time persons. Our employees are our most valuable asset. Our exceptional team members are committed to maintaining an environment of personal growth and development. Employees of our bank subscribe to a common goal: To make this the best bank it can possibly be. Diversity is an asset in the pursuit of this goal. Employees with dissimilar backgrounds, perspectives, opinions and lifestyles help us understand the motivations and desires of our many different customers. Thus, we will strive to maintain a workforce that reflects the increasing diversity of the communities we serve. We believe that each member of our workforce should be accorded the utmost respect and should be given equal opportunity and encouragement to achieve their full potential. Cooperation and teamwork are valued as much as individual growth and contribution.

Lending Policy

As a routine part of our business, we make loans to businesses and individuals located within our market areas. Our lending policy states that the function of the lending operation is twofold: to provide a means for the investment of funds at a profitable rate of return with an acceptable degree of risk, and to meet the credit needs of the creditworthy businesses and individuals who are our customers. We recognize that in the normal business of lending, some losses on loans will be inevitable and should be considered a part of the normal cost of doing business.

Our lending policy anticipates that priorities in extending loans will be modified from time to time as interest rates, market conditions and competitive factors change. The policy sets forth guidelines on a nondiscriminatory basis for lending in accordance with applicable laws and regulations. The policy describes various criteria for granting loans, including the ability to pay; the character of the customer; evidence of financial responsibility; purpose of the loan; knowledge of collateral and its value; terms of repayment; source of repayment; payment history; and economic conditions.

The lending policy further limits the amount of funds that may be loaned against specified types of real estate collateral. For certain loans secured by real estate, the policy requires an appraisal of the property offered as collateral by a state certified independent appraiser. The policy also provides general guidelines for loan to value for other types of collateral, such as accounts receivable and machinery and equipment. In addition, the policy provides general guidelines as to environmental analysis, loans to employees, executive officers and directors, problem loan identification, maintenance of an allowance for loan losses, loan review and grading, mortgage and consumer lending, and other matters relating to our lending practices.

The Board of Directors has delegated significant lending authority to officers of our bank. The Board of Directors believes this empowerment, supported by our strong credit culture and the significant experience of our commercial lending staff, enables us to be responsive to our customers. The loan policy specifies lending authority for our lending officers with amounts based on the experience level and ability of each lender. Our loan officers and loan managers are generally able to approve loans ranging from $0.25 million and $2.5 million. We have established higher approval limits for our bank's Chief Lending Officer, President and Chief Executive Officer ranging from $4.0 million up to $10.0 million. These lending authorities, however, are typically used only in rare circumstances where timing is of the essence. Loan requests exceeding $2.5 million require approval by the Officers Loan Committee, and loan requests exceeding $7.5 million, up to the legal lending limit of approximately $80.1 million, require approval by our bank's Board of Directors. We generally apply an in-house lending limit that is significantly less than our bank's legal lending limit.

Provisions of recent legislation, including the Dodd-Frank Act and EGRRCPA, when fully implemented by regulations to be adopted by federal agencies, may have a significant impact on our lending policy, especially in the areas of single-family residential real estate and other consumer lending. For additional information on this legislation and its potential impact, refer to the Risk Factor entitled "The effect of financial services legislation and regulations remains uncertain" in Item 1A- Risk Factors in this Annual Report.

Lending Activity

Commercial Loans. Our commercial lending group originates commercial loans primarily in our market areas. Our commercial lenders have extensive commercial lending experience, with most having at least ten years' experience. Loans are originated for general business purposes, including working capital, accounts receivable financing, machinery and equipment acquisition, and commercial real estate financing, including new construction and land development.

Working capital loans are often structured as a line of credit and are reviewed periodically in connection with the borrower's year-end financial reporting. These loans are generally secured by substantially all of the assets of the borrower and have a floating interest rate tied to the Wall Street Journal Prime Rate or 30-Day Libor Rate. Loans for machinery and equipment purposes typically have a maturity of three to five years and are fully amortizing, while commercial real estate loans are usually written with a five-year maturity and amortize over a 10- to 20-year period. Commercial loans typically have an interest rate that is fixed to maturity or is tied to the Wall Street Journal Prime Rate or 30-Day Libor Rate.

We evaluate many aspects of a commercial loan transaction in order to minimize credit and interest rate risk. Underwriting includes an assessment of the management, products, markets, cash flow, capital, income and collateral of the borrowing entity. This analysis includes a review of the borrower's historical and projected financial results. Appraisals are generally required to be performed by certified independent appraisers where real estate is the primary collateral, and in some cases, where equipment is the primary collateral. In certain situations, for creditworthy customers, we may accept title reports instead of requiring lenders' policies of title insurance.

Commercial real estate lending involves more risk than residential lending because loan balances are typically greater and repayment is dependent upon the borrower's business operations. We attempt to minimize the risks associated with these transactions by generally limiting our commercial real estate lending to owner-operated properties and to owners of non-owner occupied properties who have an established profitable history and satisfactory tenant structure. In many cases, risk is further reduced by requiring personal guarantees, limiting the amount of credit to any one borrower to an amount considerably less than our legal lending limit and avoiding certain types of commercial real estate financings.

We have no material foreign loans, and only limited exposure to companies engaged in energy producing and agricultural-related activities.

Single-Family Residential Real Estate Loans. We originate single-family residential real estate loans in our market areas, generally according to secondary market underwriting standards. Loans not conforming to those standards are made in certain circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years, with the fixed interest rate loans generally sold to various investors.

Our bank has a home equity line of credit program. Home equity lines of credit are generally secured by either a first or second mortgage on the borrower's primary residence. The program provides revolving credit at a rate tied to the Wall Street Journal Prime Rate.

Consumer Loans. We originate various types of consumer loans, including new and used automobile and boat loans, credit cards and overdraft protection lines of credit for our checking account customers. Consumer loans generally have shorter terms and higher interest rates and usually involve more credit risk than single-family residential real estate loans because of the type and nature of the collateral.

We believe our consumer loans are underwritten carefully, with a strong emphasis on the amount of the down payment, credit quality, employment stability and monthly income of the borrower. These loans are generally repaid on a monthly repayment schedule with the source of repayment tied to the borrower's periodic income. In addition, consumer lending collections are dependent on the borrower's continuing financial stability, and are thus likely to be adversely affected by job loss, illness and personal bankruptcy. In many cases, repossessed collateral for a defaulted consumer loan will not provide an adequate source of repayment of the outstanding loan balance because of depreciation of the underlying collateral. We believe that the generally higher yields earned on consumer loans compensate for the increased credit risk associated with such loans, and that consumer loans are important to our efforts to serve the credit needs of the communities and customers that we serve.

Loan Portfolio Quality

We utilize a comprehensive grading system for our commercial loans, whereby all commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed at various intervals.

Our independent loan review program is primarily responsible for the administration of the grading system and ensuring adherence to established lending policies and procedures. The loan review program is an integral part of maintaining our strong asset quality culture. The loan review function works closely with senior management, although it functionally reports to the Board of Directors. Using a risk-based approach to selecting credits for review, our loan review program covered approximately 52% of total commercial loans outstanding during 2020. In addition, a random sampling of retail loans is reviewed each quarter. Our watch list credits are reviewed monthly by our Board of Directors and our Watch List Committee, the latter of which is comprised of senior level officers from the administration, lending and loan review functions.

Loans are placed in a nonaccrual status when, in our opinion, uncertainty exists as to the ultimate collection of all principal and interest. As of December 31, 2020, loans placed in nonaccrual status totaled $3.4 million, or 0.1% of total loans, compared to $2.3 million, or 0.1% of total loans, at December 31, 2019. No loans were past due 90 days or more and still accruing interest at year-end 2020 or 2019.

Additional detail and information relative to the loan portfolio is incorporated by reference to Management's Discussion and Analysis of Financial Condition and Results of Operations ("Management's Discussion and Analysis") and Note 3 of the Notes to Consolidated Financial Statements in this Annual Report.

Allowance for Loan Losses

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish specific portions of the allowance based on specifically identifiable problem loans. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Allowance Analysis, loan loss migration analysis, composition of the loan portfolio, third party analysis of the loan administration processes and portfolio, and general economic conditions.

The Allowance Analysis applies reserve allocation factors to non-impaired outstanding loan balances, the result of which is combined with specific reserves to calculate an overall allowance amount. For non-impaired commercial loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. Our commercial loan portfolio is segregated into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; lending concentrations; and other external factors, including competition and regulatory environment.

We established a Covid-19 reserve allocation factor to address the Coronavirus Pandemic and its potential impact on the collectability of the loan portfolio during the second quarter of 2020. The creation of this factor reflected our belief that the traditional nine environmental factors did not sufficiently capture and address the unique circumstances, challenges and uncertainties associated with the Coronavirus Pandemic, which include unprecedented federal government stimulus and interventions, statewide mandatory closures of nonessential businesses and periodic changes to such and our ability to provide payment deferral programs to commercial and retail borrowers without the interjection of troubled debt restructuring accounting rules. We review a myriad of items when assessing this new environmental factor, including virus infection rates, economic outlooks, employment data, business closures, foreclosures, payment deferments and government-sponsored stimulus programs. The Covid-19 reserve factor resulted in a $5.3 million increase to the allowance as of December 31, 2020.

Adjustments for specific lending relationships, particularly impaired loans, are made on a case-by-case basis. Non-impaired retail loan reserve allocations are determined in a similar fashion as those for non-impaired commercial loans, except that retail loans are segmented by type of credit and not a grading system. We regularly review the Allowance Analysis and make adjustments periodically based upon identifiable trends and experience.

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2020 we placed most weight on the period starting December 31, 2010 through December 31, 2020. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and the timeliness of scheduled payments. We have a policy of requesting and reviewing periodic financial statements from commercial loan customers, and we have a disciplined and formalized review of the existence of collateral and its value. The primary risk element with respect to each residential real estate loan and consumer loan is the timeliness of scheduled payments. We have a reporting system that monitors past due loans and have adopted policies to pursue creditors' rights in order to preserve our collateral position.

Financial institutions were not required to comply with the Current Expected Credit Loss ("CECL") methodology requirements from the enactment date of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act") until the earlier of the end of the President's declaration of a National Emergency or December 31, 2020. The Consolidated Appropriations Act, 2021, that was enacted in December 2020, provided for an extension of the required CECL adoption date to January 1, 2022, which is the date we expect to adopt. An economic forecast is a key component of the CECL methodology. As we continue to experience an unprecedented economic environment whereby a sizable portion of the economy has been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus has been provided to businesses, individuals and state and local governments and financial institutions have offered businesses and individuals payment relief options, economic forecasts are regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we have elected to postpone the adoption of CECL, and will continue to use our incurred loan loss reserve model as permitted.

Additional detail regarding the allowance is incorporated by reference to Management's Discussion and Analysis and Note 3 of the Notes to Consolidated Financial Statements included in this Annual Report.

Investments

Bank Holding Company Investments. The principal investments of our bank holding company are the investments in the common stock of our bank and the common securities of our trusts. Other funds of our bank holding company may be invested from time to time in various debt instruments.

Subject to the limitations of the Bank Holding Company Act, we are also permitted to make portfolio investments in equity securities and to make equity investments in subsidiaries engaged in a variety of non-banking activities, which include real estate-related activities such as community development, real estate appraisals, arranging equity financing for commercial real estate, and owning and operating real estate used substantially by our bank or acquired for its future use. Our bank holding company has no plans at this time to make directly any of these equity investments at the bank holding company level. Our Board of Directors may, however, alter the investment policy at any time without shareholder approval.

Our Bank's Investments. Our bank may invest its funds in a wide variety of debt instruments and may participate in the federal funds market with other depository institutions. Subject to certain exceptions, our bank is prohibited from investing in equity securities. Among the equity investments permitted for our bank under various conditions and subject in some instances to amount limitations, are shares of a subsidiary insurance agency, mortgage company, real estate company, or Michigan business and industrial development company, such as our insurance company and our real estate company. Under another such exception, in certain circumstances and with prior notice to or approval of the FDIC, our bank could invest up to 10% of its total assets in the equity securities of a subsidiary corporation engaged in the acquisition and development of real property for sale, or the improvement of real property by construction or rehabilitation of residential or commercial units for sale or lease. Our bank has no present plans to make such an investment. Real estate acquired by our bank in satisfaction of or foreclosure upon loans may be held by our bank for specified periods. Our bank is also permitted to invest in such real estate as is necessary for the convenient transaction of its business. Our bank's Board of Directors may alter the bank's investment policy without shareholder approval at any time.

Additional detail and information relative to the securities portfolio is incorporated by reference to Management's Discussion and Analysis and Note 2 of the Notes to Consolidated Financial Statements included in this Annual Report.

Competition

We face substantial competition in all phases of our operations from a variety of different competitors. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, savings banks, thrifts, credit unions and other financial institutions as well as from other entities that provide financial services. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our primary competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do, and offer larger branch networks and other services which we do not. Most of these same entities have greater capital resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. Under specified circumstances (that have been modified by the Dodd-Frank Act and EGRRCPA), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. We also face new competition as a result of expansion into new markets.

Selected Statistical Information

Management's Discussion and Analysis beginning on Page F-4 in this Annual Report includes selected statistical information.

Return on Equity and Assets

Return on Equity and Asset information is included in Management's Discussion and Analysis beginning on Page F-4 in this Annual Report.

Available Information

We maintain an internet website at www.mercbank.com. We make available on or through our website, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practical after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. We do not intend the address of our website to be an active link or to otherwise incorporate the contents of our website into this Annual Report.

Item 1A. Risk Factors.

The following risk factors could affect our business, financial condition or results of operations. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report because they could cause the actual results and conditions to differ materially from those projected in forward-looking statements. Before you buy our common stock, you should know that investing in our common stock involves risks, including the risks described below. The risks that are highlighted here are not the only ones we face. If the adverse matters referred to in any of the risks actually occur, our business, financial condition or operations could be adversely affected. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks Related to Our Business

The Coronavirus Pandemic has impacted our business, financial condition and results of operations and will continue to have an impact, the scope and duration of which is highly uncertain and dependent on factors that are outside of our control.

The ongoing pandemic associated with the spread of Covid-19 has caused significant disruptions throughout the State of Michigan and across the United States and global economies and financial markets. The Coronavirus Pandemic has impacted our business, financial condition and results of operations and will continue to do so. For example, we derive a large percentage of our net income from net interest income, which is derived from the yield on interest-earning assets offset by our cost of funds. Our net interest income has been negatively impacted primarily due to reduced interest rates on variable-rate commercial loans resulting from the Federal Open Market Committee ("FOMC") significantly decreasing the targeted federal funds rate by 225 basis points during the second half of 2019 and the first quarter of 2020. Due to the Coronavirus Pandemic, the targeted federal funds rate is unlikely to be increased for the foreseeable future, resulting in prolonged pressure on our net interest income, which could reduce our net income in future periods.

Our results may also be negatively impacted by a deterioration in the quality of our loan portfolio due to the impact of the Coronavirus Pandemic on our loan customers. While we actively monitor the credit quality of our loan portfolio and make adjustments to our allowance for loan losses accordingly, the Coronavirus Pandemic has created significant disruptions in the United States economy, making it difficult to predict its impact with a high degree of certainty. While we believe we have appropriately assessed and presented our loan portfolio and allowance for loan losses to date in accordance with applicable accounting standards, we cannot be certain of that, nor can we be certain that we will adequately account for the future negative impacts of the Coronavirus Pandemic. This could negatively impact our financial condition and results of operations by increasing the amount of allowance for loan loss provisions reflected in our operating expenses, decreasing our interest income as borrowers become unable to repay their loans and increasing our operating expenses due to collection costs.

We are exposed to several additional risks associated with the Coronavirus Pandemic, including the risk that our operating effectiveness will decrease as we adapt to new policies requiring that our employees work from home; that we may temporarily lose the services of key members of our management team; that the economic downturn will negatively impact demand for loans across our loan portfolio; that the collateral securing our loans will decline in value; that reduced consumer spending will prolong the negative economic impacts of the Coronavirus Pandemic; that our portfolio of securities available for sale will decrease in value; and that we may face litigation due to our handling of the challenges associated with the Coronavirus Pandemic, including our participation in the Paycheck Protection Program.

While we believe that we have navigated the difficult environment associated with the Coronavirus Pandemic with success thus far, we may not be able to continue to do so, and this could expose our business, financial condition and results of operations to risks that could have a negative impact on your investment.

Adverse changes in economic conditions or interest rates may negatively affect our earnings, capital and liquidity.

The results of operations for financial institutions, including our bank, may be materially and adversely affected by changes in prevailing local and national economic conditions, including declines in real estate market values and the related declines in value of our real estate collateral, rapid increases or decreases in interest rates and changes in the monetary and fiscal policies of the federal government. Our profitability is heavily influenced by the spread between the interest rates we earn on loans and investments and the interest rates we pay on deposits and other interest-bearing liabilities. Substantially all of our loans are to businesses and individuals in Western, Central, and Southeastern Michigan, and any decline in the economy of these areas could adversely affect us. Like most banking institutions, our net interest spread and margin will be affected by general economic conditions and other factors that influence market interest rates and our ability to respond to changes in these rates. At any given time, our assets and liabilities may be such that they will be affected differently by a given change in interest rates.

Significant declines in the value of commercial real estate could adversely impact us.

Approximately 59% of our total commercial loans, or about 51% of our total loans, relate to commercial real estate. Stressed economic conditions may reduce the value of commercial real estate and strain the financial condition of our commercial real estate borrowers, especially in the land development and non-owner occupied commercial real estate segments of our loan portfolio. Those difficulties could adversely affect us and could produce losses and other adverse effects on our business.

Market volatility may adversely affect us.

The capital and credit markets may experience volatility and disruption. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without apparent regard to those issuers' underlying financial strength. Future levels of market disruption and volatility may have an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

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

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, thrifts, credit unions and other financial institutions as well as other entities that provide financial services, including securities firms and mutual funds. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do and offer larger branch networks and other services which we do not, including trust and international banking services. Most of these entities have greater capital and other resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. This competition may limit our growth or earnings. Under specified circumstances (that have been modified by the Dodd-Frank Act and EGRRCPA), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

Our risk management systems may fall short of their intended objectives.

We seek to monitor and control our risk exposure through a risk and control framework encompassing a variety of separate but complementary financial, credit, operational, compliance and legal reporting systems, internal controls, management review processes and other mechanisms. Our risk management process seeks to balance our ability to profit from investing or lending positions with our exposure to potential losses. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, those techniques and the judgments that accompany their application cannot anticipate every economic and financial outcome or the specifics and timing of such outcomes. Thus, we may, in the course of our activities, incur losses.

We may not be able to successfully adapt to evolving industry standards and market pressures.

Our success depends, in part, on the ability to adapt products and services to evolving industry standards. There is increasing pressure to provide products and services at lower prices. This can reduce net interest income and noninterest income from fee-based products and services. In addition, the widespread adoption of new technologies could require us to make substantial capital expenditures to modify or adapt existing products and services or develop new products and services. We may not be successful in introducing new products and services in response to industry trends or developments in technology, or those new products may not achieve market acceptance. As a result, we could lose business, be forced to price products and services on less advantageous terms to retain or attract clients, or be subject to cost increases. As a result, our business, financial condition, or results of operations may be adversely affected.

Our inability to execute or integrate potential future acquisitions successfully could impede us from realizing all of the benefits of the acquisitions, which could weaken our operations.

In addition to pursuing organic growth, we may also pursue strategic acquisition opportunities that we believe will fit our core philosophy and culture, enhance our profitability and provide appropriate risk-adjusted returns. These acquisition opportunities could be material to our business and involve a number of risks, including the following:

- ° intense competition from other banking organizations and other acquirers for potential merger candidates drives market pricing;
- ° time and expense associated with identifying and evaluating potential acquisitions and negotiating potential transactions may divert human and capital resources without producing the desired returns;
- ° estimates and judgments used to evaluate credit, operations, management and market risks with respect to the target institution or assets are inherently complex and may be inaccurate;
- ° potential exposure to unknown or contingent liabilities of targets; and
- ° regulatory timeframes for review of applications may limit the number and frequency of transactions we may be able to consummate.

If we are unable to successfully integrate potential future acquisitions, we could be impeded from realizing all of the benefits of those acquisitions and could weaken our business operations. The integration process may disrupt our business and, if implemented ineffectively, may preclude realization of the full benefits expected by us and could harm our results of operations. In addition, the overall integration of the combining companies may result in unanticipated problems, expenses, liabilities and competitive responses, and may cause our stock price to decline. The difficulties of integrating an acquisition include, among others:

- ° unanticipated issues in integration of information, communications and other systems;
- ° unanticipated incompatibility of logistics, marketing and administrative methods;
- ° maintaining employee morale and retaining key employees;
- ° integrating the business cultures of both companies;
- ° preserving important strategic client relationships;
- ° coordinating geographically diverse organizations; and
- ° consolidating corporate and administrative infrastructures and eliminating duplicative operations.

Finally, even if the operations of an acquisition are integrated successfully, we may not realize the full benefits of the acquisition, including the synergies, cost savings or growth opportunities we expect. These benefits may not be achieved within the anticipated time frame as well.

Our inability to overcome these risks could have an adverse effect on our ability to implement our business strategy, which, in turn, could have an adverse effect on our business, financial condition and results of operations.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Even routine funding transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

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

The risk of nonpayment of loans is inherent in all lending activities, and nonpayment, when it occurs, may have a materially adverse effect on our earnings and overall financial condition as well as the value of our common stock. Our focus on commercial lending may result in a larger concentration of loans to small businesses. As a result, we may assume different or greater lending risks than other banks. We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for losses based on several factors. If our assumptions are wrong, our allowance may not be sufficient to cover our losses, which would have an adverse effect on our operating results. The actual amounts of future provisions for loan losses cannot be determined at this time and may exceed the amounts of past provisions. Additions to our allowance decrease our net income.

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

We are and will continue to be dependent upon the services of our management team, including our executive officers and our other senior managers. The unanticipated loss of our executive officers, or any of our other senior managers, could have an adverse effect on our growth and performance.

In addition, we continue to depend on our key commercial loan officers. Several of our commercial loan officers are responsible, or share responsibility, for generating and managing a significant portion of our commercial loan portfolio. Our success can be attributed in large part to the relationships these officers as well as members of our management team have developed and are able to maintain with our customers as we continue to implement our community banking philosophy. The loss of any of these commercial loan officers could adversely affect our loan portfolio and performance, and our ability to generate new loans. Many of our key employees have signed agreements with us agreeing not to compete with us in one or more of our markets for specified time periods if they leave employment with us. However, we may not be able to effectively enforce such agreements.

Some of the other financial institutions in our markets also require their key employees to sign agreements that preclude or limit their ability to leave their employment and compete with them or solicit their customers. These agreements make it more difficult for us to hire loan officers with experience in our markets who can immediately solicit their former or new customers on our behalf.

Changes in the method of determining Libor, or the replacement of Libor with an alternative reference rate, may adversely affect interest income or expense.

Many of the commercial loans we make bear interest at a floating rate based on Libor, the London inter-bank offered rate. We pay interest on certain subordinated notes related to our trust preferred securities at rates based on Libor.

On July 27, 2017, the United Kingdom Financial Conduct Authority ("FCA"), which oversees Libor, formally announced that it could not assure the continued existence of Libor in its current form beyond the end of 2021, and that an orderly transition process to one or more alternative benchmarks should begin. In June 2017, the Alternative Reference Rates Committee ("ARRC"), a steering committee comprised of large U.S. financial institutions organized by the Federal Reserve, announced that it had selected a modified version of the unpublished Broad Treasuries Financing Rate as the preferred alternative reference rate for U.S. dollar obligations. That rate, now referred to as the Secured Overnight Funding Rate ("SOFR"), is determined based upon actual transactions in certain portions of the bi-lateral and tri-party overnight repurchase agreement markets for certain U.S. Treasury obligations. The Federal Reserve Bank of New York ("FRBNY") began publication of the SOFR in April 2018.

In May 2018, the Chicago Mercantile Exchange began trading SOFR futures contracts. The existence of a futures market may permit the development of a SOFR term curve. In July 2018, the Federal National Mortgage Association ("FNMA") issued bonds using SOFR (an overnight rate) as a pricing mechanism. This was possible because of an unusual bond structure, in which interest was payable quarterly, but the interest reset period was daily. By the end of 2020, each of FNMA and the Federal Home Loan Mortgage Corporation ("FHLMC") had issued more than $125 billion in SOFR-indexed debt instruments in the capital markets.

In January 2019, ICE Benchmark Administration, the current provider of Libor, proposed for comment to market participants a U.S. Dollar ICE Bank Yield Index. This index would be based on two types of U.S. dollar-denominated transaction data: primary market wholesale, unsecured funding transactions for large, internationally active banks; and secondary market transactions in wholesale, unsecured bonds issued by large, internationally active banks. These data would be used to construct a yield curve from which one-month, three-month and six-month settings could be obtained. Following comments from market participants, the ICE Benchmark Administration modified the methodology of calculation of its index (which it is continuing to test). In May 2020, it announced that the index may be made available as a credit-spread supplement to the SOFR. If the index was accepted by market participants, it might furnish commercial bank-based term rates more directly comparable to the existing structure of Libor than the government securities-based SOFR.

During 2019 and 2020, among other things, the ARRC published a white paper on ways in which market participants could use SOFR in cash markets, conducted surveys of market participants, engaged with cognizant U.S. government agencies and private sector groups regarding tax, securities, and derivatives issues presented by the transition from Libor, published sample transition provisions for a variety of types of loan and note agreements, and investigated methods by which a forward-looking term SOFR index could be established. To facilitate the development of a generally-recognized forward-looking SOFR index, on March 2, 2020 the FRBNY began publication of 30-, 90-, and 180-day SOFR Averages, as well as a SOFR Index, on each business day. The FRBNY has stated that it will consider the potential benefits of introducing calendar month-based rates and/or adding further tenors as additional reference rates.

In July 2019, both FNMA and FHLMC announced their intention to develop new adjustable-rate mortgage loan products based on SOFR. In February 2020, FNMA and FHLMC each announced that they would: (i) require inclusion of ARRC-recommended transition language in all single-family adjustable rate mortgage (“ARM”) loans closed on or after June 1, 2020; (ii) require all Libor-based single-family and multi-family ARM loans to have loan application dates on or before September 30, 2020 in order to be eligible for acquisition; and (iii) cease acquisition of single-family and multi-family Libor ARM loans on or before December 31, 2020. During the fourth quarter of 2020, each of FNMA and FHLMC began acquiring SOFR ARM loans and ceased purchasing Libor-based products.

In November 2020, the ICE Benchmark Administration announced a consultation regarding the cessation of the publication of Libor. The consultation proposed a December 31, 2021 cessation for all tenors of various foreign currencies and for the one week and two-month U.S. dollar Libor, and a June 30, 2023 cessation for the remaining overnight, one-month, three-month, six-month and twelve-month U.S. dollar Libor tenors. This represented an 18-month extension of Libor publication for the most frequently used tenors of U.S. dollar Libor from the cessation date originally proposed in 2017. The consultation period closed on January 25, 2021. ICE Benchmark Administration indicated that it would share the results of the consultation with the FCA, and subsequently publish further guidance.

In coordinated announcements on November 30, 2020, the FCA and each of the U.S. federal banking agencies recognized the proposed extension of Libor publication for the identified tenors of U.S. dollar Libor. The federal banking agencies noted that this would allow most legacy U.S. dollar Libor contracts to mature before Libor experiences disruptions. At the same time, the agencies stated that entry into new contracts using Libor as a reference rate after December 31, 2021 by supervised banking organizations would create safety and soundness risks. Accordingly, the federal banking agencies encouraged supervised banking organizations to cease using Libor as a reference rate in their agreements as soon as possible, but in any event by December 31, 2021. They also stated that new contracts entered into before December 31, 2021 should either utilize a reference rate other than Libor or have robust fallback language that includes a clearly defined alternative reference rate after Libor’s discontinuation. Certain limited exceptions to that guidance were included by the federal banking agencies, in the event that the ICE Benchmark Administration does continue to publish Libor U.S. dollar tenors after December 31, 2021.

On January 19, 2021, Governor Mario Cuomo presented the 2022 Executive Budget for the State of New York. The Executive Budget included a draft Libor-fallback statute proposed by the ARRC. The draft statute is intended to minimize legal uncertainty in Libor contracts governed by New York law, which includes many derivative contracts. There can be no assurance whether, or in what form, such draft legislation may be enacted in New York.

On January 25, 2021, the International Swaps and Derivatives Association's IBOR (interbank offered rates) Fallbacks Protocol ("Protocol") and IBOR Fallbacks Supplement ("Supplement") each took effect. Effectiveness of the Protocol means that existing swaps and other derivative contracts will incorporate the new ISDA fallbacks if both counterparties have accepted the Protocol. Effectiveness of the Supplement means that new derivatives contracts that incorporate standard ISDA definitions and reference a relevant IBOR will also incorporate the new fallbacks. These measures are intended to provide greater certainty with respect to derivative contracts.

It is unclear whether, or in what form, Libor will continue to exist after 2021. Any transition to an alternative benchmark will require careful consideration and implementation so as not to disrupt the stability of financial markets. If Libor ceases to exist, we may need to take a variety of actions, including negotiating certain of our agreements based on an alternative benchmark that may be established, if any. There is no guarantee that a transition from Libor to an alternative benchmark will not result in financial market disruptions, significant changes in benchmark rates, or adverse changes in the value of certain of our loans, and our income and expense.

Our accounting policies and methods are the basis for how we prepare our consolidated financial statements, and they require management to make estimates about matters that are inherently uncertain.

Accounting policies and processes are fundamental to how we record and report our financial condition and results of operations. We must exercise judgment in selecting and applying many of these accounting policies and processes so they comply with U.S. GAAP. In some cases, we must select the accounting policy or method to apply from two or more alternatives, any of which may be reasonable under the circumstances, yet may result in our reporting materially different results than would have been reported under a different alternative.

We have identified certain accounting policies as being critical because they require us to make difficult, subjective or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions or estimates. We have established detailed policies and control procedures that are intended to ensure these critical accounting estimates and judgments are well controlled and applied consistently. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. Because of the uncertainty surrounding management's judgments and the estimates pertaining to these matters, we cannot guarantee that we will not be required to adjust accounting policies or restate prior period financial statements. For additional information, see "Critical Accounting Policies and Estimates" beginning on page F-4 of this Annual Report and "Note 1 – Summary of Significant Accounting Policies" beginning on page F-47 of this Annual Report.

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

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

Damage to our reputation could materially harm our business.

Our relationship with many of our clients is predicated upon our reputation as a fiduciary and a service provider that adheres to the highest standards of ethics, service quality and regulatory compliance. Adverse publicity, regulatory actions, litigation, operational failures, the failure to meet client expectations and other issues with respect to one or more of our businesses could materially and adversely affect our reputation, our ability to attract and retain clients or our sources of funding for the same or other businesses. Preserving and enhancing our reputation also depends on maintaining systems and procedures that address known risks and regulatory requirements, as well as our ability to identify and mitigate additional risks that arise due to changes in our businesses and the marketplaces in which we operate, the regulatory environment and client expectations. If any of these developments has a material effect on our reputation, our business will suffer.

Our business is subject to operational risks.

We, like most financial institutions, are exposed to many types of operational risks, including the risk of fraud by employees or outsiders, unauthorized transactions by employees or operational errors. Operational errors may include clerical or record keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Given our volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully corrected. Our necessary dependence upon automated systems to record and process our transaction volume may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect.

We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control, including, for example, computer viruses or electrical or telecommunications outages, which may give rise to losses in service to customers and to loss or liability to us. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations to us, or will be subject to the same risk of fraud or operational errors by their respective employees as are we, and to the risk that our or our vendors' business continuity and data security systems prove not to be adequate. We also face the risk that the design of our controls and procedures proves inadequate or is circumvented, causing delays in detection or errors in information. Although we maintain a system of controls designed to keep operational risks at appropriate levels, there can be no assurance that we will not suffer losses from operational risks in the future that may be material in amount.

We face the risk of cyber-attack to our computer systems.

In the ordinary course of business, we collect and store sensitive data, including proprietary business information and personally identifiable information of our customers and employees in systems and on networks. The secure processing, maintenance and use of this information is critical to our operations. To date, we have not experienced a significant compromise, significant data loss or any material financial losses related to cybersecurity attacks, but our systems and those of our customers and third-party service providers are under constant threat, and it is possible that we could experience a significant event in the future. Cybersecurity threats include unauthorized access, loss or destruction of data (including confidential client information), account takeovers, unavailability of service, computer viruses or other malicious code, cyber-attacks and other events. Remote working of employees during the Coronavirus Pandemic introduces additional potential cybersecurity risks due to the use of home networks, video conferencing and other remote work technologies over which we do not have as much control as our internal systems. Cyber threats may derive from human error, fraud or malice on the part of employees or third parties, or may result from accidental technological failure. If one or more of these events occurs, it could result in the disclosure of confidential client information, damage to our reputation with our clients and the market, additional costs to us (such as repairing systems or adding new personnel or protection technologies), regulatory penalties and financial losses, to both us and our clients and customers. Such events could also cause interruptions or malfunctions in our operations (such as the lack of availability of our online banking system), as well as the operations of our clients, customers or other third parties. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as due to the expanding use of internet banking, mobile banking and other technology-based products and services by us and our customers. Although we maintain safeguards to protect against these risks, there can be no assurance that we will not suffer losses in the future that may be material in amount.

In March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. In August 2019, the federal bank regulatory agencies issued a statement recommending that banking organizations use a standardized approach to assess and improve cybersecurity preparedness. The agencies noted that the use of standardized tools, such as the FFIEC Cybersecurity Assessment Tool, makes firms better able to track their progress over time, and to share information and best practices with other financial institutions, a behavior which the bank regulatory agencies encourage. In April 2020, the federal banking agencies issued a statement highlighting the risks presented by banking organizations' use of cloud computing services in their business. The statement noted specific risks unique to the cloud computing environment, and the importance of ongoing controls of virtual infrastructure, care in the use of containers for data, and the sensitivity of use of managed security services, among other things. Although guidance of this nature does not have the full force and effect of law, it sets out supervisory priorities and expectations regarding safe and sound operation. Failure to observe such guidance may result in supervisory identification of unsafe or unsound practices or other deficiencies in risk management or other areas that do not constitute violations of law or regulation.

Regulatory Risks

The timing and effect of Federal Reserve Board policy normalization remains uncertain.

In September 2014, the Federal Reserve Board announced principles it would follow to implement monetary policy normalization, that is, to raise the federal funds rate and other short-term interest rates to more historically normal levels and to reduce the Federal Reserve's securities holdings, so as to promote its statutory mandate of maximum employment and price stability. The Federal Open Market Committee ("FOMC") took the initial step in that process by raising the federal funds rate by 25 basis points in December 2015, the first such action since December 2008. Subsequently, the FOMC refined the normalization principles and announced greater detail about its planned approach. In September 2017, the FOMC announced the start of a gradual reduction in the Federal Reserve's securities holdings, commencing in October 2017. In each of March, June, September and December 2018, the FOMC raised the federal funds rate by 25 basis points, and announced its intention to continue to raise the federal funds rate gradually over the next few years. In January 2019, the FOMC announced its intention to continue to implement monetary policy in a regime in which an ample supply of reserves ensures that control of the federal funds and other short-term interest rates is exercised primarily through adjustment of its administered rates. The FOMC stated that it was prepared to adjust the details of the reduction of its balance sheet in light of economic and financial developments, and would be prepared to use its full range of tools, including changing the size and composition of its balance sheet, if future economic conditions warranted a more accommodative monetary policy than could be achieved solely by reducing the federal funds rate.

In July 2019, the FOMC announced the cessation of the reduction in its securities portfolio and reduced the federal funds rate by 25 basis points. In August 2019, the FOMC commenced reinvestment of principal payments received from agency debt and agency mortgage-backed securities in Treasury securities and agency mortgage-backed securities, as well as the rollover of maturing Treasury securities in its portfolio. In September 2019, the FOMC again lowered the federal funds rate by 25 basis points. In October 2019, the FOMC issued a reaffirmation of its January 2019 statement, and announced that in light of recent and expected increases in the Federal Reserve's non-reserve liabilities and in order to maintain ample reserve balances over time at or above levels prevailing in early September 2019, the Federal Reserve would purchase Treasury bills at least into the second quarter of 2020. The statement also announced that the Federal Reserve would conduct term and overnight repurchase agreement operations at least through January 2020 to ensure that the supply of reserves remained ample, even during periods of sharp increases in non-reserve liabilities, and to mitigate the risk of money market pressures. At its regular October 2019 meeting, the FOMC again lowered the federal funds rate by 25 basis points.

In light of the evolving risks to economic activity posed by the Coronavirus Pandemic, the FOMC took five separate actions in March, 2020. Taken together, those actions reduced the federal funds target range to 0.00% to 0.25%, directed expanded purchases of U.S. Treasury securities and agency mortgage-backed securities and large scale overnight and term repurchase operations, committed the FOMC to use its full range of tools to support the U.S. economy, and provided U.S. dollar swap lines and repurchase facilities to certain foreign central banks and international organizations.

On August 27, 2020, the FOMC announced revisions to its Statement on Longer-Run Goals and Monetary Policy Strategy ("Statement"). Under the revised Statement, the FOMC emphasized that its statutory mandate of maximum employment is a broad-based and inclusive goal, and that its policy decisions would be informed by its assessment of the shortfall from maximum employment. Regarding price stability, the Statement provides that the FOMC seeks to achieve inflation that averages 2% over time. Accordingly, when inflation has been persistently below 2%, the FOMC will likely aim to achieve inflation moderately above 2% for some time. The revised Statement has been reflected in subsequent actions by the FOMC.

At its meeting on January 27, 2021, the FOMC kept the target range for the federal funds rate at 0.00% to 0.25%, and stated that it expects to maintain this target range until labor market conditions have reached levels consistent with the FOMC's assessment of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time. To foster smooth market functioning and accommodative monetary conditions, at the same time the FOMC directed continued monthly increases in its holdings of U.S. Treasury securities of at least $80 billion, and of agency mortgage-backed securities of at least $40 billion. There can be no assurance that the operations announced in January 2021 will continue, that they will be effective to accomplish their stated policy goals, or as to the actual impact of those operations and policies on the financial markets, the broader economy, or on our business, financial condition, results of operations, access to credit or the trading price of our common stock.

The effect of financial services legislation and regulations remains uncertain.

In response to the 2008 financial crisis, on July 21, 2010, President Obama signed the Dodd-Frank Act, the most comprehensive reform of the regulation of the financial services industry since the Great Depression of the 1930's. Among many other things, the Dodd-Frank Act provides for increased supervision of financial institutions by regulatory agencies, more stringent capital requirements for financial institutions, major changes to deposit insurance assessments by the FDIC, prohibitions on proprietary trading and sponsorship or investment in hedge funds and private equity funds by insured depository institutions, holding companies, and their affiliates, heightened regulation of hedging and derivatives activities, a greater focus on consumer protection issues, in part through the formation of a new Consumer Financial Protection Bureau ("CFPB") having powers formerly split among different regulatory agencies, extensive changes to the regulation of residential mortgage lending, imposition of limits on interchange transaction and network fees for electronic debit transactions and repeal of the prohibition on payment of interest on demand deposits. Many of the Dodd-Frank Act's provisions have delayed effective dates, while other provisions require implementing regulations of various federal agencies, some of which have not yet been adopted in final form.

On February 3, 2017, however, President Trump signed Executive Order 13772, specifying new core principles for regulating the U.S. financial system. Among other things, the President directed the Secretary of the Treasury, in consultation with federal regulatory agencies, to review existing laws and regulations and report on the extent to which they were consistent with the core principles. The Treasury Department has published several reports in response to the Executive Order. In addition, beginning in February 2017, Congress passed, and the President signed, more than a dozen resolutions under the Congressional Review Act, repealing various federal regulations, including regulations adopted by the CFPB.

On May 24, 2018, EGRRCPA was enacted, amending numerous provisions of the Dodd-Frank Act. While some of the changes affect only much larger institutions, a number of provisions relax or eliminate restrictions applicable to us and our bank. Among these latter changes are: simplified capital adequacy requirements; exemption from the proprietary trading and other restrictions of the Volcker Rule; less frequent periodic supervisory examinations; reductions in certain periodic reporting requirements; exclusion of specified amounts of reciprocal deposits, received by our bank from other insured depository institutions, from the "brokered deposit" limitations of the Federal Deposit Insurance Act; revised capital treatment for certain high volatility commercial real estate loans; and relaxation of certain requirements applicable to residential mortgage loans made to our customers.

While some of those EGRRCPA changes became effective immediately upon enactment, many others required implementing regulations by the federal banking agencies before becoming effective. At the dates indicated, the federal banking agencies adopted regulations in final form, applicable to us and our bank, implementing EGRRCPA provisions simplifying capital adequacy requirements (September 2019), granting exemption from the proprietary trading and other restrictions of the Volcker Rule (July 2019), reducing the frequency of periodic supervisory examinations (December 2018), reducing certain periodic reporting requirements (June 2019), excluding specified amounts of reciprocal deposits, received by our bank from other insured depository institutions, from the "brokered deposit" limitations of the Federal Deposit Insurance Act (March 2019), providing clarifications and revised capital treatment for certain high volatility commercial real estate loans as well as clarifying the capital treatment of certain financings of one-to-four family residential properties and the development of land (November 2019), and relaxing appraisal requirements for certain real property mortgage transactions (September 2019).

In December 2019, the FDIC (which regulates our bank) and the Office of the Comptroller of the Currency ("OCC") jointly proposed significant revisions to their respective versions of the existing uniform regulations (jointly adopted by the Federal Reserve, FDIC, and the OCC) that implement the Community Reinvestment Act. On May 20, 2020, the OCC adopted a final revised rule, but the Chair of the FDIC announced that the FDIC was not prepared to do so at that time. The Federal Reserve (which regulates our company) did not participate in the OCC/FDIC proposal. Rather, the Federal Reserve published an advance notice of proposed rulemaking, requesting feedback on different approaches to modernizing its Community Reinvestment Act regulation. The comment period has expired. There can be no assurance whether or when any proposed changes in the existing regulations will be adopted by the FDIC or the Federal Reserve.

On January 20, 2021, President Biden signed a Memorandum on Modernizing Regulatory Review, and Executive Order No. 13992, revoking a number of Executive Orders concerning federal regulation. Also, the President's chief of staff issued a Memorandum to all Executive Departments and Agencies directing, subject to certain exceptions, a temporary freeze on proposal or issuance of new or pending regulations until a designee of President Biden reviews and approves the rule.

Thus, the effect of financial services legislation and regulations remains uncertain. The implementation, amendment, or repeal of federal financial services laws or regulations may limit our business opportunities, impose additional costs on us, impact our revenues or the value of our assets, or otherwise adversely affect our business.

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

The banking industry is heavily regulated under both federal and state law. These regulations are primarily intended to protect customers, the federal deposit insurance fund, and the stability of the U.S. financial system, not our creditors or shareholders. Existing state and federal banking laws subject us to substantial limitations with respect to the making of loans, the purchase of securities, the payment of dividends and many other aspects of our business. Some of these laws may benefit us, others may increase our costs of doing business, or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, which may be accelerated by the recent change in the federal administration, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition. Federal economic and monetary policy may also affect our ability to attract deposits, make loans and achieve satisfactory interest spreads.

Minimum capital requirements have increased.

The provisions of the Dodd-Frank Act relating to capital to be maintained by financial institutions approach convergence with the standards (generally known as Basel III) adopted in December, 2010 by the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision. Among other things, those standards contain a narrower definition of elements qualifying for inclusion as Tier 1 capital and higher minimum risk-based capital levels than those specified in previous U.S. law and regulations. In July, 2013, the U.S. federal bank regulatory agencies adopted regulations to implement the provisions of the Dodd-Frank Act and Basel III for U.S. financial institutions. The new regulations became applicable to us and our bank effective January 1, 2015.

The new regulations implemented (i) revised definitions of regulatory capital elements, (ii) a new common equity Tier 1 ("CET 1") minimum capital ratio requirement, (iii) an increase in the existing minimum Tier 1 capital ratio requirement, (iv) new limits on capital distributions and certain discretionary bonus payments if an institution does not hold a specified amount of CET 1 (called a capital conservation buffer) in addition to the amount required to meet its minimum risk-based capital requirements, (v) new risk-weightings for certain categories of assets, and (vi) other requirements applicable to banking organizations which have total consolidated assets or total consolidated on-balance sheet foreign exposure exceeding specified amounts (that are greatly in excess of those of us and our bank), which elect to use the advanced measurement approach for calculating risk-weighted assets, or which are subsidiaries of banking organizations that use the advanced measurement approach ("Advanced Approaches Entities").

Among other things, the new regulations generally require banking organizations to recognize in regulatory capital most components of accumulated other comprehensive income ("AOCI"), including accumulated unrealized gains and losses on available for sale securities. This requirement, which was not imposed under previous risk-based capital regulations, may be avoided by banking organizations, such as us and our bank, that are not Advanced Approaches Entities, by making a one-time, irrevocable election on the first quarterly regulatory report following the date on which the regulations become effective as to them. We made the one-time, irrevocable election regarding the treatment of AOCI on March 31, 2015.

In addition, the new regulations (unlike the original proposal), permit companies such as us, which had total assets of less than $15 billion on December 31, 2009, and had issued trust preferred securities on or prior to May 19, 2010, to continue to include such securities in Tier 1 capital.

On January 1, 2015, for banking organizations such as us and our bank that are not Advanced Approaches Entities, the new regulations mandated a minimum ratio of CET 1 to standardized total risk-weighted assets ("RWA") of 4.5%, an increased ratio of Tier 1 capital to RWA of 6.0% (compared to the prior requirement of 4.0%), a total capital ratio (that is, the sum of Tier 1 and Tier 2 capital to RWA) of 8.0%, and a minimum leverage ratio (that is, Tier 1 capital to adjusted average total consolidated assets) of 4.0%. The calculation of these amounts is affected by the new definitions of certain capital elements. The capital conservation buffer comprised solely of CET 1 was phased-in commencing January 1, 2016, beginning at 0.625% of RWA and rising to 2.5% of RWA on January 1, 2019. Failure by a banking organization to maintain the aggregate required minimum capital ratios and capital conservation buffer will impair its ability to make certain distributions (including dividends and stock repurchases) and discretionary bonus payments to executive officers.

On May 24, 2018, EGRRCPA was enacted, amending numerous provisions of the Dodd-Frank Act. Among other things, the new law simplified capital requirements for certain organizations (such as us and our bank) by directing the federal banking agencies to develop a Community Bank Leverage Ratio ("CBLR"). The CBLR, to be set between 8% and 10% of tangible equity capital to average total consolidated assets, would apply to Qualified Community Banks. The law defines Qualified Community Banks as those depository institutions and depository institution holding companies having total consolidated assets of less than $10 billion that meet other specified risk criteria, to be determined by regulations of the federal banking agencies based on factors prescribed in the statute. A Qualified Community Bank satisfying the CBLR, by reason of the EGRRCPA provision, would be deemed to be in compliance with all applicable leverage and risk-based capital requirements and, in the case of a depository institution, be deemed "well-capitalized" for purposes of the Federal Deposit Insurance Act.

In February 2019, the federal banking agencies published in the Federal Register a notice of proposed rule-making to implement this EGRRCPA capital adequacy provision. Final rules were adopted by each of the federal banking agencies in November 2019, which became effective January 1, 2020. The final rules represent an alternative to the capital adequacy rules that became applicable to us and our bank on January 1, 2015, and that are described above (the generally applicable rules).

The final rules based on the EGRRCPA provision establish a CBLR of 9%. A "Qualifying Community Banking Organization" as defined in the final rules (a "QCBO"), may opt into the rules. To be a QCBO, a banking organization must satisfy the following criteria: (i) not be an Advanced Approaches Entity; (ii) have a leverage capital ratio greater than 9%; (iii) total consolidated assets of less than $10 billion; (iv) total off-balance sheet exposures (excluding certain derivatives) of 25% or less of total consolidated assets; and (v) a sum of total trading assets and trading liabilities of 5% or less of total consolidated assets. For this purpose, the leverage capital ratio of a banking organization is the ratio of its Tier 1 capital to its average total consolidated assets, minus amounts deducted from Tier 1 capital.

A banking organization meeting the QCBO criteria may elect to opt in to the CBLR framework (an electing banking organization). An electing banking organization is deemed to have met the "well-capitalized" ratio requirements of, and otherwise to be in compliance with, the generally applicable rules. It will not be required to calculate and report risk-based capital ratios under the generally applicable rules. In the case of an electing banking organization that is an insured bank, it will also be considered to have met the well-capitalized ratio requirements of the prompt corrective action provisions of the Federal Deposit Insurance Act. We did not opt into the CBLR framework.

If an electing banking organization subsequently fails to satisfy any of the criteria of a QCBO, but continues to report a leverage capital ratio greater than 8%, it may continue to use the CBLR framework for a grace period of up to two quarters. As long as the electing banking organization can return to compliance with all of the QCBO criteria within the two quarters, it will continue to be deemed to meet the "well-capitalized" ratio requirements and be in compliance with the generally applicable rules. A banking organization will be required to comply with the generally applicable rules, and file the relevant regulatory reports, if it: (i) is unable to restore compliance with all of the QCBO criteria (including the greater than 9% leverage capital ratio) during the two-quarter grace period; (ii) reports a leverage capital ratio of 8% or less; or (iii) ceases to satisfy the QCBO criteria because of a merger transaction.

In response to a mandate in the CARES Act, adopted in response to the Coronavirus Pandemic, the federal banking agencies adopted interim rules temporarily reducing the required CBLR. As adopted in final form, effective October 1, 2020, the required CBLR is 8% until December 31, 2020, 8.5% in 2021, and returns to 9% thereafter. The final rule also provides a community banking organization that temporarily fails to meet the QCBO criteria will remain deemed well-capitalized during a two-quarter grace period if its leverage capital ratio remains greater than the following levels during the periods indicated: before December 31, 2020, 7%; during 2021, 7.5%; and any time thereafter, 8%.

To alleviate impacts of the Coronavirus Pandemic, on December 2, 2020, the federal banking agencies adopted an interim final rule regarding regulatory thresholds based on asset size of banking organizations. Under the interim final rule, banking organizations may use total assets as of December 31, 2019 in determining eligibility under various regulatory regimes. Among the regulations covered by the interim final rule is the CBLR framework. Under the interim final rule, otherwise applicable regulatory requirements regarding asset size determinations will once again apply as of January 1, 2022.

The increased minimum capital requirements may adversely affect our ability (and that of our bank) to pay cash dividends, reduce our profitability, or otherwise adversely affect our business, financial condition or results of operations. In the event of a need for additional capital to meet these requirements, there can be no assurance of our ability to raise funding in the equity and capital markets. Factors that we cannot control, such as the disruption of financial markets or negative views of the financial services industry generally, could impair our ability to raise qualifying equity capital. In addition, our ability to raise qualifying equity capital could be impaired if investors develop a negative perception of our financial prospects. If we were unable to raise qualifying equity capital, it might be necessary for us to sell assets in order to maintain required capital ratios. We may be unable to sell some of our assets, or we may have to sell assets at a discount from market value, either of which could adversely affect our results of operations, cash flow and financial condition.

Risks Related to Our Stock

Future sales of our common stock or other securities may dilute the value of our common stock.

In many situations, our Board of Directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued preferred or common stock, including shares authorized and unissued under our equity incentive plans. In the future, we may issue additional securities, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of the common stock. In addition, option holders under our stock-based incentive plans may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

We may need to raise additional capital in the future, and such capital may not be available when needed or at all.

We may need or want to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs, particularly if our asset quality or earnings were to deteriorate significantly. Our ability to raise additional capital will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. Economic conditions and any loss of confidence in financial institutions generally may increase our cost of funding and limit access to certain customary sources of capital.

There can be no assurance that capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of equity or debt purchasers, or counterparties participating in the capital markets, may adversely affect our capital costs and our ability to raise capital and, potentially, our liquidity. Also, if we need to raise capital in the future, we may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our business, financial condition and results of operations.

Our Articles of Incorporation and By-laws and the laws of the State of Michigan contain provisions that may discourage or prevent a takeover of our company and reduce any takeover premium.

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

The Michigan Business Corporation Act contains provisions intended to protect shareholders and prohibit or discourage various types of hostile takeover activities. In addition to these provisions and the provisions of our Articles of Incorporation and By-laws, federal law requires the Federal Reserve Board's approval prior to acquiring "control" of a bank holding company. All of these provisions may delay or prevent a change in control without action by our shareholders and could adversely affect the price of our common stock.

There is a limited trading market for our common stock.

The price of our common stock has been, and will likely continue to be, subject to fluctuations based on, among other things, economic and market conditions for bank holding companies and the stock market in general, as well as changes in investor perceptions of our company. The issuance of new shares of our common stock also may affect the market for our common stock.

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM." The development and maintenance of an active public trading market depends upon the existence of willing buyers and sellers, the presence of which is beyond our control. While we are a publicly-traded company, the volume of trading activity in our stock is still relatively limited. Even if a more active market develops, there can be no assurance that such a market will continue, or that our shareholders will be able to sell their shares at or above the price at which they acquired shares.

The value of securities in our investment securities portfolio may be negatively affected by disruptions in securities markets.

Prices and volumes of transactions in the nation's securities markets can be affected suddenly by economic crises, or by other national or international crises, such as national disasters, acts of war or terrorism, changes in commodities markets, or instability in foreign governments. Disruptions in securities markets may detrimentally affect the value of securities that we hold in our investment portfolio, such as through reduced valuations due to the perception of heightened credit and liquidity risks. There can be no assurance that declines in market value associated with these disruptions will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

Item 1B. Unresolved Staff Comments

We have received no written comments regarding our periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more before the end of our 2020 fiscal year and that remain unresolved.

Item 2. Properties.

Our headquarters is located in our bank's main office facility in Grand Rapids, Michigan. Our bank operates 44 banking offices primarily concentrated throughout Western and Central Michigan, most of which are full-service facilities. We also have a banking office in Troy, Michigan, and in late 2020 we opened a residential mortgage loan production office in the Cincinnati, Ohio metropolitan area. We have larger banking facilities in Alma, Kalamazoo, Lansing, Mt. Pleasant and West Branch. The remaining banking offices generally range in size from 1,200 to 3,200 square feet, based on the location and number of employees located at the facility. All of our banking offices are owned by our bank except for seven that are rented under various operating lease agreements. In several instances, the banking offices contain more usable space than what is needed for current banking operations. This excess space, totaling approximately 23,500 square feet, is generally leased to unrelated businesses. In addition, certain functions operate out of our standalone facility located in Alma.

As part of our bank's branch rationalization efforts, we recently announced that our bank and Lake Trust Credit Union have entered into an agreement for the sale of our banking office located in Hastings, Michigan, with the sale expected to be consummated by March 31, 2021. The agreement includes the 4,300 square-foot facility, all associated assets and approximately $16 million in deposits.

We consider our properties and equipment to be well maintained, in good operating condition and capable of accommodating current growth forecasts. However, we may choose to add branch locations to expand our presence in current markets and/or in new markets or, alternatively, to consolidate, close or relocate branches if we believe it would be beneficial to our overall performance.

Item 3. Legal Proceedings.

From time to time, we may be involved in various legal proceedings that are incidental to our business. In the opinion of management, we are not a party to any legal proceedings that are material to our financial condition, either individually or in the aggregate.

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

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

Market Information and Holders

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM." At March 1, 2021, there were approximately 1,400 record holders of our common stock. In addition, we estimate that there were approximately 7,000 beneficial owners of our common stock who own their shares through brokers or banks.

Dividend Policy

The following table shows the high and low sales prices for our common stock as reported by the Nasdaq Global Select Market for the periods indicated and the quarterly cash dividends paid by us during those periods.

	High	Low	Dividend
2020			
First Quarter	$ 37.16	$ 18.90	$ 0.28
Second Quarter	26.08	18.64	0.28
Third Quarter	24.29	17.09	0.28
Fourth Quarter	28.06	17.85	0.28
2019			
First Quarter	$ 35.82	$ 27.86	$ 0.26
Second Quarter	34.69	30.58	0.26
Third Quarter	34.24	29.78	0.27
Fourth Quarter	37.32	31.60	0.27

Holders of our common stock are entitled to receive dividends that the Board of Directors may declare from time to time. We may only pay dividends out of funds that are legally available for that purpose. We are a financial holding company and substantially all of our assets are held by our bank and its subsidiaries. Our ability to pay dividends to our shareholders depends primarily on our bank's ability to pay dividends to us. Dividend payments and extensions of credit to us from our bank are subject to legal and regulatory limitations, generally based on capital levels and current and retained earnings, imposed by law and regulatory agencies with authority over our bank. The ability of our bank to pay dividends is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements. In addition, under the terms of our subordinated debentures, we would be precluded from paying dividends on our common stock if an event of default has occurred and is continuing under the subordinated debentures, or if we exercised our right to defer payments of interest on the subordinated debentures, until the deferral ended.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on our financial statements. Our bank's ability to pay cash and stock dividends or repurchase equity securities is subject to limitations under various laws and regulations and to prudent and sound banking practices.

On January 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on March 18, 2020 to shareholders of record as of March 6, 2020. On April 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on June 17, 2020 to shareholders of record as of June 5, 2020. On July 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on September 16, 2020 to shareholders of record as of September 4, 2020. On October 15, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on December 16, 2020 to shareholders of record as of December 4, 2020.

On January 17, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of $0.26 per share that was paid on March 20, 2019 to shareholders of record as of March 8, 2019. On April 11, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of $0.26 per share that was paid on June 19, 2019 to shareholders of record as of June 7, 2019. On July 11, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of $0.27 per share that was paid on September 18, 2019 to shareholders of record as of September 6, 2019. On October 10, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of $0.27 per share that was paid on December 18, 2019 to shareholders of record as of December 6, 2019.

On January 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of $0.29 per share that will be paid on March 17, 2021 to shareholders of record as of March 5, 2021.

Issuer Purchases of Equity Securities

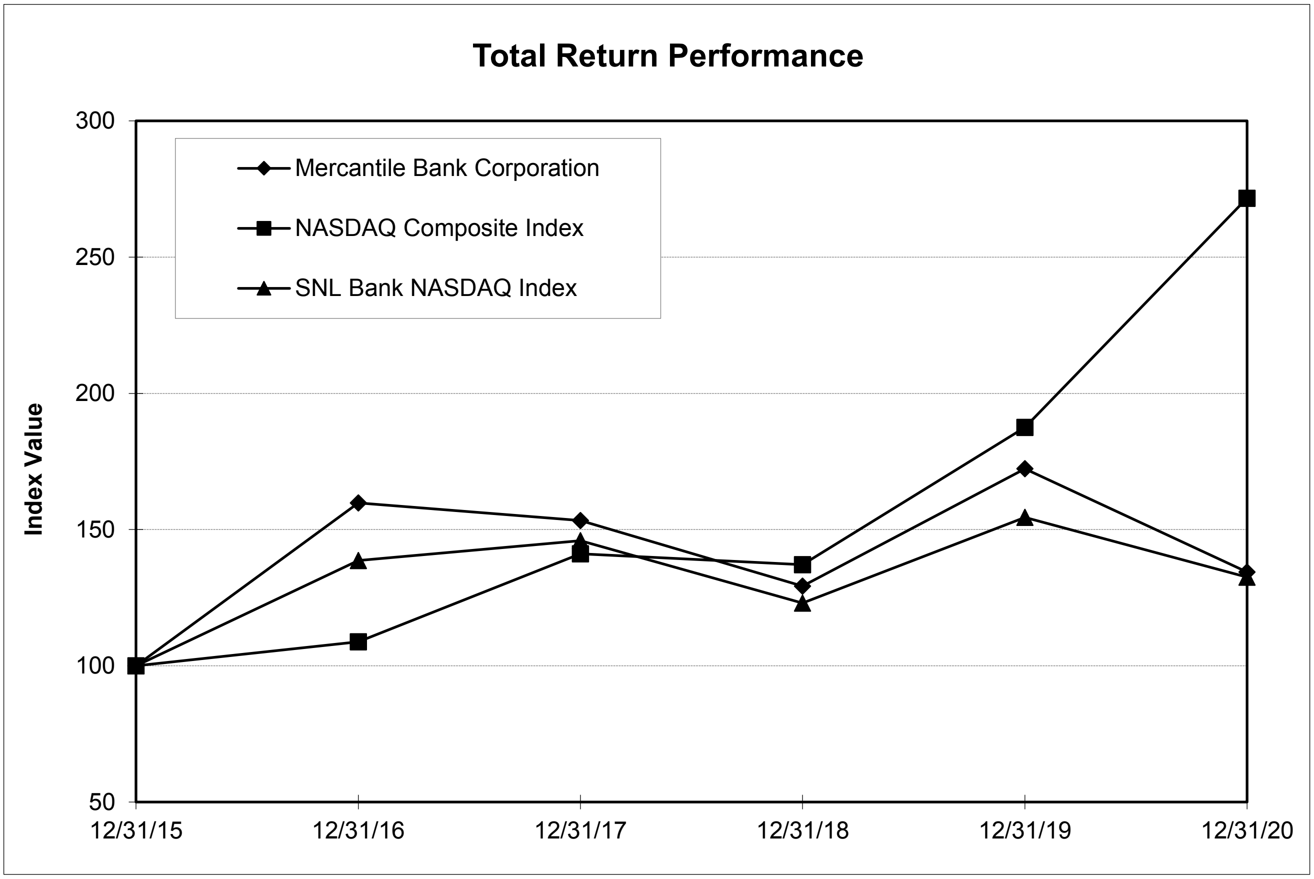
On May 7, 2019, we announced that our Board of Directors had authorized a program to repurchase up to $20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. The actual timing, number and value of shares repurchased under the program will be determined by management in its discretion and will depend on a number of factors, including the market price of our stock, general market and economic conditions, our capital position, financial performance and alternative uses of capital, and applicable legal requirements. The program may be discontinued at any time.

During the first quarter of 2020, we repurchased a total of 222,385 shares for $6.3 million, or a weighted average all-in cost per share of $28.25. After electing to temporarily cease stock repurchases in March 2020 to preserve capital for lending and other purposes while we assessed the potential impacts of the Coronavirus Pandemic, we reinstated the repurchase program during the fourth quarter of 2020; fourth quarter repurchases totaled 14,008 shares for $0.3 million, or a weighted average all-in cost of per share of $22.05. During 2019, we repurchased a total of 233,300 shares for $7.2 million, or a weighted average all-in cost per share of $30.79. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan or a new plan, which would also likely be funded from cash dividends paid to us from our bank.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares or Approximate Dollar Value that May Yet Be Purchased Under the Plans or Programs
October 1 – 31	0	$ NA	0	$ 10,136,000
November 1 – 30	14,008	22.05	14,008	9,827,000
December 1 – 31	0	NA	0	9,827,000
Total	14,008	$ 22.05	14,008	$ 9,827,000

Shareholder Return Performance Graph

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on our common stock (based on the last reported sales price of the respective year) with the cumulative total return of the Nasdaq Composite Index and the SNL Bank Nasdaq Index from December 31, 2015 through December 31, 2020. The following is based on an investment of $100 on December 31, 2015 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.



	Period Ending					
Index	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**	**12/31/19**	**12/31/20**
Mercantile Bank Corporation	100.00	159.74	153.35	129.25	172.30	134.39
NASDAQ Composite Index	100.00	108.87	141.13	137.12	187.44	271.64
SNL Bank NASDAQ Index	100.00	138.65	145.97	123.04	154.47	132.56

Item 6. Selected Financial Data.

The Selected Financial Data in this Annual Report is incorporated here by reference.

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

Management's Discussion and Analysis included in this Annual Report is incorporated here by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The information under the heading "Market Risk Analysis" included in this Annual Report is incorporated here by reference.

Item 8. Financial Statements and Supplementary Data.

The Consolidated Financial Statements, the Notes to Consolidated Financial Statements and the Reports of Independent Registered Public Accounting Firm included in this Annual Report are incorporated here by reference.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

None

Item 9A. Controls and Procedures.

As of December 31, 2020, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of December 31, 2020.

There have been no significant changes in our internal control over financial reporting during the quarter ended December 31, 2020, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2020. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2020. Refer to page F-38 for management's report.

Our independent registered public accounting firm has issued an audit report on our internal control over financial reporting which is included in this Annual Report.

Item 9B. Other Information.

None

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information presented under the captions "Election of Directors," "Executive Officers," "Section 16(a) Beneficial Ownership Reporting Compliance" and "Corporate Governance – Code of Ethics" in the definitive Proxy Statement of Mercantile Bank Corporation for our May 27, 2021 Annual Meeting of Shareholders (the "Proxy Statement"), a copy of which will be filed with the Securities and Exchange Commission before April 30, 2021, is incorporated here by reference.

Item 11. Executive Compensation.

The information presented under the captions "Executive Compensation," "Corporate Governance – Compensation Committee Interlocks and Insider Participation" and "Compensation Committee Report" in the Proxy Statement is incorporated here by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information presented under the caption "Stock Ownership of Certain Beneficial Owners and Management" in the Proxy Statement is incorporated here by reference.

Equity Compensation Plan Information

The following table summarizes information, as of December 31, 2020, relating to compensation plans under which equity securities are authorized for issuance.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	9,700	$ 32.83	361,000 (1)
Equity compensation plans not approved by security holders	0	0	0
Total	9,700	$ 32.83	361,000

(1) These securities are available under the Stock Incentive Plan of 2020. Incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information presented under the captions “Transactions with Related Persons” and “Corporate Governance – Director Independence” in the Proxy Statement is incorporated here by reference.

Item 14. Principal Accountant Fees and Services.

The information presented under the caption “Principal Accountant Fees and Services” in the Proxy Statement is incorporated here by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Financial Statements. The following financial statements and reports of the independent registered public accounting firm of Mercantile Bank Corporation and its subsidiaries are filed as part of this report:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets --- December 31, 2020 and 2019

Consolidated Statements of Income for each of the three years in the period ended December 31, 2020

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2020

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2020

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2020

Notes to Consolidated Financial Statements

The Consolidated Financial Statements, the Notes to Consolidated Financial Statements, and the Reports of Independent Registered Public Accounting Firm listed above are incorporated by reference in Item 8 of this report.

(2) Financial Statement Schedules

Not applicable

(b) Exhibits:

The Exhibit Index immediately preceding the Signatures Page hereto is incorporated by reference under this item.

(c) Financial Statements Not Included In Annual Report

Not applicable

Item 16. Form 10-K Summary

None.

MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION
December 31, 2020 and 2019

MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION
December 31, 2020 and 2019

CONTENTS

SELECTED FINANCIAL DATA

Consolidated Results of Operations:	2020	2019	2018	2017	2016
	(Dollars in thousands except per share data)				
Interest income	$ 148,313	$ 158,337	$ 141,981	$ 125,543	$ 118,457
Interest expense	26,067	33,803	21,899	15,795	12,590
Net interest income	122,246	124,534	120,082	109,748	105,867
Provision for loan losses	14,050	1,750	1,100	2,950	2,900
Noninterest income	45,172	26,956	19,010	19,001	21,038
Noninterest expense	98,520	89,280	86,170	79,716	77,118
Income before income tax expense	54,848	60,460	51,822	46,083	46,887
Income tax expense	10,710	11,004	9,798	14,809	14,974
Net income	$ 44,138	$ 49,456	$ 42,024	$ 31,274	$ 31,913
Consolidated Balance Sheet Data:					
Total assets	$ 4,437,344	$ 3,632,915	$ 3,363,907	$ 3,286,704	$ 3,082,571
Cash and cash equivalents	626,006	233,731	75,354	200,101	183,596
Securities	405,349	352,657	353,388	346,780	336,086
Loans	3,216,358	2,856,667	2,753,085	2,558,552	2,378,620
Allowance for loan losses	37,967	23,889	22,380	19,501	17,961
Bank owned life insurance	72,131	70,297	69,647	68,689	67,198
Deposits	3,411,553	2,690,384	2,463,708	2,522,365	2,374,985
Securities sold under agreements to repurchase	118,365	102,675	103,519	118,748	131,710
Federal Home Loan Bank advances	394,000	354,000	350,000	220,000	175,000
Subordinated debentures	47,563	46,881	46,199	45,517	44,835
Shareholders' equity	441,554	416,561	375,249	365,870	340,811
Consolidated Financial Ratios:					
Return on average assets	1.07%	1.39%	1.28%	1.00%	1.07%
Return on average shareholders' equity	10.32%	12.52%	11.33%	8.82%	9.35%
Average shareholders' equity to average assets	10.34%	11.09%	11.33%	11.28%	11.42%
Nonperforming loans to total loans	0.11%	0.08%	0.15%	0.28%	0.25%
Allowance for loan losses to total loans *	1.33%	0.84%	0.81%	0.76%	0.76%
Tier 1 leverage capital	9.77%	11.28%	11.41%	11.27%	11.17%
Common equity risk-based capital	11.34%	11.00%	10.41%	10.74%	10.88%
Tier 1 risk-based capital	12.68%	12.36%	11.80%	12.21%	12.47%
Total risk-based capital	13.80%	13.09%	12.50%	12.88%	13.13%
Per Common Share Data:					
Net income:					
Basic	$ 2.71	$ 3.01	$ 2.53	$ 1.90	$ 1.96
Diluted	2.71	3.01	2.53	1.90	1.96
Book value per share at end of period	27.04	25.36	22.70	22.05	20.76
Dividends declared	1.12	1.06	1.68	0.74	1.16
Dividend payout ratio	40.62%	34.59%	65.44%	38.52%	58.70%

(*) Excludes Paycheck Protection Program Loans

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

FORWARD-LOOKING STATEMENTS

The following discussion and other portions of 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 our company. Words such as "anticipates," "believes," "estimates," "expects," "intends," "is likely," "plans," "projects," and 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") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update, amend, or clarify forward-looking statements, whether as a result of new information, future events (whether anticipated or unanticipated), or otherwise.

Future Factors include, among others, adverse changes in interest rates and interest rate relationships; significant declines in the value of commercial real estate; market volatility; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; our participation in the PayCheck Protection Program administered by the Small Business Administration; changes in the method of determining Libor, or the replacement of Libor with an alternative reference rate; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; risks associated with cyber-attacks, information security breaches and other criminal activities on our computer systems; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; damage to our reputation resulting from adverse publicity, regulatory actions, litigation, operational failures, the failure to meet client expectations and other facts; changes in the national and local economies, including the significant disruption to financial market and other economic activity caused by the outbreak of Covid-19; and other risk factors described in Item 1A of this Annual Report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's Discussion and Analysis of Financial Condition and Results of Operations ("Management's Discussion and Analysis") is based on Mercantile Bank 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, revenues 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, and actual results could differ from those estimates. We have reviewed the analyses with the Audit Committee of our Board of Directors.

<u>Allowance For Loan Losses</u>: The allowance for loan losses ("allowance") is maintained at a level we believe is adequate to absorb probable incurred losses identified and inherent in the loan portfolio. Our evaluation of the adequacy of the allowance is an estimate based on past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, guidance from bank regulatory agencies, and assessments of the impact of current and anticipated economic conditions on the loan portfolio. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off. Loan losses are charged against the allowance when we believe the uncollectability of a loan is likely. The balance of the allowance represents our best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance in the future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance in the future. In either instance, unanticipated changes could have a significant impact on the allowance and operating results. Loans made under the Paycheck Protection Program are fully guaranteed by the Small Business Administration; therefore, such loans do not have an associated allowance.

We complete a migration analysis quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2020, we placed most weight on the period starting December 31, 2010 through December 31, 2020. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future. Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

We established a Covid-19 reserve allocation factor to address the Coronavirus Pandemic and its potential impact on the collectability of the loan portfolio during the second quarter of 2020. The creation of this factor reflected our belief that the traditional nine environmental factors did not sufficiently capture and address the unique circumstances, challenges and uncertainties associated with the Coronavirus Pandemic, which include unprecedented federal government stimulus and interventions, statewide mandatory closures of nonessential businesses and periodic changes to such and our ability to provide payment deferral programs to commercial and retail borrowers without the interjection of troubled debt restructuring accounting rules. We review a myriad of items when assessing this new environmental factor, including virus infection rates, economic outlooks, employment data, business closures, foreclosures, payment deferments and government-sponsored stimulus programs. The Covid-19 reserve factor resulted in a $5.3 million increase to the allowance as of December 31, 2020.

The allowance is increased through a provision charged to operating expense. Uncollectable loans are charged-off through the allowance. Recoveries of loans previously charged-off are added to the allowance. A loan is considered impaired when it is probable that contractual principal and interest payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement. Impairment is evaluated on an individual loan basis. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan’s existing interest rate or at the fair value of collateral if repayment is expected solely from the collateral. The timing of obtaining outside appraisals varies, generally depending on the nature and complexity of the property being evaluated, general breadth of activity within the marketplace and the age of the most recent appraisal. For collateral dependent impaired loans, in most cases we obtain and use the “as is” value as indicated in the appraisal report, adjusting for any expected selling costs. In certain circumstances, we may internally update outside appraisals based on recent information impacting a particular or similar property, or due to identifiable trends (e.g., recent sales of similar properties) within our markets. The expected future cash flows exclude potential cash flows from certain guarantors. To the extent these guarantors are able to provide repayments, a recovery would be recorded upon receipt. Loans are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship. Our policy for recognizing income on impaired loans is to accrue interest unless a loan is placed on nonaccrual status. We put loans into nonaccrual status when the full collection of principal and interest is not expected.

Financial institutions were not required to comply with the Current Expected Credit Loss (“CECL”) methodology requirements from the enactment date of the Coronavirus Aid, Relief and Economic Security Act (“CARES Act”) until the earlier of the end of the President’s declaration of a National Emergency or December 31, 2020. The Consolidated Appropriations Act, 2021, that was enacted in December 2020, provided for an extension of the required CECL adoption date to January 1, 2022, which is the date we expect to adopt. An economic forecast is a key component of the CECL methodology. As we continue to experience an unprecedented economic environment whereby a sizable portion of the economy has been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus has been provided to businesses, individuals and state and local governments and financial institutions have offered businesses and individuals payment relief options, economic forecasts are regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we have elected to postpone the adoption of CECL, and will continue to use our incurred loan loss reserve model as permitted.

Income Tax Accounting: Current income tax assets and liabilities are established for the amount of taxes payable or refundable for the current year. In the preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome may be uncertain. We periodically review and evaluate the status of our tax positions and make adjustments as necessary. Deferred income tax assets and liabilities are also established for the future tax consequences of events that have been recognized in our financial statements or tax returns. A deferred income tax asset or liability is recognized for the estimated future tax effects attributable to temporary differences that can be carried forward (used) in future years. The valuation of our net deferred income tax asset is considered critical as it requires us to make estimates based on provisions of the enacted tax laws. The assessment of the realizability of the net deferred income tax asset involves the use of estimates, assumptions, interpretations and judgments concerning accounting pronouncements, federal and state tax codes and the extent of future taxable income. There can be no assurance that future events, such as court decisions, positions of federal and state taxing authorities, and the extent of future taxable income will not differ from our current assessment, the impact of which could be significant to the consolidated results of operations and reported earnings.

Accounting guidance requires us to assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors that may impact future operating results. Significant weight is given to evidence that can be objectively verified.

Securities: Securities available for sale consist of bonds and notes which might be sold prior to maturity due to changes in interest rates, prepayment risks, yield and availability of alternative investments, liquidity needs and other factors. Securities classified as available for sale are reported at their fair value. Declines in the fair value of securities below their cost that are other-than-temporary are reflected as realized losses. In estimating other-than-temporary losses, we consider: (1) the length of time and extent that fair value has been less than carrying value; (2) the financial condition and near term prospects of the issuer; and (3) our ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value. Fair values for securities available for sale are generally obtained from outside sources and applied to individual securities within the portfolio. The difference between the amortized cost and the current fair value of securities is recorded as a valuation adjustment and reported in other comprehensive income.

Mortgage Servicing Rights: Mortgage servicing rights are recognized as assets based on the allocated fair value of retained servicing rights on loans sold. Servicing rights are carried at the lower of amortized cost or fair value and are expensed in proportion to, and over the period of, estimated net servicing income. We utilize a discounted cash flow model to determine the value of our servicing rights. The valuation model utilizes mortgage loan prepayment speeds, the remaining life of the mortgage loan pool, delinquency rates, our cost to service loans and other factors to determine the cash flow that we will receive from servicing each grouping of loans. These cash flows are then discounted based on current interest rate assumptions to arrive at the fair value of the right to service those loans. Impairment is evaluated quarterly based on the fair value of the servicing rights, using groupings of the underlying loans classified by interest rates. Any impairment of a grouping is reported as a valuation allowance.

Goodwill: Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed if conditions in the market place or changes in the company's organizational structure occur. Due to current stressed economic and market conditions, we assessed goodwill for impairment as of March 31, 2020, June 30, 2020, September 30, 2020, and October 1, 2020. For March 31, 2020, we used a discounted income approach and a market valuation model, which compared the inherent value of our company to valuations of recent transactions in the market place to determine if our goodwill had been impaired. Using this quantitative methodology, we determined goodwill was not impaired as of March 31, 2020. For June 30, 2020, September 30, 2020, and October 1, 2020, we used the Step 0 methodology for which we assessed the macro and microeconomic conditions, industry and market conditions, financial performance, and our underlying stock performance. We concluded it was more likely than not our fair value was greater than its carrying amount at the end of each period; therefore, no further testing was required.

INTRODUCTION

This Management's Discussion and Analysis should be read in conjunction with the consolidated financial statements contained in this Annual Report. This discussion provides information about the consolidated financial condition and results of operations of Mercantile Bank Corporation and its consolidated subsidiary, Mercantile Bank of Michigan ("our bank"), and of Mercantile Bank Real Estate Co., L.L.C. ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance company"), subsidiaries of our bank. Unless the text clearly suggests otherwise, references to "us," "we," "our," or "the company" include Mercantile Bank Corporation and its wholly-owned subsidiaries referred to above.

CORONAVIRUS PANDEMIC

The U.S. economy deteriorated rapidly during the latter part of the first quarter and into the second quarter of 2020 due to the ongoing pandemic of coronavirus disease 2019 ("Covid-19") caused by severe acute respiratory syndrome coronavirus 2 (the "Coronavirus Pandemic"). While the economic fallout has stabilized somewhat, there remains a significant amount of stress and uncertainty across national and global economies. This uncertainty is heightened as certain geographic areas continue to experience surges in Covid-19 cases and governments at all levels continue to react to changes in circumstances.

The Coronavirus Pandemic is a highly unusual, unprecedented and evolving public health and economic crisis and may have a material negative impact on our financial condition and results of operations. We continue to occupy an asset-sensitive position, whereby interest rate environments characterized by numerous and/or high magnitude interest rate reductions have a negative impact on our net interest income and net income. Additionally, the consequences of the unprecedented economic impact of the Coronavirus Pandemic may produce declining asset quality, reflected by a higher level of loan delinquencies and loan charge-offs, as well as downgrades of commercial lending relationships, which may necessitate additional provisions for our allowance and reduced net income.

The following section summarizes the primary measures that directly impact us and our customers.

- Paycheck Protection Program

  The Paycheck Protection Program ("PPP") reflects a substantial expansion of the Small Business Administration's 100% guaranteed 7(a) loan program. The CARES Act authorized up to $350 billion in loans to businesses with fewer than 500 employees, including non-profit organizations, tribal business concerns, self-employed and individual contractors. The PPP provides 100% guaranteed loans to cover specific operating costs, with the maximum loan size capped at the lesser of 250% of the average monthly payroll costs or $10.0 million. PPP loans are eligible to be forgiven based upon certain criteria. In general, the amount of the loan that is forgivable is the sum of the payroll costs, interest payments on mortgages, rent and utilities incurred or paid by the business during a prescribed period beginning on the loan origination date. Any remaining balance after forgiveness is maintained at the 100% guarantee for the duration of the loan. The loan tenor is 24 months for loans originated prior to June 5, 2020 and 60 months for loans originated on or after June 5, 2020. Loans originated prior to June 5, 2020 can be modified to a tenor of 60 months upon the mutual agreement of the lender and borrower. We have not modified the maturity date of any loans made prior to June 5, 2020. The interest rate on the loan is fixed at 1.00%, with the financial institution receiving a loan origination fee ranging from 1% to 5% of the loan amount paid by the Small Business Administration. The loan origination fees, net of the direct origination costs, have totaled approximately $15.0 million and are being accreted into interest income on loans using the level yield methodology. The program was originally scheduled to end on June 30, 2020, but was subsequently modified to end on August 8, 2020. Participation in the PPP has had a significant impact on the composition of our loan and deposit portfolios and our net interest income starting during the second quarter of 2020, which is expected to remain well into 2021. We originated approximately 2,200 loans aggregating $554 million under the PPP, with no customer payments but $189 million in forgiveness transactions on approximately 900 PPP loans recorded through December 31, 2020.

  Under the CARES Act, a PPP loan is assigned a risk weight of 0% under the risk-based capital rules of the federal banking agencies. On April 9, 2020, the federal banking agencies issued an interim final rule allowing financial institutions to exclude PPP loans from the average asset calculation to the degree the PPP loans are financed through the Paycheck Protection Program Lending Facility ("PPPLF") for the Tier 1 Leverage Capital Ratio.

- Individual Economic Impact Payments
  The Internal Revenue Service began making Individual Economic Impact Payments in mid-April via direct deposit or mailed checks. Individuals with adjusted gross income of $75,000 or less received payments of $1,200, with a reduction formula for those individuals with adjusted gross income over $75,000 but less than $99,000. Individuals with adjusted gross income of over $99,000 did not receive a payment. Married couples filing jointly with adjusted gross income of $150,000 or less received payments of $2,400, with a reduction formula for those married couples filing jointly with adjusted gross income over $150,000 but less than $198,000. Married couples filing jointly with adjusted gross income of over $198,000 did not receive a payment.

- Troubled Debt Restructuring Relief
  From March 1, 2020 through 60 days after the end of the National Emergency (or December 31, 2020 if earlier), a financial institution may elect to suspend GAAP principles and regulatory determinations with respect to loan modifications related to Covid-19 that would otherwise be categorized as troubled debt restructurings. Banking agencies must defer to the financial institution's election. We elected to suspend GAAP principles and regulatory determinations as permitted. The Consolidated Appropriations Act, 2021 extended the suspension date to January 1, 2022.

- Current Expected Credit Loss Methodology Delay
  Financial institutions are not required to comply with the CECL methodology requirements from the enactment date of the CARES Act until the earlier of the end of the National Emergency or December 31, 2020. We elected to postpone CECL adoption as permitted. The Consolidated Appropriations Act, 2021 extended the adoption deferral date to January 1, 2022.

In early April 2020, in response to the early stages of the Coronavirus Pandemic and its pervasive impact across the economy and financial markets, we developed internal programs of loan payment deferments for commercial and retail borrowers. For commercial borrowers, we offered 90-day (three payments) interest only amendments as well as 90-day (three payments) principal and interest payment deferments. Under the latter program, borrowers were extended a 12-month single payment note at 0% interest in an amount equal to three payments, with loan proceeds used to make the scheduled payments. The single payment notes receive a loan grade equal to the loan grade of each respective borrowing relationship. Certain of our commercial loan borrowers subsequently requested and received an additional 90-day (three payments) interest only amendment or 90-day (three payments) principal and interest payment deferment. Under the latter program, the amount equal to the three payments was added to the original deferment note which has nine months remaining to maturity; however, the original 0% interest rate is modified to equal the rate associated with each borrower's traditional lending relationship with us for the remainder of the term.

At the peak of activity in mid-July, nearly 750 borrowers with loan balances aggregating $719 million were participating in the commercial loan deferment program. However, as of December 31, 2020, only 19 borrowers with loan balances aggregating $8.0 million remained in the commercial loan deferment program. For retail borrowers, we offered 90-day (three payments) principal and interest payment deferments, with deferred amounts added to the end of the loan. As of June 30, 2020, we had processed 260 principal and interest payment deferments with loan balances totaling $23.8 million. These payment deferral transactions largely applied to the borrowers' April, May and June loan payments. As of December 31, 2020, only 14 borrowers with loan balances aggregating $1.8 million remained in the retail loan payment deferment program.

In April, 2020, the Federal Reserve initiated the PPPLF, which is designed to facilitate lending by financial institutions to small businesses under the PPP. Only PPP loans are eligible to serve as collateral for the PPPLF, with each dollar of PPP loans providing one dollar of advance availability. The maturity date of an extension of credit under the PPPLF will equal the maturity date of the pool of PPP loans pledged to secure the extension of credit. Any principal payments received by the financial institution on the PPP loans, such as PPP loan forgiveness payments from the Small Business Administration or principal payments from the borrower after the initial six-month deferment period, must be used to pay down the PPPLF advance by the same dollar amount, maintaining the dollar-for-dollar advance amount and PPP aggregate loan balance relationship. The interest rate on PPPLF advances is fixed at 0.35%. No PPPLF advances could be obtained after September 30, 2020. We obtained a PPPLF advance in the amount of $43.7 million in late April 2020 and paid it off in full in early June 2020. As of December 31, 2020, we had no advances outstanding under the PPPLF.

SUBSEQUENT EVENTS

On December 27, 2020, the Consolidated Appropriations Act, 2021 was signed into law. This $900 billion Coronavirus Pandemic relief package includes $284 billion in aid for small businesses through a second round of forgivable loans through the PPP. In general, the framework of loans originated under the second round are similar to that of the initial round. As of February 26, 2021, we had originated about 900 loans aggregating $181 million in second round PPP loans.

We originated approximately 2,200 loans aggregating $554 million under the initial round of the PPP. As of December 31, 2020, we had received no customer payments but had received $189 million in forgiveness payments from the Small Business Administration on about 900 PPP loans. As of February 26, 2021, we had received no customer payments but had received $266 million in forgiveness payments from the Small Business Administration on approximately 1,400 loans.

As part of our bank's branch rationalization efforts, we recently announced that our bank and Lake Trust Credit Union have entered into an agreement for the sale of our banking office located in Hastings, Michigan, with the sale expected to be consummated by March 31, 2021. The agreement includes the 4,300 square-foot facility, all associated assets and approximately $16 million in deposits.

FINANCIAL OVERVIEW

We recorded net income of $44.1 million, or $2.71 per basic and diluted share, for 2020, compared to net income of $49.5 million, or $3.01 per basic and diluted share, for 2019. The net impact of a gain on the sale of a former branch facility and write-downs of former branch facilities decreased net income during 2020 by approximately $1.1 million, or $0.07 per diluted share. Bank owned life insurance claims and the net impact of gains and losses on sales and write-downs of former branch facilities increased net income during 2019 by approximately $2.7 million, or $0.16 per diluted share. Excluding the impacts of these transactions, diluted earnings per share decreased $0.07, or 2.5%, during 2020 compared to 2019.

The lower level of net income during 2020 compared to 2019 resulted from higher provision expense and noninterest expense and decreased net interest income, which more than offset increased noninterest income. The loan loss reserve build during 2020, which primarily reflected increased allocations associated with changes in certain environmental factors and an allocation related to a newly-created Covid-19 pandemic environmental factor, was viewed as a precautionary measure to guard against any potential deterioration in the quality of the loan portfolio stemming from the pandemic and associated weakened economic conditions. The higher level of noninterest expense mainly reflected increased compensation, occupancy, furniture and equipment, and Federal Deposit Insurance Corporation ("FDIC") insurance premium costs, along with increased write-downs of former branch facilities. The decline in net interest income depicted a lower yield on earning assets, which more than offset the positive impact of growth in earning assets. The improved noninterest income primarily reflected increased mortgage banking income.

We believe the overall quality of our loan portfolio remains strong, with nonperforming loans equaling only 0.11% of total loans as of December 31, 2020. Gross loan charge-offs during 2020 totaled $0.8 million, while recoveries of prior period loan charge-offs totaled $0.9 million, providing for net loan recoveries of $0.1 million, or 0.01% of average total loans. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries. Accruing loans past due 30 to 89 days remain very low.

Commercial loans increased $352 million during 2020, and at December 31, 2020 totaled $2.79 billion, or 86.9% of our loan portfolio. As of December 31, 2019, the commercial loan portfolio comprised 85.5% of total loans. The increase in commercial loans during 2020 primarily reflects activity under the PPP. Originations of PPP loans, primarily during the second quarter and to a lesser degree the third quarter, totaled $554 million. We started to receive PPP loan forgiveness payments from the Small Business Administration during the fourth quarter, totaling $189 million through year-end 2020 and providing for a net balance of $365 million at December 31, 2020. Excluding PPP loans, our commercial and industrial loan segment declined $66.1 million during 2020, in large part reflecting a reduction in lines of credit during the second quarter. Non-owner occupied commercial real estate ("CRE") loans increased $82.1 million and multi-family and residential rental loans grew $21.6 million, while owner-occupied CRE loans declined $49.1 million. We believe our loan portfolio remains well diversified. As a percentage of total commercial loans, commercial and industrial loans and owner-occupied CRE loans combined equaled 60.0% as of December 31, 2020, compared to 58.4% at December 31, 2019. The current commercial loan pipeline remains strong, and at year-end 2020, we had almost $100 million in unfunded loan commitments on commercial construction and development loans that are in the construction phase.

We experienced significant deposit growth during 2020, primarily reflecting federal government stimulus payments and reduced business and consumer investing and spending, along with PPP loan proceeds being deposited into customers' accounts at the time the loans were originated and remaining on deposit at year-end 2020. Local deposits increased $808 million during 2020, in large part comprised of a $508 million increase in noninterest-bearing checking accounts. In addition, interest-bearing checking accounts were up $141 million, money market deposits grew $103 million and savings deposits increased $68.8 million. Brokered deposits declined $86.5 million, comprising 1.4% of total deposits at December 31, 2020 compared to 5.0% at year-end 2019.

We recorded a loan loss provision expense of $14.1 million during 2020, a substantial increase over the $1.8 million recorded during 2019. Approximately 80% of the provision expense recorded during 2020 is reflective of increased allocations associated with qualitative factors, namely economic conditions, loan review and value of underlying collateral dependent commercial loans, as well as the creation of a Coronavirus Pandemic environmental factor ("Covid-19 factor"). The Covid-19 factor, developed during the second quarter, is designed to address the unique challenges and economic uncertainty resulting from the Coronavirus Pandemic and its potential impact on the collectability of the loan portfolio. The provision expense recorded during 2020 also reflects the downgrading of certain non-impaired commercial loan relationships, most of which occurred during the third quarter.

Noninterest income during 2020 was $45.2 million, compared to $27.0 million in 2019. The significant growth primarily reflects increased mortgage banking income stemming from a sizeable upturn in refinance activity spurred by a decrease in residential mortgage loan interest rates, an increase in purchase activity, and the continuing success of strategic initiatives that have been implemented over the past several years to gain market share and increase production. Mortgage banking income totaled $29.3 million in 2020, compared to $8.5 million during 2019.

Noninterest expense totaled $98.5 million during 2020, compared to $89.3 million in 2019. The higher level of expense primarily resulted from increased compensation costs, mainly reflecting higher residential mortgage lender commissions and related incentives, as well as annual merit pay increases and a larger bonus accrual. Occupancy and equipment and furniture costs were up $1.7 million on a combined basis in 2020 compared to 2019, mainly reflecting the late 2019 completion of our main office expansion.

FINANCIAL CONDITION

Our total assets increased $804 million during 2020, and totaled $4.44 billion as of December 31, 2020. Total loans increased $360 million, interest-earning deposits were up $383 million and securities available for sale increased $52.7 million. Total deposits increased $721 million and FHLBI advances were up $40.0 million. Local deposit growth exceeded net loan growth, with the excess funds maintained with the Federal Reserve Bank of Chicago.

Earning Assets

Average earning assets equaled 94.1% of average total assets during 2020, compared to 93.4% during 2019. The loan portfolio continued to comprise a majority of earning assets, followed by interest-earning deposits and securities. Average total loans equaled 82.0% of average earning assets during 2020, compared to 85.8% in 2019, while average interest-earning deposits and average securities comprised 9.2% and 8.8% of average earning assets during 2020 and 3.4% and 10.8% during 2019, respectively.

Our loan portfolio has historically been primarily comprised of commercial loans. Commercial loans increased $352 million during 2020, and at December 31, 2020 totaled $2.79 billion, or 86.9% of our loan portfolio. As of December 31, 2019, the commercial loan portfolio comprised 85.5% of total loans. The increase in commercial loans during 2020 primarily reflects activity under the PPP. Originations of PPP loans, primarily during the second quarter and to a lesser degree during the third quarter, totaled $554 million. We started to receive PPP loan forgiveness payments from the Small Business Administration during the fourth quarter, totaling $189 million through year-end 2020, and providing for a net balance of $365 million as of December 31, 2020. Excluding PPP loans, our commercial and industrial loan segment declined $66.1 million during 2020, in large part reflecting a reduction in lines of credit during the second quarter. Non-owner occupied CRE loans increased $82.1 million and multi-family and residential rental loans grew $21.6 million, while owner-occupied CRE loans declined $49.1 million. We believe our loan portfolio remains well diversified. As a percentage of total commercial loans, commercial and industrial loans and owner-occupied CRE loans combined equaled 60.0% as of December 31, 2020, compared to 58.4% at December 31, 2019.

As of December 31, 2020, availability on commercial construction and development loans that are in the construction phase totaled almost $100 million, with most of the funds expected to be drawn over the next 12 to 18 months. Our current pipeline reports indicate strong commercial loan funding opportunities in future periods, including $228 million in new lending commitments. Our commercial lenders also report additional opportunities they are currently discussing with existing borrowers and potential new customers. We remain committed to prudent underwriting standards that provide for an appropriate yield and risk relationship, as well as concentration limits we have established within our commercial loan portfolio. Usage of existing commercial lines of credit was relatively stable during the last six months of 2020, after having declined by about $110 million during the second quarter largely reflecting the Coronavirus Pandemic and associated weakened economic conditions.

Residential mortgage loans increased $21.0 million during 2020, totaling $361 million, or 11.2% of total loans, at December 31, 2020. We originated $864 million in residential mortgage loans during 2020, compared to $369 million in 2019. The 135% increase is primarily attributable to a sizeable upturn in refinance activity spurred by a decrease in residential mortgage loan interest rates, an increase in purchase activity, and the continuing success of strategic initiatives that have been implemented over the past several years to gain market share and increase production. Almost 66% of the residential mortgage loans originated during 2020 consisted of refinance transactions, compared to about 50% during 2019. Residential mortgage loans originated for sale, generally consisting of longer-term fixed rate residential mortgage loans, totaled $672 million during 2020, or almost 78% of the total residential mortgage loans originated. Residential mortgage loans originated not sold are generally comprised of adjustable rate residential mortgage loans. We are very pleased with the results of our strategic initiatives associated with the growth of our residential mortgage banking operation over the past few years, and remain optimistic that origination volumes will continue to be solid in future periods.

Other consumer-related loans declined $13.8 million during 2020, and at December 31, 2020 totaled $61.6 million, or 1.9% of the loan portfolio. Other consumer-related loans equaled 2.6% of total loans as of December 31, 2019. We expect this loan portfolio segment to decline in future periods as scheduled principal payments exceed origination volumes.

The following table summarizes our loan portfolio:

	12/31/20	12/31/19	12/31/18	12/31/17	12/31/16
Commercial:					
Commercial & Industrial *	$1,145,423,000	$ 846,551,000	$ 822,723,000	$ 753,764,000	$ 713,903,000
Land Development & Construction	55,055,000	56,119,000	44,885,000	29,873,000	34,828,000
Owner Occupied Commercial Real Estate	529,953,000	579,003,000	548,619,000	526,328,000	450,464,000
Non-Owner Occupied Commercial Real Estate	917,436,000	835,346,000	816,282,000	791,685,000	748,269,000
Multi-Family & Residential Rental	146,095,000	124,525,000	127,597,000	101,918,000	117,883,000
Total Commercial	2,793,962,000	2,441,544,000	2,360,106,000	2,203,568,000	2,065,347,000
Retail:					
1-4 Family Mortgages	360,776,000	339,749,000	307,540,000	254,559,000	195,226,000
Home Equity & Other Consumer Loans	61,620,000	75,374,000	85,439,000	100,425,000	118,047,000
Total Retail	422,396,000	415,123,000	392,979,000	354,984,000	313,273,000
Total Loans	$3,216,358,000	$2,856,667,000	$2,753,085,000	$2,558,552,000	$2,378,620,000

(*) For December 31, 2020, includes $365 million in loans originated under the Paycheck Protection Program.

The following table presents total loans outstanding as of December 31, 2020, according to scheduled repayments of principal on fixed rate loans and repricing frequency on variable rate loans. Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.

	Less Than One Year	One Through Five Years	More Than Five Years	Total
Construction and land development	$ 63,821,000	$ 65,689,000	$100,839,000	$ 230,349,000
Real estate - residential properties	25,966,000	153,263,000	229,874,000	409,103,000
Real estate - multi-family properties	4,327,000	38,373,000	45,753,000	88,453,000
Real estate - commercial properties	249,984,000	807,964,000	285,841,000	1,343,789,000
Commercial and industrial	402,245,000	643,088,000	82,387,000	1,127,720,000
Consumer	2,068,000	14,115,000	761,000	16,944,000
Total loans	$ 748,411,000	$1,722,492,000	$745,455,000	$3,216,358,000
Fixed rate loans	$ 365,124,000	$1,610,804,000	$611,366,000	$2,587,294,000
Floating rate loans	383,287,000	111,688,000	134,089,000	629,064,000
Total loans	$ 748,411,000	$1,722,492,000	$745,455,000	$3,216,358,000

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to provide effective loan portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans, which exhibit characteristics (financial or otherwise) that could cause the loans to become nonperforming or require restructuring in the future, are included on the internal loan watch list. Senior management and the Board of Directors review this list regularly. Market value estimates of collateral on impaired loans, as well as on foreclosed and repossessed assets, are reviewed periodically; however, we have a process in place to monitor whether value estimates at each quarter-end are reflective of current market conditions. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside and internal valuations based on identifiable trends within our markets, such as recent sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address distressed market conditions.

Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled $4.1 million (0.1% of total assets) as of December 31, 2020, compared to $2.7 million (0.1% of total assets) as of December 31, 2019. The volume of nonperforming assets has remained low over the past several years. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with a relatively steady level of watch list credits and what we believe are strong credit administration practices, we are pleased with the overall quality of the loan portfolio.

The following tables provide a breakdown of nonperforming assets by property type:

NONPERFORMING LOANS

	12/31/20	12/31/19	12/31/18	12/31/17	12/31/16
Residential Real Estate:					
Land Development	$ 35,000	$ 34,000	$ 0	$ 0	$ 16,000
Construction	0	0	0	0	0
Owner Occupied / Rental	2,519,000	2,104,000	3,157,000	3,381,000	2,739,000
	2,554,000	2,138,000	3,157,000	3,381,000	2,755,000
Commercial Real Estate:					
Land Development	0	0	0	35,000	95,000
Construction	0	0	0	0	0
Owner Occupied	619,000	134,000	950,000	2,241,000	285,000
Non-Owner Occupied	22,000	0	0	0	488,000
	641,000	134,000	950,000	2,276,000	868,000
Non-Real Estate:					
Commercial Assets	172,000	0	17,000	1,444,000	2,293,000
Consumer Assets	17,000	12,000	17,000	42,000	23,000
	189,000	12,000	34,000	1,486,000	2,316,000
Total	$ 3,384,000	$ 2,284,000	$ 4,141,000	$ 7,143,000	$ 5,939,000

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

	12/31/20	12/31/19	12/31/18	12/31/17	12/31/16
Residential Real Estate:					
Land Development	$ 0	$ 0	$ 0	$ 0	$ 0
Construction	0	0	0	0	0
Owner Occupied / Rental	88,000	260,000	398,000	193,000	144,000
	88,000	260,000	398,000	193,000	144,000
Commercial Real Estate:					
Land Development	0	0	0	0	0
Construction	0	0	0	0	0
Owner Occupied	613,000	192,000	413,000	2,031,000	325,000
Non-Owner Occupied	0	0	0	36,000	0
	613,000	192,000	413,000	2,067,000	325,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	0	0	0	0	0
	0	0	0	0	0
Total	$ 701,000	$ 452,000	$ 811,000	$ 2,260,000	$ 469,000

The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

	2020	2019	2018	2017	2016
Beginning balance	$ 2,284,000	$ 4,141,000	$ 7,143,000	$ 5,939,000	$ 5,444,000
Additions	3,361,000	698,000	2,909,000	7,604,000	5,655,000
Returns to performing status	(105,000)	(126,000)	(175,000)	(232,000)	(13,000)
Principal payments	(1,701,000)	(2,140,000)	(5,028,000)	(4,234,000)	(4,166,000)
Loan charge-offs	(455,000)	(289,000)	(708,000)	(1,934,000)	(981,000)
Total	$ 3,384,000	$ 2,284,000	$ 4,141,000	$ 7,143,000	$ 5,939,000

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

	2020	2019	2018	2017	2016
Beginning balance	$ 452,000	$ 811,000	$ 2,260,000	$ 469,000	$ 1,293,000
Additions	758,000	462,000	1,114,000	4,401,000	725,000
Sale proceeds	(485,000)	(792,000)	(2,380,000)	(677,000)	(1,428,000)
Valuation write-downs	(24,000)	(29,000)	(183,000)	(1,933,000)	(121,000)
Total	$ 701,000	$ 452,000	$ 811,000	$ 2,260,000	$ 469,000

Gross loan charge-offs during 2020 totaled $0.8 million, while recoveries of prior period loan charge-offs totaled $0.9 million, providing for net loan recoveries of $0.1 million, or 0.01% of average total loans. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries. Accruing loans past due 30 to 89 days remain very low.

The following table summarizes changes in the allowance for the past five years. For the years 2019, 2018, 2017 and 2016, presented loan and allowance data are reflective of only originated loans and the allowance for originated loans. We terminated the application of purchase accounting associated with our merger with Firstbank effective January 1, 2020.

	2020	2019	2018	2017	2016
Loans outstanding at year-end	$ 3,216,358,000	$ 2,614,725,000	$ 2,452,446,000	$ 2,169,957,000	$ 1,884,548,000
Daily average balance of loans outstanding during the year	$ 3,190,742,000	$ 2,584,234,000	$ 2,295,251,000	$ 2,054,809,000	$ 1,784,978,000
Balance of allowance for loans at beginning of year (*)	$ 23,889,000	$ 21,554,000	$ 19,133,000	$ 17,868,000	$ 15,233,000
Loans charged-off:					
Commercial, financial and agricultural	(614,000)	(455,000)	(367,000)	(2,272,000)	(980,000)
Construction and land development	0	0	(61,000)	(20,000)	0
Residential real estate	(129,000)	(361,000)	(551,000)	(687,000)	(809,000)
Instalment loans to individuals	(96,000)	(67,000)	(210,000)	(204,000)	(344,000)
Total charge-offs	(839,000)	(883,000)	(1,189,000)	(3,183,000)	(2,133,000)
Recoveries of previously charged-off loans:					
Commercial, financial and agricultural	488,000	302,000	1,757,000	1,445,000	754,000
Construction and land development	0	24,000	832,000	129,000	334,000
Residential real estate	314,000	239,000	531,000	131,000	522,000
Instalment loans to individuals	65,000	63,000	90,000	102,000	60,000
Total recoveries	867,000	628,000	3,210,000	1,807,000	1,670,000
Net loan (charge-offs) recoveries	28,000	(255,000)	2,021,000	(1,376,000)	(463,000)
Provision for loan losses	14,050,000	1,867,000	400,000	2,641,000	3,098,000
Balance of allowance for loans at end of year	$ 37,967,000	$ 23,166,000	$ 21,554,000	$ 19,133,000	$ 17,868,000
Ratio of net loan (charge-offs) recoveries to average loans outstanding during the year	0.01%	(0.01%)	0.09%	(0.07%)	(0.03%)
Ratio of allowance to loans outstanding at year-end	1.18%	0.89%	0.88%	0.88%	0.95%

(*) For the December 31, 2020 column, the balance of allowance for loans at beginning of year includes the December 31, 2019 balance of the allowance for acquired loans.

The following table illustrates the breakdown of the allowance for loans balance by loan type (dollars in thousands) and of the total loan portfolio (in percentages). For the years 2019, 2018, 2017 and 2016, presented loan and allowance data are reflective of only originated loans and the allowance for originated loans. We terminated the application of purchase accounting associated with our merger with Firstbank effective January 1, 2020.

	12/31/2020		12/31/2019		12/31/2018		12/31/2017		12/31/2016	
	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio
Commercial, financial and agricultural	$33,235	79.6%	$20,599	76.0%	$19,228	86.7%	$15,616	77.8%	$15,035	85.8%
Construction and land development	813	7.2	340	9.0	270	2.0	1,260	7.6	991	6.0
Residential real estate	3,595	12.7	1,863	14.2	1,778	10.0	1,758	13.3	1,374	6.4
Instalment loans to individuals	265	0.5	294	0.8	234	1.3	406	1.3	508	1.8
Unallocated	59	0.0	70	0.0	44	0.0	93	0.0	(40)	0.0
Total	$37,967	100.0%	$23,166	100.0%	$21,554	100.0%	$19,133	100.0%	$17,868	100.0%

The following table depicts the ratio of our allowance to nonperforming loans:

	12/31/20	12/31/19	12/31/18	12/31/17	12/31/16
Ratio of allowance to nonperforming loans	1,122.0%	1,045.9%	540.4%	273.0%	302.4%

The increasing trend of the ratio of our allowance to nonperforming loans over the past several years generally reflects the combined impact of an increased allowance balance and reduction in nonperforming loans.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish specific portions of the allowance based on specifically identifiable problem loans. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Allowance Analysis, loan loss migration analysis, composition of the loan portfolio, third party analysis of the loan administration processes and portfolio, and general economic conditions.

Financial institutions were not required to comply with the CECL methodology requirements from the enactment date of the CARES Act until the earlier of the end of the President's declaration of a National Emergency or December 31, 2020. The Consolidated Appropriations Act, 2021, that was enacted in December 2020, provided for an extension of the required CECL adoption date to January 1, 2022, which is the date we plan to adopt. An economic forecast is a key component of the CECL methodology. As we continue to experience an unprecedented economic environment whereby a sizable portion of the economy has been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus has been provided to businesses, individuals and state and local governments and financial institutions have offered businesses and individuals payment relief options, economic forecasts are regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we have elected to postpone the adoption of CECL, and will continue to use our incurred loan loss reserve model as permitted.

The Allowance Analysis applies reserve allocation factors to non-impaired outstanding loan balances, the result of which is combined with specific reserves to calculate an overall allowance amount. For non-impaired commercial loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. Our commercial loan portfolio is segregated into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; lending concentrations; and other external factors, including competition and regulatory environment.

We established a Covid-19 reserve allocation factor to address the Coronavirus Pandemic and its potential impact on the collectability of the loan portfolio during the second quarter of 2020. The creation of this factor reflected our belief that the traditional nine environmental factors did not sufficiently capture and address the unique circumstances, challenges and uncertainties associated with the Coronavirus Pandemic, which include unprecedented federal government stimulus and interventions, statewide mandatory closures of nonessential businesses and periodic changes to such and our ability to provide payment deferral programs to commercial and retail borrowers without the interjection of troubled debt restructuring accounting rules. We review a myriad of items when assessing this new environmental factor, including virus infection rates, economic outlooks, employment data, business closures, foreclosures, payment deferments and government-sponsored stimulus programs. The Covid-19 reserve factor resulted in a $5.3 million increase to the allowance as of December 31, 2020.

Adjustments for specific lending relationships, particularly impaired loans, are made on a case-by-case basis. Non-impaired retail loan reserve allocations are determined in a similar fashion as those for non-impaired commercial loans, except that retail loans are segmented by type of credit and not a grading system. We regularly review the Allowance Analysis and make adjustments periodically based upon identifiable trends and experience.

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2020 we placed most weight on the period starting December 31, 2010 through December 31, 2020. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future. We continue to actively monitor our loan portfolio and assess reserve allocation factors in light of the Coronavirus Pandemic and its impact on the U.S. economic environment and our borrowers in particular.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

Approximately 80% of the provision expense recorded during 2020 is reflective of increased allocations associated with qualitative factors, with the remainder primarily reflecting the downgrading of certain non-impaired commercial loan relationships.

During the first quarter, we changed the trend rating on the economic and business conditions environmental factor from slightly deteriorating to severely deteriorating due to the initial and expected stressed economic environment resulting from the Coronavirus Pandemic. This modification impacted all loan portfolio segments, adding $4.0 million to the required allowance during the quarter. Also during the first quarter, we improved the trend rating on the lending policies environmental factor from slightly deteriorating to relatively stable to reflect the duration since the Firstbank merger in 2014 and recent loan policy enhancements. This modification impacted all loan portfolio segments, subtracting $3.0 million from the required allowance level. In addition, during the first quarter we improved the trend rating on the changes in the experience, ability, and depth of lending management and staff environmental factor from slightly deteriorating to relatively stable to reflect the duration since personnel changes were made as part of the Firstbank merger and personnel changes necessitated by the retirement of our former CEO about two years ago. This modification impacted the commercial loan portfolio segment, subtracting $2.0 million from the required allowance.

During the second quarter, we changed the impact rating of the economic and business conditions environmental factor from moderate to high due to the ongoing and expected stressed economic environment resulting from the Coronavirus Pandemic. This modification impacted all loan portfolio segments, adding $4.0 million to the required allowance level. We also established the Covid-19 factor to address the Coronavirus Pandemic and its potential impact on the collectability of the loan portfolio. The creation of this factor reflected our belief that the traditional nine environmental factors did not sufficiently capture and address the unique circumstances, challenges and uncertainties associated with the Coronavirus Pandemic, which include unprecedented federal government stimulus and interventions, statewide mandatory closures of nonessential businesses and periodic changes to such and our ability to provide payment deferral programs to commercial and retail borrowers without the interjection of troubled debt restructuring accounting rules. We review a myriad of items when assessing this new environmental factor, including virus infection rates, economic outlooks, employment data, business closures, foreclosures, payment deferments and government-sponsored stimulus programs. Impacting all loan portfolio segments, the establishment of the Covid-19 factor added $3.9 million to the required allowance level.

During the third quarter, we completed a comprehensive review of risk ratings assigned to many commercial loan relationships, especially those operating in lines of business that were hardest hit by the Coronavirus Pandemic. The review resulted in loan rating downgrades of 159 of the reviewed relationships (eight of which were moved to the watch list), and an increase to the required allowance of approximately $3.0 million.

During the fourth quarter, we made further changes to several environmental factors, including loan review, value of underlying collateral dependent commercial loans and the Covid-19 factor. For the loan review environmental factor, we lowered the trend from slightly deteriorating to moderately deteriorating to reflect a reduction in the level of commercial loans being review by our loan review function, in large part reflecting personnel within that department spending a significant amount of time administering our PPP activities. This change impacted the commercial loan portfolio segment, and increased the required allowance by $0.7 million. We lowered the trend rating of the value of underlying collateral dependent commercial loans from relatively stable to slightly deteriorating to reflect valuation softness we have noticed in our larger markets. Impacting only the owner-occupied CRE and non-owner occupied CRE portfolio segments, this change increased the required allowance by $1.7 million. Reflecting the ongoing uncertainty associated with the Coronavirus Pandemic, including increased infections and the apparently slow roll-out of the vaccine, we lowered the impact rating on the Covid-19 factor from moderate to moderate-to-high. This change impacted all loan portfolio segments, and added $1.4 million to the required allowance level.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and the timeliness of scheduled payments. We have a policy of requesting and reviewing periodic financial statements from commercial loan customers, and we have a disciplined and formalized review of the existence of collateral and its value. The primary risk element with respect to each residential real estate loan and consumer loan is the timeliness of scheduled payments. We have a reporting system that monitors past due loans and have adopted policies to pursue creditors' rights in order to preserve our collateral position.

The allowance for loans equaled $38.0 million as of December 31, 2020, or 1.2% of total loans outstanding. The allowance for loans equaled 0.8% of total loans at year-end 2019. As of December 31, 2020, the allowance for loans was comprised of $37.4 million in general reserves relating to non-impaired loans and $0.6 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings.

Although we believe the allowance is adequate to absorb losses as they arise, there can be no assurance that we will not sustain losses in any given period that could be substantial in relation to, or greater than, the size of the allowance.

Troubled debt restructurings totaled $23.6 million at December 31, 2020, consisting of $0.5 million that are on nonaccrual status and $23.1 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, is not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of $1.3 million as of December 31, 2020 had been subject to previous partial charge-offs aggregating $1.2 million. Those partial charge-offs were recorded as follows: $0.2 million in 2020, less than $0.1 million in 2019, 2018, 2017, 2015, 2014, 2013, 2012 and 2010, $0.1 million in 2016 and $0.3 million in 2011. As of December 31, 2020, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled less than $0.1 million.

The following table provides a breakdown of our loans categorized as troubled debt restructurings:

	12/31/20	12/31/19	12/31/18	12/31/17	12/31/16
Performing	$ 23,133,000	$ 11,788,000	$ 19,223,000	$ 6,128,000	$ 12,480,000
Nonperforming	510,000	353,000	229,000	2,434,000	1,132,000
Total	$ 23,643,000	$ 12,141,000	$ 19,452,000	$ 8,562,000	$ 13,612,000

Securities available for sale increased $52.7 million during 2020, totaling $387 million as of December 31, 2020. The securities portfolio equaled 8.4% of average earning assets during 2020, compared to 10.3% during 2019. During 2020, purchases of U.S. Government agency bonds totaled $345 million, in part reflecting the reinvestment of funds from $289 million in called U.S. Government agency bonds and $17.7 million in principal paydowns on U.S. Government agency issued or guaranteed mortgage-backed securities. Municipal bond purchases aggregated $24.8 million, with municipal bond maturities and calls totaling $12.9 million. No bonds were sold during 2020. At December 31, 2020, the securities portfolio was primarily comprised of U.S. Government agency bonds (63%), municipal bonds (31%) and U.S. Government agency issued or guaranteed mortgage-backed securities (6%). All of our securities are currently designated as available for sale, and therefore are stated at fair value. The fair value of securities designated as available for sale at December 31, 2020 totaled $387 million, including a net unrealized gain of $6.9 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function.

The following table reflects the composition of the securities portfolio:

	12/31/20		12/31/19		12/31/18	
	Carrying Value	Percent	Carrying Value	Percent	Carrying Value	Percent
U.S. Government agency debt obligations	$242,141,000	62.5%	$186,410,000	55.7%	$187,077,000	55.5%
Mortgage-backed securities	24,890,000	6.4	42,470,000	12.7	43,658,000	12.9
Municipal general obligations	107,824,000	27.9	101,079,000	30.2	102,497,000	30.4
Municipal revenue bonds	11,992,000	3.1	4,196,000	1.3	3,634,000	1.1
Other investments	500,000	0.1	500,000	0.1	500,000	0.1
Totals	$387,347,000	100.0%	$334,655,000	100.0%	$337,366,000	100.0%

FHLBI stock totaled $18.0 million as of December 31, 2020, unchanged from the balance at December 31, 2019. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We continue to receive regular quarterly cash dividends, and we expect a cash dividend will continue in future quarterly periods.

Market values on our U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies and municipal bonds are determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of certain non-rated securities issued by relatively small municipalities generally located within our markets is estimated at carrying value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with the requirements of accounting guidelines. Reference is made to Note 17 of the Notes to Consolidated Financial Statements for additional information.

The following table shows by class of maturities as of December 31, 2020, the amounts and weighted average yields (on a fully taxable-equivalent basis) of investment securities:

	Carrying Value	Average Yield
Obligations of U.S. Government agencies:		
One year or less	$ 0	NA
Over one through five years	64,597,000	0.52%
Over five through ten years	118,002,000	1.12
Over ten years	59,542,000	1.90
	242,141,000	1.15
Obligations of states and political subdivisions:		
One year or less	5,939,000	2.52
Over one through five years	29,877,000	2.61
Over five through ten years	62,539,000	2.84
Over ten years	21,461,000	2.58
	119,816,000	2.72
Mortgage-backed securities	24,890,000	2.10
Other investments	500,000	4.13
Totals	$ 387,347,000	1.70%

Interest-earning deposit balances, primarily consisting of excess funds deposited with the Federal Reserve Bank of Chicago and a correspondent bank, are used to manage daily liquidity needs and interest rate sensitivity. The average balance of these funds equaled $357 million, or 9.2% of average earning assets during 2020, compared to a more typical $115 million, or 3.4%, during 2019. The higher level during 2020 reflects increased local deposit balances, primarily a product of federal government stimulus programs as well as lower business and individual investing and spending. We anticipate the level of interest-earning deposit balances to remain elevated throughout at least a majority of 2021 given the conditions associated with the Coronavirus Pandemic.

Non-Earning Assets

Cash and due from bank balances averaged 1.4% of total assets during 2020, similar to the average level during 2019, and no significant changes are expected in future periods. Net premises and equipment increased $1.6 million during 2020, equaling $59.0 million as of December 31, 2020, or 1.3% of total assets. Net purchases during 2020 totaled $9.0 million, in large part reflecting the construction and opening of a new regional banking center in Mt. Pleasant, Michigan and a new banking facility in Clare, Michigan. Depreciation expense during 2020 totaled $5.2 million. Banking facility closures resulted in a $2.2 million reduction in net premises and equipment during 2020.

Foreclosed and repossessed assets totaled $0.7 million at December 31, 2020, compared to $0.5 million at December 31, 2019. Almost the entire balance at year-end 2020 consisted of properties that were former banking office facilities that were closed during 2020. Although we expect periodic transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on certain impaired lending relationships, we believe the strong quality of our loan portfolio will limit any overall increase in, and average balance of, this nonperforming asset category.

Source of Funds
Total deposits increased $721 million during 2020, totaling $3.41 billion as of December 31, 2020. Local deposits increased $808 million, while out-of-area deposits decreased $86.5 million during 2020. As a percent of total deposits, out-of-area deposits declined from 5.0% at December 31, 2019 to 1.4% as of year-end 2020. FHLBI advances increased $40.0 million during 2020, totaling $394 million as of December 31, 2020.

Noninterest-bearing checking accounts increased $508 million during 2020, while interest-bearing checking accounts and money market deposit accounts increased $141 million and $103 million, respectively. The increases in these transactional deposit products largely reflect federal government stimulus, especially the PPP, as well as lower business investing and spending. Savings deposits were up $68.8 million during 2020, primarily reflecting the impact of federal government stimulus programs and lower consumer investing and spending. Local time deposits decreased $12.8 million, generally reflecting the maturities of certain time deposits that were not renewed as we did not aggressively seek to renew these time deposits that were opened as part of a special time deposit campaign we ran during the early part of 2019, which more than offset new time deposits from several municipal deposit customers. The reduction in out-of-area deposits during 2020 reflects maturities not replaced as the funds were no longer needed.

Sweep accounts increased $15.7 million during 2020, totaling $118 million as of December 31, 2020. The average balance of sweep accounts equaled $133 million during 2020. The aggregate balance of this funding type can be subject to relatively large daily fluctuations given the nature of the customers utilizing this product and the sizable balances that many of the customers maintain. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

FHLBI advances increased $40.0 million during 2020, reflecting new advances obtained primarily to replace advance maturities and manage interest rate risk. FHLBI advances totaled $394 million as of December 31, 2020. In June 2020, we executed a blend and extend transaction with the FHLBI to extend the duration of the FHLBI advance portfolio as part of our interest rate risk management program. We prepaid seven advances aggregating $70.0 million with maturities ranging from August 2020 through October 2021 and fixed interest rates from 1.36% to 2.84% and averaging 1.97%, using the proceeds from seven new advances aggregating $70.0 million with maturities ranging from June 2024 through June 2027 and fixed interest rates from 0.55% to 1.18% and averaging 0.84%. Prepayment fees totaling $0.9 million were embedded into the fixed rates on the newly obtained advances, equating to 0.22% of the 0.84% average rate of the new advances. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on certain commercial real estate property loans, and substantially all other assets of our bank under a blanket lien arrangement. Our borrowing line of credit at year-end 2020 totaled $754 million, with remaining availability based on collateral of $354 million.

Shareholders' equity increased $25.0 million during 2020, totaling $442 million as of December 31, 2020. Positively impacting shareholders' equity was net income of $44.1 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling $17.9 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of $3.6 million. Share repurchases reduced shareholders' equity by $6.6 million during 2020. Positively impacting shareholders' equity during 2020 was a $1.8 million after-tax increase in the market value of available for sale securities.

RESULTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2020 and 2019

Summary
We recorded net income of $44.1 million, or $2.71 per basic and diluted share, for 2020, compared to net income of $49.5 million, or $3.01 per basic and diluted share, for 2019. The net impact of a gain on the sale of a former branch facility and write-downs of former branch facilities decreased net income during 2020 by approximately $1.1 million, or $0.07 per diluted share. Bank owned life insurance claims and the net impact of gains and losses on sales and write-downs of former branch facilities increased net income during 2019 by approximately $2.7 million, or $0.16 per diluted share. Excluding the impacts of these transactions, diluted earnings per share decreased $0.07, or 2.5%, during 2020 compared to 2019.

The lower level of net income during 2020 compared to 2019 resulted from higher provision expense and noninterest expense and decreased net interest income, which more than offset increased noninterest income. The loan loss reserve build during 2020, which primarily reflected increased allocations associated with changes in certain environmental factors and an allocation related to a newly-created Covid-19 pandemic environmental factor, was viewed as a precautionary measure to guard against any potential deterioration in the quality of the loan portfolio stemming from the pandemic and associated weakened economic conditions. The higher level of noninterest expense mainly reflected increased compensation, occupancy, furniture and equipment, and FDIC insurance premium costs, along with increased write-downs of former branch facilities. The decline in net interest income depicted a lower yield on earning assets, which more than offset the positive impact of growth in earning assets. The improved noninterest income primarily reflected increased mortgage banking income.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2020 and 2019:

	2020	2019
Return on average assets	1.07%	1.39%
Return on average shareholders' equity	10.32%	12.52%
Average shareholders' equity to average assets	10.34%	11.09%

Net Interest Income

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled $149 million and $26.1 million during 2020, respectively, providing for net interest income of $122 million. During 2019, interest income and interest expense equaled $159 million and $33.8 million, respectively, providing for net interest income of $125 million. In comparing 2020 with 2019, interest income decreased 6.3%, interest expense was down 22.9%, and net interest income declined 1.8%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The $2.3 million decrease in net interest income in 2020 compared to 2019 resulted from a lower net interest margin, which more than offset an increased level of average earning assets. During 2020, the net interest margin equaled 3.15%, down from 3.75% during 2019 due to a lower yield on average earning assets, which more than offset a reduction in the cost of funds. The lower yield on average earning assets mainly resulted from a decreased yield on commercial loans, primarily reflecting reduced interest rates on variable-rate loans stemming from the Federal Open Market Committee ("FOMC") significantly lowering the targeted federal funds rate by a total of 225 basis points during the last six months of 2019 and the first three months of 2020. The decreased cost of funds mainly reflected lower interest rates paid on local deposit accounts and borrowings, reflecting the declining interest rate environment. A change in funding mix, consisting of an increase in lower-cost non-time deposits as a percentage of total funding sources, also contributed to the decreased cost of funds. During 2020, earning assets averaged $3.89 billion, representing an increase of $563 million, or 16.9%, from the $3.33 billion average during 2019. Average loans increased $338 million, and average interest-earning deposits were up $242 million, while average securities decreased $16.5 million. The increase in average loans primarily depicted PPP loan originations of approximately $554 million during 2020; PPP loans averaged approximately $370 million during the year.

The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2020, 2019 and 2018. The subsequent table also depicts the dollar amount of change in interest income and interest expense of interest-earning assets and interest-bearing liabilities, respectively, segregated between change due to volume and change due to rate. Tax-exempt securities interest income and yield for 2020, 2019 and 2018 have been computed on a tax equivalent basis using a marginal tax rate of 21.0%. Securities interest income was increased by $0.2 million in both 2020 and 2019, and $0.3 million in 2018, for this non-GAAP, but industry standard, adjustment. These adjustments equated to one basis point increases in our net interest margin during all three years.

(Dollars in thousands)	Years ended December 31,								
	2020			2019			2018		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Taxable securities	$ 236,097	$ 7,740	3.28%	$ 259,221	$ 7,919	3.05%	$ 233,372	$ 6,736	2.89%
Tax-exempt securities	106,935	2,538	2.37	100,291	2,471	2.46	110,514	2,509	2.27
Total securities	343,032	10,278	3.00	359,512	10,390	2.89	343,886	9,245	2.69
Loans	3,190,742	137,399	4.31	2,853,021	145,816	5.11	2,628,906	131,763	5.01
Interest-earning deposits	356,501	876	0.25	114,527	2,371	2.07	69,559	1,243	1.79
Total earning assets	3,890,275	148,553	3.82	3,327,060	158,577	4.77	3,042,351	142,251	4.68
Allowance for loan losses	(30,164)			(23,914)			(21,173)		
Cash and due from banks	58,345			53,151			48,207		
Other non-earning assets	215,112			205,348			203,252		
Total assets	$4,133,568			$3,561,645			$3,272,637		
Interest-bearing checking accounts	$ 392,053	$ 1,263	0.32%	$ 315,735	$ 529	0.17%	$ 359,371	$ 552	0.15%
Savings deposits	297,825	185	0.06	276,852	319	0.12	320,387	381	0.12
Money market accounts	542,967	1,968	0.36	485,044	5,664	1.17	474,651	5,322	1.12
Time deposits	590,421	11,568	1.96	644,904	14,752	2.29	478,741	7,614	1.59
Total interest-bearing deposits	1,823,266	14,984	0.82	1,722,535	21,264	1.23	1,633,150	13,869	0.85
Short-term borrowings	137,658	173	0.13	106,630	295	0.28	102,076	273	0.27
Federal Home Loan Bank advances	386,896	8,571	2.22	369,688	8,977	2.43	239,068	4,647	1.94
Other borrowings	49,792	2,339	4.70	49,427	3,267	6.61	49,048	3,110	6.34
Total interest-bearing liabilities	2,397,612	26,067	1.09	2,248,280	33,803	1.50	2,023,342	21,899	1.08
Checking accounts	1,291,542			902,180			863,384		
Other liabilities	16,909			16,272			15,115		
Total liabilities	3,706,063			3,166,732			2,901,841		
Average equity	427,505			394,913			370,796		
Total liabilities and equity	$4,133,568			$3,561,645			$3,272,637		
Net interest income		$122,486			$124,774			$ 120,352	
Rate spread			2.73%			3.27%			3.60%
Net interest margin			3.15%			3.75%			3.96%

	Years ended December 31,					
	2020 over 2019			2019 over 2018		
	Total	Volume	Rate	Total	Volume	Rate
Increase (decrease) in interest income						
Taxable securities	$ (179,000)	$ (735,000)	$ 556,000	$ 1,183,000	$ 711,000	$ 472,000
Tax exempt securities	67,000	160,000	(93,000)	(38,000)	(189,000)	151,000
Loans	(8,417,000)	16,094,000	(24,511,000)	14,053,000	11,413,000	2,640,000
Interest-earning deposit balances	(1,495,000)	1,894,000	(3,389,000)	1,128,000	906,000	222,000
Net change in tax-equivalent interest income	(10,024,000)	17,413,000	(27,437,000)	16,326,000	12,841,000	3,485,000
Increase (decrease) in interest expense						
Interest-bearing demand deposits	734,000	152,000	582,000	(23,000)	(71,000)	48,000
Savings deposits	(134,000)	23,000	(157,000)	(62,000)	(50,000)	(12,000)
Money market accounts	(3,696,000)	607,000	(4,303,000)	342,000	118,000	224,000
Time deposits	(3,184,000)	(1,180,000)	(2,004,000)	7,138,000	3,155,000	3,983,000
Short-term borrowings	(122,000)	70,000	(192,000)	22,000	12,000	10,000
Federal Home Loan Bank advances	(406,000)	405,000	(811,000)	4,330,000	2,974,000	1,356,000
Other borrowings	(928,000)	24,000	(952,000)	157,000	24,000	133,000
Net change in interest expense	(7,736,000)	101,000	(7,837,000)	11,904,000	6,162,000	5,742,000
Net change in tax-equivalent net interest income	$ (2,288,000)	$17,312,000	$(19,600,000)	$ 4,422,000	$ 6,679,000	$(2,257,000)

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income decreased $10.0 million during 2020 from that earned in 2019, totaling $149 million in 2020 compared to $159 million in the previous year. The decrease in interest income is attributable to a lower yield on average earning assets, which more than offset the positive impact of an increased level of average earning assets. During 2020 and 2019, earning assets had an average yield (tax equivalent-adjusted basis) of 3.82% and 4.77%, respectively. The lower yield on average earning assets mainly resulted from a decreased yield on commercial loans, primarily reflecting reduced interest rates on variable-rate loans stemming from the previously-mentioned FOMC rate cuts. A change in earning asset mix and a decreased yield on interest-earning deposits also contributed to the lower yield on average earning assets. On average, lower-yielding interest-earning deposits represented 9.2% of earning assets during 2020, up from 3.4% during 2019, while higher-yielding loans represented 82.0% of earning assets during 2020, down from 85.8% during 2019. The significant increase in interest-earning deposits during 2020 primarily reflected increased local deposits stemming from federal government stimulus programs as well as lower business and consumer investing and spending. The yield on interest-earning deposits was 0.25% during 2020, down from 2.07% during 2019, mainly reflecting the decreased interest rate environment. Accelerated discount accretion on called U.S. Government agency bonds totaling $3.0 million was recorded as interest income during 2020. The accelerated discount accretion positively impacted the yield on average earning assets during 2020 by eight basis points.

Interest income generated from the loan portfolio decreased $8.4 million in 2020 compared to the level earned in 2019; a decrease in loan yield from 5.11% in 2019 to 4.31% in 2020 resulted in a $24.5 million decline in interest income, while growth in the loan portfolio during 2020 resulted in a $16.1 million increase in interest income. The lower yield on loans mainly resulted from a decreased yield on commercial loans, which equaled 4.35% during 2020, down from 5.21% during 2019 primarily due to the aforementioned FOMC rate cuts during the last six months of 2019 and first three months of 2020.

Interest income generated from the securities portfolio decreased $0.1 million in 2020 compared to the level earned in 2019; a decrease in the average balance of the securities portfolio during 2020 resulted in a reduction in interest income of $0.6 million, while an increase in the yield on securities from 2.89% during 2019 to 3.00% during 2020 resulted in a $0.5 million increase in interest income. The increased yield on securities mainly reflected $3.0 million in accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income during 2020; accelerated discount accretion totaled $0.3 million during 2019. Interest income on interest-earning deposits decreased $1.5 million in 2020 compared to the level earned in 2019; a decline in the yield on interest-earning deposits, reflecting the decreased interest rate environment, resulted in a $3.4 million reduction in interest income, while growth in these balances resulted in a $1.9 million increase in interest income. The increase in average interest-earning deposits during 2020 primarily stemmed from growth in local deposits.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from borrowed funds. Interest expense decreased $7.7 million during 2020 from that expensed in 2019, totaling $26.1 million in 2020 compared to $33.8 million in the previous year. The decrease in interest expense resulted from a lower cost of funds, which more than offset an increase in the average balance of interest-bearing liabilities. During 2020 and 2019, interest-bearing liabilities had a weighted average rate of 1.09% and 1.50%, respectively; a decrease in interest expense of $7.8 million was recorded during 2020 due to the lower cost of funds. Average interest-bearing liabilities were $2.40 billion during 2020, up $149 million, or 6.6%, from the $2.25 billion average during 2019; the growth in average interest-bearing liabilities resulted in an increase in interest expense of $0.1 million. The lower average cost of interest-bearing liabilities resulted from decreased costs of local deposits and borrowings and a change in funding mix. The cost of interest-bearing non-time deposit accounts decreased from 0.60% during 2019 to 0.28% during 2020, primarily reflecting lower interest rates paid on money market accounts; the reduced interest rates mainly reflected the decreased interest rate environment. The cost of time deposits declined from 2.29% during 2019 to 1.96% during 2020 due to lower rates paid on local time deposits, depicting the decreased interest rate environment, and a change in composition, mainly reflecting a decline in higher-cost brokered funds. The cost of borrowed funds decreased from 2.39% during 2019 to 1.93% during 2020, mainly reflecting lower costs of subordinated debentures and FHLBI advances, along with a change in borrowing mix. The cost of subordinated debentures was 4.80% during 2020, down from 6.77% during 2019 due to decreases in the 90-Day Libor Rate. The cost of FHLBI advances was 2.22% during 2020, down from 2.43% during 2019, primarily reflecting the declining interest rate environment and the impact of a blend and extend transaction that was executed in June 2020. The blend and extend transaction with the FHLBI, which extended the duration of our FHLBI advance portfolio as part of our interest rate risk management program, consisted of us prepaying seven advances aggregating $70.0 million with maturities ranging from August 2020 through October 2021 and fixed interest rates from 1.36% to 2.84% and averaging 1.97%, using the proceeds from seven new advances aggregating $70.0 million with maturities ranging from June 2024 through June 2027 and fixed interest rates from 0.55% to 1.18% and averaging 0.84%. Average lower-cost sweep accounts represented 23.1% and 20.0% of average total borrowings during 2020 and 2019, respectively, while average higher-cost FHLBI advances represented 67.4% and 70.3% of average total borrowings during the respective time periods.   A change in funding mix, consisting of an increase in average lower-cost interest-bearing non-time deposits and a decrease in average higher-cost time deposits as a percentage of average total interest-bearing liabilities, also contributed to the lower weighted average cost of interest-bearing liabilities during 2020 compared to 2019.

A lower average rate paid on interest-bearing non-time deposits during 2020 resulted in a $3.9 million decrease in interest expense, while a $155 million increase in the average balance of these deposits equated to a $0.8 million increase in interest expense. A lower average rate paid on time deposits during 2020 resulted in a $2.0 million decrease in interest expense, while a $54.5 million decrease in the average balance of time deposits equated to a $1.2 million reduction in interest expense. A decreased average rate paid on short-term borrowings, which are comprised almost entirely of sweep accounts, during 2020 resulted in a $0.2 million decline in interest expense, while a $31.0 million increase in the average balance of these borrowings resulted in a $0.1 million increase in interest expense. A lower average rate paid on average FHLBI advances during 2020 resulted in a $0.8 million reduction in interest expense, while a $17.2 million increase in the average balance of advances resulted in a $0.4 million increase in interest expense. A slight increase in average other borrowings during 2020 resulted in a nominal increase in interest expense, while a decreased average rate paid on the borrowings resulted in a $1.0 million decline in interest expense.

Provision for Loan Losses
A loan loss provision expense of $14.1 million was recorded in 2020, compared to a provision expense of $1.8 million recorded in 2019. Approximately 80% of the provision expense recorded during 2020 consisted of increased allocations associated with existing environmental factors, including economic and business conditions, loan review, and value of underlying collateral dependent loans, and an allocation stemming from the creation of a Covid-19 pandemic environmental factor. The Covid-19 pandemic environmental factor, developed during the second quarter of 2020, is designed to address the unique challenges and economic uncertainty resulting from the pandemic and its potential impact on the collectability of the loan portfolio. The provision expense recorded during 2020 also reflected the downgrading of certain non-impaired commercial loan relationships, most of which occurred during the third quarter. The provision expense recorded during 2019 primarily reflected ongoing net loan growth, as well as an increased allocation related to a change in the nature and volume of the consumer mortgage loan portfolio environmental factor.

During 2020, recoveries of prior-period loan charge-offs totaling $0.9 million slightly exceeded loan charge-offs, providing for a nominal level of net loan recoveries. During 2019, loan charge-offs totaled $0.9 million, while recoveries of prior-period loan charge-offs equaled $0.7 million, providing for net loan charge-offs of $0.2 million, or an annualized 0.01% of average total loans. The allowance for loans, as a percentage of total loans, was 1.2% as of December 31, 2020, and 0.8% as of December 31, 2019. Excluding PPP loans, the allowance for loans represented 1.3% of total loans as of December 31, 2020.

Noninterest Income
Noninterest income during 2020 was $45.2 million, compared to $27.0 million during 2019. Noninterest income during 2019 included bank owned life insurance claims totaling $2.6 million and gains on the sales of former branch facilities totaling $0.8 million. Excluding these transactions, noninterest income increased $21.7 million, or 92.1%, during 2020 compared to 2019. The improved level of noninterest income primarily resulted from increased mortgage banking income stemming from a sizeable upturn in refinance activity spurred by a decrease in residential mortgage loan interest rates, a higher level of purchase activity, the continuing success of strategic initiatives that were implemented to gain market share, and an increase in the percentage of originated loans being sold. Mortgage banking income totaled $29.3 million during 2020, representing an increase of $20.9 million, or nearly 246%, from the $8.5 million earned during 2019. We originated $864 million in residential mortgage loans during 2020, which was approximately 135% higher than originations during 2019. Almost 66% of the residential mortgage loans originated during 2020 consisted of refinance transactions, compared to approximately 50% during 2019. Residential mortgage loans originated for sale, generally consisting of longer-term fixed rate residential mortgage loans, totaled $672 million, or approximately 78% of total mortgage loans originated, during 2020. During 2019, residential mortgage loans originated for sale totaled $257 million, or nearly 70% of total mortgage loans originated. Fee income generated from an interest rate swap program that was implemented during the fourth quarter of 2020 and growth in payroll processing fees also contributed to the improved noninterest income during 2020. The interest rate swap program provides certain commercial borrowers with a longer-term fixed-rate option and assists us in managing associated longer-term interest rate risk. Service charges on accounts and credit and debit card income during 2020, which were negatively impacted by Covid-19 pandemic-related events, including business shutdowns and stay-at-home orders, approximated 2019 levels.

Noninterest Expense
Noninterest expense totaled $98.5 million during 2020, compared to $89.3 million during 2019. Overhead costs during 2020 included write-downs of former branch facilities totaling $1.4 million, while overhead costs during 2019 included a loss on the sale of a former branch facility of $0.5 million and a write-down of a former branch facility of $0.1 million. Excluding these transactions, noninterest expense increased $8.5 million, or 9.6%, during 2020 compared to 2019. The higher level of expense primarily resulted from increased salary and benefit costs, which were up a combined $6.0 million in 2020 compared to 2019. The increased salary expense mainly reflected higher residential mortgage lender commissions and related incentives, as well as annual employee merit pay increases and a larger bonus accrual, while the increased benefit expense primarily reflected higher insurance costs. The higher level of commissions and associated incentives primarily depicted the significant increase in residential mortgage loan originations during 2020. Occupancy and equipment and furniture costs were up $1.7 million on a combined basis during 2020 compared to 2019, mainly reflecting increased depreciation expense associated with an expansion of our main office that was completed during the latter part of 2019. Data processing costs increased $1.2 million during 2020 compared to 2019, primarily depicting growth in transaction volume, new product offerings, and stay-at-home efforts and activities, including providing employees with access to work computers while working remotely. FDIC insurance premiums increased $0.9 million in 2020 compared to 2019, mainly reflecting deposit insurance assessment credits being applied against regular assessments during 2019.

As part of a branch network efficiency plan, we closed three branches during the fourth quarter of 2020. As a result of these branch network efficiency actions, we recorded pre-tax charges of $0.3 million for severance-related payments and $1.4 million for valuation adjustments during 2020. Annual pre-tax savings of approximately $0.7 million are anticipated as a result of these actions.

Federal Income Tax Expense

During 2020, we recorded income before federal income tax of $54.8 million and a federal income tax expense of $10.7 million, compared to income before federal income tax of $60.5 million and a federal income tax expense of $11.0 million during 2019. The decrease in federal income tax expense in 2020 compared to 2019 resulted from the lower level of income before federal income tax. Our effective tax rate was 19.5% during 2020, compared to 18.2% during 2019. The aforementioned nontaxable bank owned life insurance claims positively impacted the effective tax rate in 2019.

RESULTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2019 and 2018

Summary

We recorded net income of $49.5 million, or $3.01 per basic and diluted share, for 2019, compared to net income of $42.0 million, or $2.53 per basic and diluted share, for 2018. Bank owned life insurance claims and the net impact of gains and losses on sales and write-downs of former branch facilities increased reported net income during 2019 by approximately $2.7 million, or $0.16 per diluted share. Interest income related to purchased loan accounting entries increased net income during 2019 by $1.1 million, or $0.07 per diluted share, and net income during 2018 by $3.2 million, or $0.19 per diluted share. Excluding the impacts of these transactions, diluted earnings per share increased $0.44, or 18.8%, during 2019 compared to 2018.

Our earnings performance in 2019 benefited from increased net interest income and noninterest income, which more than offset increased provision expense and noninterest expense. The improved net interest income resulted from a higher level of earning assets. Noninterest income during 2019 included bank owned life insurance claims and gains on the sales of former branch facilities, while noninterest income during 2018 included a one-time accounting adjustment related to mortgage banking activities. In addition to increasing in 2019 compared to 2018 on a reported basis, noninterest income also grew after excluding the impacts of these transactions. Growth in noninterest income primarily resulted from increased mortgage banking activity income; increases in credit and debit card income, service charges on accounts, and payroll processing revenue also contributed to the improved level of noninterest income. The amount of provision expense necessitated by net loan growth during 2018 was partially mitigated by net loan recoveries being recorded during the period, resulting in a lower provision expense during 2018 compared to 2019. The higher level of noninterest expense primarily reflects increased salary costs.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2019 and 2018:

	2019	2018
Return on average assets	1.39%	1.28%
Return on average shareholders' equity	12.52%	11.33%
Average shareholders' equity to average assets	11.09%	11.33%

Net Interest Income

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled $159 million and $33.8 million during 2019, respectively, providing for net interest income of $125 million. During 2018, interest income and interest expense equaled $142 million and $21.9 million, respectively, providing for net interest income of $120 million. In comparing 2019 with 2018, interest income increased 11.5%, interest expense was up 54.4%, and net interest income increased 3.7%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The $4.4 million increase in net interest income in 2019 compared to 2018 resulted from an increased level of average earning assets, which more than offset a lower net interest margin. During 2019, earning assets averaged $3.33 billion, or $285 million higher than average earning assets during 2018. Average loans increased $224 million, average interest-earning deposits increased $45.0 million, and average securities increased $15.6 million. During 2019, the net interest margin equaled 3.75%, down from 3.96% during 2018 due to a higher cost of funds, which more than offset an increased yield on average earning assets. The higher cost of funds primarily resulted from increased costs of time deposits and borrowed funds and a change in funding mix. The improved yield on average earning assets mainly resulted from an increased yield on commercial loans, primarily reflecting higher interest rates on variable-rate loans stemming from the FOMC raising the targeted federal funds rate by 25 basis points on four occasions during 2018. The positive impact of these rate increases more than offset the negative impact of decreased interest rates on variable-rate commercial loans resulting from the FOMC lowering the targeted federal funds rate by 25 basis points on three occasions during the last six months of 2019.

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income increased $16.3 million during 2019 from that earned in 2018, totaling $159 million in 2019 compared to $142 million in the previous year. The increase in interest income is attributable to an increased level of, and a higher yield on, average earning assets. During 2019 and 2018, earning assets had an average yield (tax equivalent-adjusted basis) of 4.77% and 4.68%, respectively. The improved yield on average earning assets mainly resulted from an increased yield on commercial loans, primarily reflecting higher interest rates on variable-rate loans stemming from the previously-mentioned FOMC rate hikes. Increased yields on securities and interest-earning deposit balances also contributed to the higher yield on average earning assets.

Interest income generated from the loan portfolio increased $14.1 million in 2019 compared to the level earned in 2018; growth in the loan portfolio during 2019 resulted in an $11.4 million increase in interest income, while an increase in loan yield from 5.01% in 2018 to 5.11% in 2019 resulted in a $2.7 million increase in interest income. The higher yield on loans mainly resulted from an increased yield on commercial loans. The yield on commercial loans equaled 5.21% during 2019, up from 5.11% during 2018 primarily due to the FOMC rate hikes in 2018. Interest income related to purchased loan accounting entries totaled $1.4 million in 2019, compared to $4.0 million in 2018.

Interest income generated from the securities portfolio increased $1.1 million in 2019 compared to the level earned in 2018; an increase in the yield on securities from 2.69% during 2018 to 2.89% during 2019 resulted in a $0.6 million increase in interest income, while an increase in the average balance of the securities portfolio resulted in an increase in interest income of $0.5 million. The increased yield on securities mainly reflects $0.3 million in accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income during 2019; no accelerated discount accretion was recorded during 2018. Interest income on interest-earning deposits increased $1.1 million in 2019 compared to the level earned in 2018; a higher average balance of interest-earning deposits resulted in a $0.9 million increase in interest income, while an increase in the yield on these balances resulted in a $0.2 million increase in interest income. The growth in average interest-earning deposits during 2019 primarily stemmed from certain deposit-gathering initiatives, an increase in wholesale funds, and several large commercial loan paydowns.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from borrowed funds. Interest expense increased $11.9 million during 2019 from that expensed in 2018, totaling $33.8 million in 2019 compared to $21.9 million in the previous year. The increase in interest expense resulted from an increase in the average balance of interest-bearing liabilities and a higher cost of funds. Average interest-bearing liabilities were $2.25 billion during 2019, up $225 million, or 11.1%, from the $2.02 billion average during 2018; the growth in average interest-bearing liabilities resulted in an increase in interest expense of $6.2 million. During 2019 and 2018, interest-bearing liabilities had a weighted average rate of 1.50% and 1.08%, respectively; an increase in interest expense of $5.7 million was recorded during 2019 due to the higher cost of funds. The higher average cost of interest-bearing liabilities mainly resulted from increased costs of time deposits and borrowed funds and a change in funding mix. The cost of time deposits increased from 1.59% during 2018 to 2.29% during 2019 due to higher rates being paid on each category of time deposits, primarily reflecting the rising interest rate environment during 2018. A higher-costing time deposit special campaign, which was introduced in mid-first quarter 2019 and ended in early April 2019, also contributed to the increased cost of time deposits. The cost of borrowed funds increased from 2.06% during 2018 to 2.39% during 2019, mainly reflecting a higher cost of FHLBI advances, which equaled 2.43% and 1.94% during 2019 and 2018, respectively. The higher cost of FHLBI advances primarily reflects the rising interest rate environment during 2018 and the lengthening of the average weighted maturity of the advance portfolio. Longer-term FHLBI advances totaling $194 million were obtained during the last eight months of 2018 and first month of 2019 to meet various funding needs.

Average higher-costing time deposits and borrowed funds represented 28.7% and 23.4%, respectively, of average interest-bearing liabilities during 2019, compared to 23.7% and 19.3%, respectively, during 2018. Increased reliance on more costly wholesale funds during 2019, most of which occurred in late 2018 and January 2019, was necessitated by various funding requirements, including ongoing loan growth and seasonal deposit withdrawals by certain business customers for bonus and tax payments. Average lower-costing interest-bearing non-time deposits represented 47.9% of average interest-bearing liabilities during 2019, down from 57.0% during 2018.

A higher average rate paid on interest-bearing non-time deposits during 2019 resulted in a $0.3 million increase in interest expense, while a $76.8 million decrease in the average balance of these deposits equated to a nominal decrease in interest expense. A $4.0 million increase in interest expense during 2019 resulted from a higher average rate paid on time deposits. Average time deposits increased $166 million during 2019; the increased average balance equated to an increase in interest expense of $3.1 million. Slight increases in the average balance of, and average rate paid on, short-term borrowings, comprised almost entirely of sweep accounts, resulted in nominal increases in interest expense during 2019. Average FHLBI advances increased $131 million during 2019, resulting in a $3.0 million increase in interest expense, while a higher average rate paid on the advances resulted in a $1.3 million increase in interest expense. A $0.4 million increase in average other borrowings resulted in a nominal increase in interest expense, while a higher average rate paid on the borrowings resulted in a $0.1 million increase in interest expense.

Net interest income and the net interest margin during 2019 and 2018 were affected by purchase accounting accretion and amortization associated with fair value measurements. Increases in interest income on loans totaling $1.4 million and $4.0 million were recorded during 2019 and 2018, respectively. Purchased loan accretion amounts vary from period to period as a result of periodic cash flow re-estimations, loan payoffs, and payment performance.

Provision for Loan Losses

A loan loss provision expense of $1.8 million was recorded in 2019, compared to a provision expense of $1.1 million recorded in 2018. The provision expense recorded during both 2019 and 2018 mainly reflected ongoing net loan growth. In addition, the provision expense recorded during 2019 depicted an increased allocation related to a change in the nature and volume of the consumer mortgage loan portfolio environmental factor, while the provision expense recorded during 2018 reflected increased allocations related to changes in the competition, economic conditions, and concentrations environmental factors. The amount of provision expense necessitated by net loan growth and environmental factor changes during 2018 was partially mitigated by net loan recoveries being recorded during the period.

Net loan charge-offs of $0.2 million were recorded during 2019, while net loan recoveries of $1.8 million were recorded during 2018. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of both December 31, 2019 and December 31, 2018. Our allowance for acquired loans totaled $0.7 million and $0.8 million as of December 31, 2019 and December 31, 2018, respectively.

Noninterest Income

Noninterest income was $27.0 million during 2019, compared to $19.0 million during 2018. Noninterest income during 2019 included bank owned life insurance claims totaling $2.6 million and gains on the sales of former branch facilities totaling $0.8 million, while noninterest income during 2018 included a one-time $0.9 million accounting adjustment related to mortgage banking activities in prior years. Excluding these transactions, noninterest income increased $5.4 million, or 29.9%, during 2019 compared to 2018. The improved level of noninterest income in 2019 compared to 2018 primarily resulted from increased mortgage banking activity income stemming from the success of continuing strategic initiatives designed to increase market presence, along with a higher level of refinance activity resulting from a decrease in residential mortgage loan interest rates and a higher percentage of originated loans being sold. Growth in credit and debit card income, service charges on accounts, and payroll processing fees also contributed to the improved level of noninterest income in 2019.

Noninterest Expense

Noninterest expense during 2019 was $89.3 million, an increase of $3.1 million, or 3.6%, from the $86.2 million expensed during 2018. The higher level of expense primarily resulted from increased salary costs, mainly reflecting annual employee merit pay increases, higher residential mortgage loan lender commissions, and increased stock-based compensation expense. Pay increases for all hourly employees, which went into effect on April 1, 2018, also contributed to the higher level of salary costs during 2019.

Data processing costs were up $0.7 million during 2019 compared to 2018 primarily due to increases in debit and credit card and internet banking expenses stemming from growth in transaction volume and new product offerings, along with increased software amortization expense mainly resulting from the implementation of certain software solutions. Occupancy and furniture and equipment costs increased $0.5 million on a combined basis in 2019 compared to 2018 mainly due to higher depreciation expense, in large part stemming from an expansion of our main office and equipment purchases. FDIC deposit insurance premiums were down $0.7 million in 2019 compared to 2018 as a result of deposit insurance credits being applied against regular assessments.

Federal Income Tax Expense

During 2019, we recorded income before federal income tax of $60.5 million and a federal income tax expense of $11.0 million, compared to income before federal income tax of $51.8 million and a federal income tax expense of $9.8 million during 2018. The increase in federal income tax expense in 2019 compared to 2018 resulted from the higher level of income before federal income tax. Our effective tax rate was 18.2% during 2019, compared to 18.9% during 2018. The aforementioned nontaxable bank owned life insurance claims positively impacted the effective tax rate in 2019.

CAPITAL RESOURCES

Shareholders' equity increased $25.0 million during 2020, totaling $442 million as of December 31, 2020. Positively impacting shareholders' equity was net income of $44.1 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling $17.9 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of $3.6 million. Share repurchases reduced shareholders' equity by $6.6 million during 2020. Positively impacting shareholders' equity during 2020 was a $1.8 million after-tax increase in the market value of available for sale securities.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. As of December 31, 2020, our bank's total risk-based capital ratio was 13.5%, compared to 13.0% at December 31, 2019. Our bank's total regulatory capital increased $32.3 million during 2020, primarily reflecting the net impact of net income totaling $49.6 million, an increase in the allowance of $14.1 million and cash dividends paid to Mercantile Bank Corporation aggregating $32.5 million. Our bank's total risk-based capital ratio was also impacted by a $114 million increase in total risk-weighted assets. As of December 31, 2020, our bank's total regulatory capital equaled $457 million, or $118 million in excess of the amount necessary to attain the 10.0% minimum total risk-based capital ratio, which is among the requirements to be categorized as "well capitalized."

We maintain a stock repurchase program, which is discussed in Part II, Item 5 "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" in this Annual Report.

LIQUIDITY

Liquidity is measured by our ability to raise funds through deposits, borrowed funds, capital or cash flow from the repayment of loans and securities. These funds are used to fund loans, meet deposit withdrawals, maintain reserve requirements and operate our company. Liquidity is primarily achieved through local and out-of-area deposits and liquid assets such as securities available for sale, matured and called securities, federal funds sold and interest-earning deposit balances. Asset and liability management is the process of managing the balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

To assist in providing needed funds, we regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and advances from the FHLBI, totaled $441 million, or 11.2% of combined deposits and borrowed funds as of December 31, 2020, compared to $487 million, or 15.5% of combined deposits and borrowed funds, as of December 31, 2019.

Sweep accounts increased $15.7 million during 2020, totaling $118 million as of December 31, 2020. The average balance of sweep accounts equaled $133 million during 2020. The aggregate balance of this funding type can be subject to relatively large daily fluctuations given the nature of the customers utilizing this product and the sizable balances that many of the customers maintain. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

Information regarding our repurchase agreements as of December 31, 2020 and during 2020 is as follows:

Outstanding balance at December 31, 2020	$ 118,365,000
Weighted average interest rate at December 31, 2020	0.12%
Maximum daily balance twelve months ended December 31, 2020	$ 173,186,000
Average daily balance for twelve months ended December 31, 2020	$ 132,880,000
Weighted average interest rate for twelve months ended December 31, 2020	0.12%

FHLBI advances increased $40.0 million during 2020, reflecting new advances obtained primarily to replace advance maturities and manage interest rate risk. FHLBI advances totaled $394 million as of December 31, 2020. In June 2020, we executed a blend and extend transaction with the FHLBI to extend the duration of the FHLBI advance portfolio as part of our interest rate risk management program. We prepaid seven advances aggregating $70.0 million with maturities ranging from August 2020 through October 2021 and fixed interest rates from 1.36% to 2.84% and averaging 1.97%, using the proceeds from seven new advances aggregating $70.0 million with maturities ranging from June 2024 through June 2027 and fixed interest rates from 0.55% to 1.18% and averaging 0.84%. Prepayment fees totaling $0.9 million were embedded into the fixed rates on the newly obtained advances, equating to 0.22% of the 0.84% average rate of the new advances. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on certain commercial real estate property loans, and substantially all other assets of our bank under a blanket lien arrangement. Our borrowing line of credit at year-end 2020 totaled $754 million, with remaining availability based on collateral of $354 million.

We also have the ability to borrow up to $70.0 million on a daily basis through correspondent banks using established unsecured federal funds purchased lines of credit. These lines of credit were not accessed during 2020. In contrast, our interest-earning deposit accounts at the Federal Reserve Bank of Chicago and a correspondent bank averaged $352 million during 2020. We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to $35.7 million at December 31, 2020. We did not utilize this line of credit during the past ten years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2020, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated maturity	$2,856,438,000	$ 0	$ 0	$ 0	$2,856,438,000
Certificates of deposit	327,246,000	179,602,000	48,267,000	0	555,115,000
Short-term borrowings	118,365,000	0	0	0	118,365,000
Federal Home Loan Bank advances	20,000,000	174,000,000	130,000,000	70,000,000	394,000,000
Subordinated debentures	0	0	0	47,563,000	47,563,000
Other borrowed money	0	0	0	2,433,000	2,433,000
Property leases	573,000	1,159,000	503,000	1,195,000	3,430,000

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. At December 31, 2020, we had a total of $1.41 billion in unfunded loan commitments and $20.5 million in unfunded standby letters of credit. Of the total unfunded loan commitments, $1.18 billion were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and $228 million were for loan commitments generally expected to close and become funded within the next 12 to 18 months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

The following table depicts our loan commitments at the end of the past three years:

	12/31/20	12/31/19	12/31/18
Commercial unused lines of credit	$ 1,019,496,000	$ 776,493,000	$ 784,895,000
Unused lines of credit secured by 1-4 family residential properties	59,396,000	60,858,000	57,378,000
Credit card unused lines of credit	72,495,000	58,199,000	47,432,000
Other consumer unused lines of credit	30,707,000	18,135,000	20,231,000
Commitments to make loans	227,558,000	101,961,000	101,517,000
Standby letters of credit	20,543,000	22,798,000	25,322,000
Total	$ 1,430,195,000	$ 1,038,444,000	$ 1,036,775,000

We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, economic or market conditions, reductions in earnings performance, declining capital levels or situations beyond our control could cause liquidity challenges. While we believe it is unlikely that a funding crisis of any significant degree is likely to materialize, we have developed a comprehensive contingency funding plan that provides a framework for meeting liquidity disruptions.

MARKET RISK ANALYSIS

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. We have only limited agricultural-related loan assets and therefore have no significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates is assumed to be insignificant. Interest rate risk is the exposure of our financial condition to adverse movements in interest rates. We derive our income primarily from the excess of interest collected on interest-earning assets over the interest paid on interest-bearing liabilities. The rates of interest we earn on our assets and owe on our liabilities generally are established contractually for a period of time. Since market interest rates change over time, we are exposed to lower profitability if we cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to our earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to our safety and soundness.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality.

We use two interest rate risk measurement techniques. The first, which is commonly referred to as GAP analysis, measures the difference between the dollar amounts of interest-sensitive assets and liabilities that will be refinanced or repriced during a given time period. A significant repricing gap could result in a negative impact to the net interest margin during periods of changing market interest rates.

The following table depicts our GAP position as of December 31, 2020:

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total
Assets:					
Commercial loans (1)	$ 444,790,000	$ 275,587,000	$1,555,114,000	$ 514,820,000	$2,790,311,000
Residential real estate loans	7,479,000	18,487,000	153,263,000	229,874,000	409,103,000
Consumer loans	1,110,000	958,000	14,115,000	761,000	16,944,000
Securities (2)	19,567,000	6,487,000	117,750,000	261,545,000	405,349,000
Interest-earning deposits	560,424,000	750,000	2,000,000	0	563,174,000
Allowance for loan losses	0	0	0	0	(37,967,000)
Other assets	0	0	0	0	290,430,000
Total assets	1,033,370,000	302,269,000	1,842,242,000	1,007,000,000	$4,437,344,000
Liabilities:					
Interest-bearing checking	473,053,000	0	0	0	473,053,000
Savings deposits	338,070,000	0	0	0	338,070,000
Money market accounts	611,912,000	0	0	0	611,912,000
Time deposits under $100,000	35,330,000	55,680,000	74,538,000	0	165,548,000
Time deposits $100,000 & over	79,500,000	156,736,000	153,331,000	0	389,567,000
Short-term borrowings	118,365,000	0	0	0	118,365,000
Federal Home Loan Bank advances	0	20,000,000	304,000,000	70,000,000	394,000,000
Other borrowed money	49,996,000	0	0	0	49,996,000
Noninterest-bearing checking	0	0	0	0	1,433,403,000
Other liabilities	0	0	0	0	21,876,000
Total liabilities	1,706,226,000	232,416,000	531,869,000	70,000,000	3,995,790,000
Shareholders' equity	0	0	0	0	441,554,000
Total liabilities & shareholders' equity	1,706,226,000	232,416,000	531,869,000	70,000,000	$4,437,344,000
Net asset (liability) GAP	$ (672,856,000)	$ 69,853,000	$1,310,373,000	$ 937,000,000	
Cumulative GAP	$ (672,856,000)	$(603,003,000)	$ 707,370,000	$1,644,370,000	
Percent of cumulative GAP to total assets	(15.2%)	(13.6%)	15.9%	37.1%	

(1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.
(2) Mortgage-backed securities are categorized by expected maturities based upon prepayment trends as of December 31, 2020.

The second interest rate risk measurement used is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, it serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates.

Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest-sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing. These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude, and frequency of interest rate changes and changes in market conditions and our strategies, among other factors.

We conducted multiple simulations as of December 31, 2020, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 100 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested dollar and percentage changes in net interest income over the next twelve months in comparison to the $115 million in net interest income projected using our balance sheet amounts and anticipated replacement rates as of December 31, 2020. The resulting estimates are generally within our policy parameters established to manage and monitor interest rate risk.

Interest Rate Scenario	Dollar Change In Net Interest Income	Percent Change In Net Interest Income
Interest rates down 100 basis points	$ (750,000)	(0.7%)
Interest rates up 100 basis points	5,880,000	5.1
Interest rates up 200 basis points	10,860,000	9.4
Interest rates up 300 basis points	15,640,000	13.6
Interest rates up 400 basis points	20,320,000	17.7

The resulting estimates have been significantly impacted by the current interest rate and economic environment, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans and out-of-area deposits, which comprise a sizable portion of our balance sheet.

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Mercantile Bank Corporation
Grand Rapids, Michigan

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Mercantile Bank Corporation (the "Company") as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2020, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2020 and 2019, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2020, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2020, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated March 5, 2021 expressed an unqualified opinion thereon.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the consolidated financial statements that was communicated or required to be communicated to the audit committee and that: (1) relate(s) to accounts or disclosures that are material to the consolidated financial statements, and (2) involved especially challenging, subjective or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing separate opinions on the critical audit matter or on the accounts or disclosures to which it relates.

Allowance for Loan Losses – General Reserve

As described in Notes 1 and 3 to the Company's consolidated financial statements, the Company has a gross loan balance of $3,216,358,000 and related allowance for loan losses ("allowance") balance of $37,967,000 at December 31, 2020. The allowance consists of loans individually and collectively evaluated for impairment. Loans collectively evaluated for impairment are grouped using similar risk characteristics using historical loss experience that is adjusted for certain qualitative environmental factors.

We identified the estimation of the qualitative environmental factors as a critical audit matter. Management's assumptions related to the qualitative environmental factors, such as economic trends, credit quality trends, valuation trends, and external factors, such as Covid-19, which are used to adjust the quantitative historical losses, are highly subjective and have a significant impact on the allowance. Auditing these assumptions involves especially challenging and subjective auditor judgment due to the extent of specialized knowledge about the industry and local economy needed to assess these assumptions.

The primary procedures we performed to address this critical audit matter included:

- Testing the design and operating effectiveness of internal controls over:
    - The completeness and accuracy of the data used by management to assess the qualitative environmental factors
    - Management's monitoring review of the conclusions related to the qualitative environmental factors and the resulting adjustment to the allowance.
- Evaluating the relevance and reliability of the data used by management to support their assessment of the qualitative environmental factors by comparing to source data.
- Performing an independent assessment of the reasonableness of qualitative environmental factors by evaluating trends in internal and external data, including using alternative source data, evaluating the impact of Covid-19, and comparing to the conclusions reached by management.

/s/ BDO USA, LLP
BDO USA, LLP

We have served as the Company's auditor since 2006.

Grand Rapids, Michigan
March 5, 2021

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Mercantile Bank Corporation
Grand Rapids, Michigan

Opinion on Internal Control over Financial Reporting

We have audited Mercantile Bank Corporation's (the "Company's") internal control over financial reporting as of December 31, 2020, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2020, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2020, and the related notes, and our report dated March 5, 2021 expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report by Mercantile Bank Corporation's Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ BDO USA, LLP
BDO USA, LLP
Grand Rapids, Michigan
March 5, 2021

REPORT BY MERCANTILE BANK CORPORATION'S MANAGEMENT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles. There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles as of December 31, 2020. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2020, Mercantile Bank Corporation maintained an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles based on those criteria.

The Company's independent auditors have issued an audit report on the effectiveness of the Company's internal control over financial reporting as found on page F-37.

Mercantile Bank Corporation

/s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
President and Chief Executive Officer

/s/ Charles E. Christmas
Charles E. Christmas
Executive Vice President, Chief Financial Officer and Treasurer

MERCANTILE BANK CORPORATION
CONSOLIDATED BALANCE SHEETS
December 31, 2020 and 2019

	2020	2019
ASSETS		
Cash and due from banks	$ 62,832,000	$ 53,262,000
Interest-earning deposits	563,174,000	180,469,000
Total cash and cash equivalents	626,006,000	233,731,000
Securities available for sale	387,347,000	334,655,000
Federal Home Loan Bank stock	18,002,000	18,002,000
Loans	3,216,358,000	2,856,667,000
Allowance for loan losses	(37,967,000)	(23,889,000)
Loans, net	3,178,391,000	2,832,778,000
Premises and equipment, net	58,959,000	57,327,000
Bank owned life insurance	72,131,000	70,297,000
Goodwill	49,473,000	49,473,000
Core deposit intangible, net	2,436,000	3,840,000
Other assets	44,599,000	32,812,000
Total assets	$ 4,437,344,000	$ 3,632,915,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$ 1,433,403,000	$ 924,916,000
Interest-bearing	1,978,150,000	1,765,468,000
Total deposits	3,411,553,000	2,690,384,000
Securities sold under agreements to repurchase	118,365,000	102,675,000
Federal Home Loan Bank advances	394,000,000	354,000,000
Subordinated debentures	47,563,000	46,881,000
Accrued interest and other liabilities	24,309,000	22,414,000
Total liabilities	3,995,790,000	3,216,354,000
Commitments and contingent liabilities (Note 13)		
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at December 31, 2020 and December 31, 2019	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,330,476 shares outstanding at December 31, 2020 and 16,425,136 shares outstanding at December 31, 2019	302,029,000	305,035,000
Retained earnings	134,039,000	107,831,000
Accumulated other comprehensive gain/(loss)	5,486,000	3,695,000
Total shareholders’ equity	441,554,000	416,561,000
Total liabilities and shareholders’ equity	$ 4,437,344,000	$ 3,632,915,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2020, 2019 and 2018

	2020	2019	2018
Interest income			
Loans, including fees	$ 137,399,000	$ 145,816,000	$ 131,763,000
Securities, taxable	7,740,000	7,919,000	6,736,000
Securities, tax-exempt	2,298,000	2,231,000	2,239,000
Other interest-earning assets	876,000	2,371,000	1,243,000
Total interest income	148,313,000	158,337,000	141,981,000
Interest expense			
Deposits	14,984,000	21,264,000	13,869,000
Short-term borrowings	173,000	295,000	273,000
Federal Home Loan Bank advances	8,571,000	8,977,000	4,647,000
Subordinated debentures and other borrowings	2,339,000	3,267,000	3,110,000
Total interest expense	26,067,000	33,803,000	21,899,000
Net interest income	122,246,000	124,534,000	120,082,000
Provision for loan losses	14,050,000	1,750,000	1,100,000
Net interest income after provision for loan losses	108,196,000	122,784,000	118,982,000
Noninterest income			
Service charges on deposit and sweep accounts	4,578,000	4,584,000	4,358,000
Mortgage banking activities	29,346,000	8,485,000	4,109,000
Credit and debit card fees	5,973,000	5,925,000	5,354,000
Payroll processing	1,745,000	1,626,000	1,462,000
Earnings on bank owned life insurance	1,214,000	3,886,000	1,287,000
Interest rate swap program fees	932,000	0	0
Letter of credit fees	268,000	278,000	245,000
Other income	1,116,000	2,172,000	2,195,000
Total noninterest income	45,172,000	26,956,000	19,010,000
Noninterest expense			
Salaries and benefits	59,799,000	53,833,000	50,910,000
Occupancy	7,950,000	7,061,000	6,711,000
Furniture and equipment rent, depreciation and maintenance	3,350,000	2,583,000	2,470,000
Data processing	10,440,000	9,235,000	8,557,000
Advertising	1,292,000	1,446,000	1,648,000
FDIC insurance costs	1,138,000	225,000	930,000
Other expense	14,551,000	14,897,000	14,944,000
Total noninterest expenses	98,520,000	89,280,000	86,170,000
Income before federal income tax expense	54,848,000	60,460,000	51,822,000
Federal income tax expense	10,710,000	11,004,000	9,798,000
Net income	$ 44,138,000	$ 49,456,000	$ 42,024,000
Earnings per common share:			
Basic	$ 2.71	$ 3.01	$ 2.53
Diluted	$ 2.71	$ 3.01	$ 2.53

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2020, 2019 and 2018

	2020	2019	2018
Net income	$ 44,138,000	$ 49,456,000	$ 42,024,000
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale	2,268,000	15,106,000	(4,225,000)
Fair value of interest rate swap	0	0	2,000
Total other comprehensive income (loss)	2,268,000	15,106,000	(4,223,000)
Tax effect of unrealized holding gains (losses) on securities available for sale	(477,000)	(3,172,000)	846,000
Tax effect of fair value of interest rate swap	0	0	(1,000)
Total tax effect of other comprehensive income (loss)	(477,000)	(3,172,000)	845,000
Other comprehensive income (loss), net of tax effect	1,791,000	11,934,000	(3,378,000)
Comprehensive income	**$ 45,929,000**	**$ 61,390,000**	**$ 38,646,000**

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2020, 2019 and 2018

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
Balances, January 1, 2018	$ 0	$ 309,772	$ 61,001	$ (4,903)	$ 365,870
Reclassification of equity securities related to ASU 2016-01 adoption			(42)	42	0
Employee stock purchase plan (1,579 shares)		52			52
Dividend reinvestment plan (37,450 shares)		1,165			1,165
Stock option exercises (11,481 shares)		108			108
Stock grants to directors for retainer fees (12,404 shares)		441			441
Stock-based compensation expense		2,410			2,410
Share repurchase program (199,905 shares)		(5,943)			(5,943)
Cash dividends ($1.68 per common share)			(27,500)		(27,500)
Net income for 2018			42,024		42,024
Change in net unrealized gain/(loss) on securities available for sale, net of tax effect				(3,379)	(3,379)
Change in fair value of interest rate swap, net of tax effect				1	1
Balances, December 31, 2018	$ 0	$ 308,005	$ 75,483	$ (8,239)	$ 375,249

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)
Years ended December 31, 2020, 2019 and 2018

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
Balances, January 1, 2019	$ 0	$ 308,005	$ 75,483	$ (8,239)	$ 375,249
Employee stock purchase plan (1,507 shares)		50			50
Dividend reinvestment plan (21,503 shares)		729			729
Stock option exercises (8,200 shares)		128			128
Stock grants to directors for retainer fees (11,905 shares)		375			375
Stock-based compensation expense		2,931			2,931
Share repurchase program (233,300 shares)		(7,183)			(7,183)
Cash dividends ($1.06 per common share)			(17,108)		(17,108)
Net income for 2019			49,456		49,456
Change in net unrealized gain/(loss) on securities available for sale, net of tax effect				11,934	11,934
Balances, December 31, 2019	$ 0	$ 305,035	$ 107,831	$ 3,695	$ 416,561

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)
Years ended December 31, 2020, 2019 and 2018

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
Balances, January 1, 2020	$ 0	$ 305,035	$ 107,831	$ 3,695	$ 416,561
Employee stock purchase plan (2,264 shares)		49			49
Dividend reinvestment plan (35,479 shares)		814			814
Stock option exercises, net (753 shares)		3			3
Stock grants to directors for retainer fees (17,716 shares)		394			394
Stock-based compensation expense		2,325			2,325
Share repurchase program (236,393 shares)		(6,591)			(6,591)
Cash dividends ($1.12 per common share)			(17,930)		(17,930)
Net income for 2020			44,138		44,138
Change in net unrealized gain/(loss) on securities available for sale, net of tax effect				1,791	1,791
Balances, December 31, 2020	$ 0	$ 302,029	$ 134,039	$ 5,486	$ 441,554

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2020, 2019 and 2018

	2020	2019	2018
Cash flows from operating activities			
Net income	$ 44,138,000	$ 49,456,000	$ 42,024,000
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	9,425,000	9,553,000	9,766,000
Accretion of acquired loans	(449,000)	(686,000)	(1,373,000)
Provision for loan losses	14,050,000	1,750,000	1,100,000
Deferred income tax expense (benefit)	(4,141,000)	26,000	(372,000)
Stock-based compensation expense	2,325,000	2,931,000	2,410,000
Stock grants to directors for retainer fee	394,000	375,000	441,000
Proceeds from sales of mortgage loans held for sale	677,634,000	261,021,000	101,146,000
Origination of mortgage loans held for sale	(665,992,000)	(256,767,000)	(96,179,000)
Net gain on sales of mortgage loans held for sale	(29,541,000)	(8,108,000)	(3,536,000)
Net gain from sales and valuation write-downs of foreclosed assets	(325,000)	(254,000)	(169,000)
Net gain from sale and write-downs on former bank premises	(27,000)	(436,000)	(78,000)
Net loss from sales and disposals of premises and equipment	1,514,000	294,000	134,000
Earnings on bank owned life insurance	(1,214,000)	(3,886,000)	(1,287,000)
Net change in:			
Accrued interest receivable	(917,000)	(48,000)	(1,126,000)
Other assets	(10,892,000)	(7,636,000)	(2,193,000)
Accrued interest and other liabilities	1,895,000	(2,818,000)	11,029,000
Net cash from operating activities	37,877,000	44,767,000	61,737,000
Cash flows from investing activities			
Purchases of securities available for sale	(369,682,000)	(62,084,000)	(48,664,000)
Proceeds from maturities, calls and repayments of securities available for sale	321,164,000	79,478,000	40,308,000
Purchases of Federal Home Loan Bank stock	0	(1,980,000)	(4,986,000)
Loan originations and payments, net	(341,461,000)	(99,620,000)	(193,556,000)
Purchases of bank owned life insurance	(700,000)	(4,500,000)	0
Proceeds from bank owned life insurance cash value release and death benefits	0	7,708,000	0
Purchases of premises and equipment, net	(8,989,000)	(13,484,000)	(6,318,000)
Proceeds from sales of former bank premises	162,000	854,000	1,964,000
Proceeds from sales of foreclosed assets	700,000	790,000	772,000
Net cash for investing activities	(398,806,000)	(92,838,000)	(210,480,000)
Cash flows from financing activities			
Net (decrease) increase in time deposits	(99,294,000)	170,921,000	(30,091,000)
Net (decrease) increase in all other deposits	820,463,000	55,755,000	(28,566,000)
Net (decrease) increase in securities sold under agreements to repurchase	15,690,000	(844,000)	(15,229,000)
Proceeds from Federal Home Loan Bank advances	60,000,000	44,000,000	160,000,000
Maturities of Federal Home Loan Bank advances	(20,000,000)	(40,000,000)	(30,000,000)
Proceeds from stock option exercises, net of cashless exercises	3,000	128,000	108,000
Employee stock purchase plan	49,000	50,000	52,000
Dividend reinvestment plan	814,000	729,000	1,165,000
Repurchases of common stock	(6,591,000)	(7,183,000)	(5,943,000)
Payment of cash dividends to common shareholders	(17,930,000)	(17,108,000)	(27,500,000)
Net cash from financing activities	753,204,000	206,448,000	23,996,000

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
Years ended December 31, 2020, 2019 and 2018

	2020	2019	2018
Net change in cash and cash equivalents	392,275,000	158,377,000	(124,747,000)
Cash and cash equivalents at beginning of period	233,731,000	75,354,000	200,101,000
Cash and cash equivalents at end of period	$ 626,006,000	$ 233,731,000	$ 75,354,000
Supplemental disclosures of cash flows information			
Cash paid during the year for:			
Interest	$ 27,703,000	$ 32,103,000	$ 21,569,000
Federal income taxes	10,950,000	11,975,000	10,075,000
Noncash financing and investing activities:			
Transfers from loans to foreclosed assets	146,000	337,000	744,000
Transfers from bank premises to other real estate owned	613,000	258,000	296,000

See accompanying notes to consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The consolidated financial statements include the accounts of Mercantile Bank Corporation ("Mercantile") and its subsidiary, Mercantile Bank of Michigan ("our bank"), and of Mercantile Bank Real Estate Co., L.L.C. ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance company"), subsidiaries of our bank, after elimination of significant intercompany transactions and accounts.

Mercantile has five separate business trusts: Mercantile Bank Capital Trust I, Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III and Firstbank Capital Trust IV ("our trusts"). Our trusts were formed to issue trust preferred securities. We issued subordinated debentures to our trusts in return for the proceeds raised from the issuance of the trust preferred securities. Our trusts are not consolidated, but instead we report the subordinated debentures issued to the trusts as liabilities.

Nature of Operations: Mercantile was incorporated on July 15, 1997 to establish and own the bank based in Grand Rapids, Michigan. Our bank began operations on December 15, 1997. We completed the merger of Firstbank Corporation ("Firstbank"), a Michigan corporation with approximately $1.5 billion in total assets and 46 branch locations, into Mercantile as of June 1, 2014.

Our bank is a community-based financial institution. Our bank's primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial loans, residential mortgage loans, and instalment loans. Substantially all loans are secured by specific items of collateral including business assets, real estate or consumer assets. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by commercial or residential real estate. We have no material foreign loans or significant overdraft balances. Our bank's loan accounts and retail deposits are primarily with customers located in the communities in which we have bank office locations. As an alternative source of funds, our bank has also issued certificates of deposit to depositors outside of its primary market areas. Substantially all revenues are derived from banking products and services and investment securities. While we monitor the revenue streams of the various products and services offered, we manage our business on the basis of one operating segment, banking.

Our real estate company was organized on July 21, 2003, principally to develop, construct, and own a facility in downtown Grand Rapids that serves as our bank's main office and Mercantile's headquarters. This facility was placed into service during the second quarter of 2005. The facility was transferred to our bank, and our real estate company was dissolved on December 18, 2020.

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent. To date, we have not provided the insurance products noted above and currently have no plans to do so.

We have evaluated subsequent events for potential recognition and/or disclosure through the date these financial statements were issued.

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 actual results could differ. The allowance for loan losses and the fair values of financial instruments are particularly subject to change.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Events: The U.S. economy deteriorated rapidly during the latter part of the first quarter and into the second quarter of 2020 due to the ongoing Coronavirus Pandemic. While the economic fallout has stabilized somewhat, there remains a significant amount of stress and uncertainty across national and global economies. This uncertainty is heightened as certain geographic areas continue to experience surges in Covid-19 cases and governments at all levels continue to react to changes in circumstances.

The Coronavirus Pandemic is a highly unusual, unprecedented and evolving public health and economic crisis and may have a material negative impact on our financial condition and results of operations. We continue to occupy an asset-sensitive position, whereby interest rate environments characterized by numerous and/or high magnitude interest rate reductions have a negative impact on our net interest income and net income. Additionally, the consequences of the unprecedented economic impact of the Coronavirus Pandemic may produce declining asset quality, reflected by a higher level of loan delinquencies and loan charge-offs, as well as downgrades of commercial lending relationships, which may necessitate additional provisions for our allowance and reduced net income.

The following section summarizes the primary measures that directly impact us and our customers.

- Paycheck Protection Program

  The Paycheck Protection Program ("PPP") reflects a substantial expansion of the Small Business Administration's 100% guaranteed 7(a) loan program. The CARES Act authorized up to $350 billion in loans to businesses with fewer than 500 employees, including non-profit organizations, tribal business concerns, self-employed and individual contractors. The PPP provides 100% guaranteed loans to cover specific operating costs, with the maximum loan size capped at the lesser of 250% of the average monthly payroll costs or $10.0 million. PPP loans are eligible to be forgiven based upon certain criteria. In general, the amount of the loan that is forgivable is the sum of the payroll costs, interest payments on mortgages, rent and utilities incurred or paid by the business during a prescribed period beginning on the loan origination date. Any remaining balance after forgiveness is maintained at the 100% guarantee for the duration of the loan. The loan tenor is 24 months for loans originated prior to June 5, 2020 and 60 months for loans originated on or after June 5, 2020. Loans originated prior to June 5, 2020 can be modified to a tenor of 60 months upon the mutual agreement of the lender and borrower. We have not modified the maturity date of any loans made prior to June 5, 2020. The interest rate on the loan is fixed at 1.00%, with the financial institution receiving a loan origination fee ranging from 1% to 5% of the loan amount paid by the Small Business Administration. The loan origination fees, net of the direct origination costs, have totaled approximately $15.0 million and are being accreted into interest income on loans using the level yield methodology. The program was originally scheduled to end on June 30, 2020, but was subsequently modified to end on August 8, 2020. Participation in the PPP has had a significant impact on the composition of our loan and deposit portfolios and our net interest income starting during the second quarter of 2020, which is expected to remain well into 2021. We originated approximately 2,200 loans aggregating $554 million under the PPP, with no customer payments but $189 million in forgiveness payments from the Small Business Administration on approximately 900 PPP loans recorded through December 31, 2020.

  Under the CARES Act, a PPP loan is assigned a risk weight of 0% under the risk-based capital rules of the federal banking agencies. On April 9, 2020, the federal banking agencies issued an interim final rule allowing financial institutions to exclude PPP loans from the average asset calculation to the degree the PPP loans are financed through the Paycheck Protection Program Lending Facility ("PPPLF") for the Tier 1 Leverage Capital Ratio.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- Individual Economic Impact Payments
  The Internal Revenue Service began making Individual Economic Impact Payments in mid-April via direct deposit or mailed checks. Individuals with adjusted gross income of $75,000 or less received payments of $1,200, with a reduction formula for those individuals with adjusted gross income over $75,000 but less than $99,000. Individuals with adjusted gross income of over $99,000 did not receive a payment. Married couples filing jointly with adjusted gross income of $150,000 or less received payments of $2,400, with a reduction formula for those married couples filing jointly with adjusted gross income over $150,000 but less than $198,000. Married couples filing jointly with adjusted gross income of over $198,000 did not receive a payment.

- Troubled Debt Restructuring Relief
  From March 1, 2020 through 60 days after the end of the National Emergency (or December 31, 2020 if earlier), a financial institution may elect to suspend GAAP principles and regulatory determinations with respect to loan modifications related to Covid-19 that would otherwise be categorized as troubled debt restructurings. Banking agencies must defer to the financial institution's election. We elected to suspend GAAP principles and regulatory determinations as permitted. The Consolidated Appropriations Act, 2021 extended the suspension date to January 1, 2022.

- Current Expected Credit Loss Methodology Delay
  Financial institutions are not required to comply with the CECL methodology requirements from the enactment date of the CARES Act until the earlier of the end of the National Emergency or December 31, 2020. We elected to postpone CECL adoption as permitted. The Consolidated Appropriations Act, 2021 extended the adoption deferral date to January 1, 2022.

In early April 2020, in response to the early stages of the Coronavirus Pandemic and its pervasive impact across the economy and financial markets, we developed internal programs of loan payment deferments for commercial and retail borrowers. For commercial borrowers, we offered 90-day (three payments) interest only amendments as well as 90-day (three payments) principal and interest payment deferments. Under the latter program, borrowers were extended a 12-month single payment note at 0% interest in an amount equal to three payments, with loan proceeds used to make the scheduled payments. The single payment notes receive a loan grade equal to the loan grade of each respective borrowing relationship. Certain of our commercial loan borrowers subsequently requested and received an additional 90-day (three payments) interest only amendment or 90-day (three payments) principal and interest payment deferment. Under the latter program, the amount equal to the three payments was added to the original deferment note which has nine months remaining to maturity; however, the original 0% interest rate is modified to equal the rate associated with each borrower's traditional lending relationship with us for the remainder of the term. Peak of activity in the commercial loan deferment program was in mid-July, 2020; however, as of December 31, 2020, only 19 borrowers with loan balances aggregating $8.0 million remained in the commercial loan deferment program. For retail borrowers, we offered 90-day (three payments) principal and interest payment deferments, with deferred amounts added to the end of the loan. Peak of activity was in early third quarter of 2020; however, as of December 31, 2020, only 14 borrowers with loan balances aggregating $1.8 million remained in the retail loan payment deferment program.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In April, 2020, the Federal Reserve initiated the PPPLF, which is designed to facilitate lending by financial institutions to small businesses under the PPP. Only PPP loans are eligible to serve as collateral for the PPPLF, with each dollar of PPP loans providing one dollar of advance availability. The maturity date of an extension of credit under the PPPLF will equal the maturity date of the pool of PPP loans pledged to secure the extension of credit. Any principal payments received by the financial institution on the PPP loans, such as PPP loan forgiveness payments from the Small Business Administration or principal payments from the borrower after the initial six-month deferment period, must be used to pay down the PPPLF advance by the same dollar amount, maintaining the dollar-for-dollar advance amount and PPP aggregate loan balance relationship. The interest rate on PPPLF advances is fixed at 0.35%. No PPPLF advances could be obtained after September 30, 2020. We obtained a PPPLF advance in the amount of $43.7 million in late April 2020 and paid it off in full in early June 2020. As of December 31, 2020, we had no advances outstanding under the PPPLF.

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

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

Interest income includes amortization of purchase premiums and accretion of discounts. Premiums and discounts on securities are amortized or accreted on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Declines in the fair value of debt securities below their amortized cost that are other-than-temporary impairment (“OTTI”) are reflected in earnings or other comprehensive income, as appropriate. For those debt securities whose fair value is less than their amortized cost, we consider our intent to sell the security, whether it is more likely than not that we will be required to sell the security before recovery and whether we expect to recover the entire amortized cost of the security based on our assessment of the issuer’s financial condition. In analyzing an issuer’s financial condition, we consider whether the securities are issued by the federal government or its agencies, and whether downgrades by bond rating agencies have occurred. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement, and 2) OTTI related to other factors, such as liquidity conditions in the market or changes in market interest rates, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost.

Loans: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to $4.4 million and $0.5 million, respectively, at December 31, 2020 and 2019.

Interest income on commercial loans and mortgage loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer and credit card loans are typically charged off no later than when they are 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related mortgage loan sold, which is reduced by the cost allocated to the servicing right. We generally lock in the sale price to the purchaser of the mortgage loan at the same time we make an interest rate commitment to the borrower.

Year-end mortgage loans held for sale, included in total loans in the balance sheet, were as follows:

	2020	2019
Mortgage loans held for sale	$ 22,888,000	$ 4,978,000
Less: Allowance to adjust to lower of cost or market	0	0
Mortgage loans held for sale, net	$ 22,888,000	$ 4,978,000

Mortgage Loan Derivatives: We enter into forward contracts and interest rate lock commitments in the ordinary course of business, which are accounted for as derivatives. The derivatives are not designated as hedges and are carried at fair value. The net gain or loss on derivatives is included in mortgage banking activities in the income statement. The balance of derivatives was immaterial at December 31, 2020 and 2019.

Mortgage Banking Activities: Mortgage loan servicing rights are recognized as assets based on the allocated value of retained servicing rights on mortgage loans sold. Mortgage loan servicing rights are carried at the lower of amortized cost or fair value and are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the rights using groupings of the underlying mortgage loans as to interest rates. Any impairment of a grouping is reported as a valuation allowance.

Servicing fee income is recorded for fees earned for servicing mortgage loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. Amortization of mortgage loan servicing rights is netted against mortgage loan servicing income and recorded in mortgage banking activities in the consolidated statements of income.

Troubled Debt Restructurings: A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons, grant a concession to a borrower considered to be experiencing financial difficulties that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or balance of the loan, a reduction of accrued interest, an extension of the maturity date or renewal of the loan at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans. Accruing troubled debt restructurings are generally excluded from nonperforming loans as it is considered probable that all contractual principal and interest due under the restructured terms will be collected.

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In accordance with current accounting guidance, loans modified as troubled debt restructurings are, by definition, considered to be impaired loans. Impairment for these loans is measured on a loan-by-loan basis similar to other impaired loans as described below under “Allowance for Loan Losses.” Certain loans modified as troubled debt restructurings may have been previously measured for impairment and included in the allowance under a general allowance methodology (i.e., pooling). In these circumstances, the allowance may be impacted to the extent there is a difference in the results obtained by the initial measurement methodology and the methodology applied to reflect a troubled debt restructuring. Loans modified as troubled debt restructurings that subsequently default are factored into the determination of the allowance in the same manner as other defaulted loans.

The federal banking agencies issued an “*Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus”* on March 22, 2020, which was subsequently revised on April 7, 2020. This guidance encourages financial institutions to work prudently with borrowers that are or may be unable to meet their contractual obligations because of the effects of the Coronavirus Pandemic. Pursuant to the guidance, the federal banking agencies concluded, in consultation with FASB staff, that short-term modifications (e.g. six months) made on a good faith basis to borrowers who were current prior to any relief are not troubled debt restructurings. This guidance complements Section 4013 of the CARES Act, which specified that Coronavirus-related modifications made on loans that were current as of December 31, 2019 and that occur between March 1, 2020 and the earlier of 60 days after the date of termination of the National Emergency declared by President Trump on March 13, 2020 (the “National Emergency”) or December 31, 2020, as applicable, are not troubled debt restructurings. As part of the Consolidated Appropriations Act that was enacted in late 2020, this guidance was extended to January 1, 2022.

Allowance for Loan Losses: The allowance for loan losses (“allowance”) is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when we believe the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. We estimate credit losses based on individual loans determined to be impaired and on all other loans grouped on similar risk characteristics. Our historical loss component is generally the most significant of the allowance components and is based on historical loss experience by credit risk grade for commercial loans and payment status for mortgage and consumer loans. Loans are pooled based on similar risk characteristics supported by observable data. The historical loss experience component of the allowance represents the results of migration analysis of historical net charge-offs for portfolios of loans, including groups of commercial loans within each credit risk grade. For measuring loss exposure in a pool of loans, the historical net charge-off or migration experience is utilized to estimate expected future losses to be realized from the pool of loans. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative environmental factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, competition, increasing interest rates, external factors, Coronavirus Pandemic environment, and other considerations. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

A loan is considered impaired when, based on current information and events, it is probable we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and collateral value. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. We determine the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of delay, the reasons for delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

Financial institutions were not required to comply with the CECL methodology requirements from the enactment date of the CARES Act until the earlier of the end of the President's declaration of a National Emergency or December 31, 2020. The Consolidated Appropriations Act, 2021, that was enacted in December 2020, provided for a further extension of the required CECL adoption date to January 1, 2022. An economic forecast is a key component of the CECL methodology. As we continue to experience an unprecedented economic environment whereby a sizable portion of the economy has been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus has been provided to businesses, individuals and state and local governments and financial institutions have offered businesses and individuals payment relief options, economic forecasts are regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we have elected to postpone the adoption of CECL, and will continue to use our incurred loan loss reserve model as permitted.

Loans made under PPP are fully guaranteed by the Small Business Administration; therefore, such loans do not have an associated allowance.

<u>Transfers of Financial Assets</u>: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from our bank and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) our bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. Our transfers of financial assets are generally limited to commercial loan participations sold and residential mortgage loans sold in the secondary market.

<u>Premises and Equipment</u>: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 33 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized. Premises and equipment are reviewed for impairment when events indicate their carrying amount may not be recoverable based on future undiscounted cash flows. If impaired, the assets are recorded at the lower of carrying value or fair value.

<u>Foreclosed Assets:</u> Assets acquired through or in lieu of foreclosure are initially recorded at their estimated fair value net of estimated selling costs, establishing a new cost basis. If fair value subsequently declines, a valuation allowance is recorded through noninterest expense, as are collection and operating costs after acquisition. Foreclosed assets, included in other assets in the balance sheet, totaled \$0.7 million and \$0.5 million as of December 31, 2020 and 2019, respectively.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Bank Owned Life Insurance: Our bank has purchased life insurance policies on certain key officers. Bank owned life insurance is recorded at its cash surrender value, or the amount that can be realized.

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2019, we elected to perform a qualitative assessment for our annual impairment test and concluded it was more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

Due to current stressed economic and market conditions, we assessed goodwill for impairment as of March 31, 2020, June 30, 2020, September 30, 2020 and October 1, 2020. For March 31, 2020, we performed a quantitative analysis, which used a discounted income approach and a market valuation model, which compared the inherent value of our company to valuations of recent transactions in the market place to determine if our goodwill had been impaired. Using this quantitative methodology, we determined goodwill was not impaired as of March 31, 2020. For June 30, 2020, September 30, 2020, and October 1, 2020, we used the Step 0 qualitative methodology for which we assessed the macro and microeconomic conditions, industry and market conditions, financial performance, and our underlying stock performance. We concluded it was more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

The core deposit intangible that arose from the merger with Firstbank was initially measured at fair value and is being amortized into noninterest expense over a ten-year period using the sum-of-the-years-digits methodology.

Repurchase Agreements: Our bank sells certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions, with the obligations to repurchase the securities sold reflected as liabilities and the securities underlying the agreements remaining in assets in the Consolidated Balance Sheets.

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

Stock-Based Compensation: Compensation cost for equity-based awards is measured on the grant date based on the fair value of the award at that date, and is recognized over the requisite service period, net of estimated forfeitures. Fair value of stock option awards is estimated using a closed option valuation (Black-Scholes) model. Fair value of restricted stock awards is based upon the quoted market price of the common stock on the date of grant.

Revenue from Contracts with Customers: We record revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, “Revenue from Contracts with Customers” (“Topic 606”). Under Topic 606, we must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) we satisfy a performance obligation. No revenue has been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Our primary sources of revenue are derived from interest and dividends earned on loans, securities and other financial instruments that are not within the scope of Topic 606. We have evaluated the nature of our contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary.

We generally satisfy our performance obligations on contracts with customers as services are rendered, and the transaction prices are typically fixed and charged either on a periodic basis (generally monthly) or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Advertising Costs: Advertising costs are expensed as incurred.

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

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

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans using the treasury stock method. Our unvested stock awards, which contain non-forfeitable rights to dividends whether paid or unpaid (i.e., participating securities), are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, our unvested stock awards are excluded from the calculations of both basic and diluted earnings per share.

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

Derivatives: Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have historically generally consisted of interest rate swap agreements that qualified for hedge accounting. We do not use derivatives for trading purposes.

Changes in the fair value of derivatives that are designated, for accounting purposes, as a hedge of the variability of cash flows to be received on various assets and liabilities and are effective are reported in other comprehensive income. They are later reclassified into earnings in the same periods during which the hedged transaction affects earnings and are included in the line item in which the hedged cash flows are recorded. If hedge accounting does not apply, changes in the fair value of derivatives are recognized immediately in current earnings as interest income or expense.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

If designated as a hedge, we formally document the relationship between the derivative instrument and the hedged item, as well as the risk-management objective and the strategy for undertaking the hedge transaction. This documentation includes linking cash flow hedges to specific assets on the balance sheet. If designated as a hedge, we also formally assess, both at the hedge's inception and on an ongoing basis, whether the derivative instrument that is used is highly effective in offsetting changes in cash flows of the hedged items. Ineffective hedge gains and losses are recognized immediately in current earnings as noninterest income or expense.

We discontinue hedge accounting when we determine the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, or treatment of the derivatives as a hedge is no longer appropriate or intended.

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. We do not believe there are any such matters outstanding that would have a material effect on the financial statements.

Reclassifications: Certain items in the prior years' financial statements have been reclassified to conform to the current year presentation.

Subsequent Events: On December 27, 2020, the Consolidated Appropriations Act, 2021 was signed into law. This $900 billion Coronavirus Pandemic relief package includes $284 billion in aid for small businesses through a second round of forgivable loans through the PPP. In general, the framework of loans originated under the second round is similar to that of the initial round. As of February 26, 2021, we had originated about 900 loans aggregating $181 million in second round PPP loans.

We originated approximately 2,200 loans aggregating $554 million under the initial round of the PPP. As of December 31, 2020, we had received no customer payments but had received $189 million in forgiveness payments from the Small Business Administration on about 900 PPP loans. As of February 26, 2021, we had received no customer payments but had received $266 million in forgiveness payments from the Small Business Administration on approximately 1,400 loans.

As part of our bank's branch rationalization efforts, we recently announced that our bank and Lake Trust Credit Union have entered into an agreement for the sale of our banking office located in Hastings, Michigan, with the sale expected to be consummated by March 31, 2021. The agreement includes the 4,300 square-foot facility, all associated assets and approximately $16 million in deposits.

Accounting Standards Updates: In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU (as subsequently amended by ASU 2018-01, ASU 2018-10, ASU 2018-11 and ASU 2018-20) establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The ASU was effective for annual and interim periods beginning after December 15, 2018. The adoption of this new standard as of January 1, 2019 resulted in the recording of a ROU asset and associated lease liability of approximately $1.3 million.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU (as subsequently amended by ASU 2018-19) significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (i) financial assets subject to credit losses and measured at amortized cost, and (ii) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans, and expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. This ASU is effective for interim and annual reporting periods beginning after December 15, 2019.

Financial institutions were not required to comply with the CECL methodology requirements from the enactment date of the CARES Act until the earlier of the end of the President's declaration of a National Emergency or December 31, 2020. The Consolidated Appropriations Act, 2021, that was enacted in December 2020, provided for a further extension of the required CECL adoption date to January 1, 2022. An economic forecast is a key component of the CECL methodology. As we continue to experience an unprecedented economic environment whereby a sizable portion of the economy has been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus has been provided to businesses, individuals and state and local governments and financial institutions have offered businesses and individuals payment relief options, economic forecasts are regularly updated and there is no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we have elected to postpone the adoption of CECL, and will continue to use our incurred loan loss reserve model as permitted.

NOTE 2 – SECURITIES

The amortized cost and fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2020				
U.S. Government agency debt obligations	$242,522,000	$ 516,000	$ (897,000)	$242,141,000
Mortgage-backed securities	23,869,000	1,021,000	0	24,890,000
Municipal general obligation bonds	101,991,000	5,833,000	0	107,824,000
Municipal revenue bonds	11,521,000	473,000	(2,000)	11,992,000
Other investments	500,000	0	0	500,000
	$380,403,000	$ 7,843,000	$ (899,000)	$387,347,000
2019				
U.S. Government agency debt obligations	$185,103,000	$ 2,449,000	$ (1,142,000)	$186,410,000
Mortgage-backed securities	41,998,000	554,000	(82,000)	42,470,000
Municipal general obligation bonds	98,245,000	2,864,000	(30,000)	101,079,000
Municipal revenue bonds	4,133,000	63,000	0	4,196,000
Other investments	500,000	0	0	500,000
	$329,979,000	$ 5,930,000	$ (1,254,000)	$334,655,000

Securities with unrealized losses at year-end 2020 and 2019, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2020						
U.S. Government agency debt obligations	$118,650,000	$ 897,000	$ 0	$ 0	$118,650,000	$ 897,000
Mortgage-backed securities	0	0	0	0	0	0
Municipal general obligation bonds	0	0	0	0	0	0
Municipal revenue bonds	423,000	2,000	0	0	423,000	2,000
Other investments	0	0	0	0	0	0
	$119,073,000	$ 899,000	$ 0	$ 0	$119,073,000	$ 899,000
2019						
U.S. Government agency debt obligations	$ 25,650,000	$ 349,000	$ 73,913,000	$ 793,000	$ 99,563,000	$ 1,142,000
Mortgage-backed securities	2,838,000	28,000	10,423,000	54,000	13,261,000	82,000
Municipal general obligation bonds	3,755,000	18,000	994,000	12,000	4,749,000	30,000
Municipal revenue bonds	0	0	0	0	0	0
Other investments	0	0	0	0	0	0
	$ 32,243,000	$ 395,000	$ 85,330,000	$ 859,000	$117,573,000	$ 1,254,000

NOTE 2 – SECURITIES (Continued)

We evaluate securities for other-than-temporary impairment at least on a quarterly basis. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability we have to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. For those debt securities whose fair value is less than their amortized cost basis, we also consider our intent to sell the security, whether it is more likely than not that we will be required to sell the security before recovery and if we do not expect to recover the entire amortized cost basis of the security. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred and the results of reviews of the issuer's financial condition.

At December 31, 2020, 64 debt securities with fair values totaling $119 million had unrealized losses aggregating $0.9 million. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair values of debt securities at December 31, 2020, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

	Weighted Average Yield	Amortized Cost	Fair Value
Due in one year or less	2.52%	$ 5,906,000	$ 5,939,000
Due from one to five years	1.16	93,320,000	94,474,000
Due from five to ten years	1.67	176,848,000	180,541,000
Due after ten years	2.07	79,960,000	81,003,000
Mortgage-backed securities	2.10	23,869,000	24,890,000
Other investments	4.13	500,000	500,000
	1.67%	$ 380,403,000	$ 387,347,000

No securities were sold during the last three years.

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $109 million and $96.5 million at December 31, 2020 and December 31, 2019, respectively, with estimated market values of $116 million and $99.4 million at the respective dates. Securities issued by all other states and their political subdivisions had a combined amortized cost of $4.1 million and $5.9 million at December 31, 2020 and December 31, 2019, respectively, with estimated market values of $4.2 million and $5.9 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $118 million and $103 million at December 31, 2020 and 2019, respectively. Investments in FHLBI stock are restricted and may only be resold to, or redeemed by, the issuer.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans originated for investment are stated at their principal amount outstanding adjusted for partial charge-offs, the allowance, and net deferred loan fees and costs. Interest income on loans is accrued over the term of the loans primarily using the simple interest method based on the principal balance outstanding. Interest is not accrued on loans where collectability is uncertain. Accrued interest is included in other assets in the Consolidated Balance Sheets. Loan origination fees and certain direct costs incurred to extend credit are deferred and amortized over the term of the loan or loan commitment period as an adjustment to the related loan yield.

Year-end loans disaggregated by class of loan within the loan portfolio segments were as follows:

	December 31, 2020		December 31, 2019		Percent Increase
	Balance	%	Balance	%	(Decrease)
Commercial:					
Commercial and industrial (1)	$1,145,423,000	35.6%	$ 846,551,000	29.6%	35.3%
Vacant land, land development, and residential construction	55,055,000	1.7	56,119,000	2.0	(1.9)
Real estate – owner occupied	529,953,000	16.5	579,003,000	20.3	(8.5)
Real estate – non-owner occupied	917,436,000	28.5	835,346,000	29.2	9.8
Real estate – multi-family and residential rental	146,095,000	4.6	124,525,000	4.4	17.3
Total commercial	2,793,962,000	86.9	2,441,544,000	85.5	14.4
Retail:					
Home equity and other	61,620,000	1.9	75,374,000	2.6	(18.2)
1-4 family mortgages	360,776,000	11.2	339,749,000	11.9	6.2
Total retail	422,396,000	13.1	415,123,000	14.5	1.8
Total loans	$3,216,358,000	100.0%	$2,856,667,000	100.0%	12.6%

(1) For December 31, 2020, includes $365 million in loans originated under the Paycheck Protection Program.

Concentrations within the loan portfolio were as follows at year-end:

	2020		2019	
	Balance	Percentage of Loan Portfolio	Balance	Percentage of Loan Portfolio
Commercial real estate loans to lessors of non-residential buildings	$ 649,162,000	20.2%	$ 580,708,000	20.3%

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Year-end nonperforming loans were as follows:

	2020	2019
Loans past due 90 days or more still accruing interest	$ 0	$ 0
Nonaccrual loans	3,384,000	2,284,000
Total nonperforming loans	$ 3,384,000	$ 2,284,000

The recorded principal balance of nonperforming loans was as follows:

	December 31, 2020	December 31, 2019
Commercial:		
Commercial and industrial	$ 172,000	$ 0
Vacant land, land development, and residential construction	0	0
Real estate – owner occupied	619,000	134,000
Real estate – non-owner occupied	22,000	0
Real estate – multi-family and residential rental	0	2,000
Total commercial	813,000	136,000
Retail:		
Home equity and other	242,000	255,000
1-4 family mortgages	2,329,000	1,893,000
Total retail	2,571,000	2,148,000
Total nonperforming loans	$ 3,384,000	$ 2,284,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of December 31, 2020:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$ 261,000	$ 172,000	$ 0	$ 433,000	$ 1,144,990,000	$ 1,145,423,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	55,055,000	55,055,000	0
Real estate – owner occupied	0	197,000	421,000	618,000	529,335,000	529,953,000	0
Real estate – non-owner occupied	0	0	23,000	23,000	917,413,000	917,436,000	0
Real estate – multi-family and residential rental	0	0	0	0	146,095,000	146,095,000	0
Total commercial	261,000	369,000	444,000	1,074,000	2,792,888,000	2,793,962,000	0
Retail:							
Home equity and other	112,000	65,000	54,000	231,000	61,389,000	61,620,000	0
1- 4 family mortgages	1,147,000	247,000	342,000	1,736,000	359,040,000	360,776,000	0
Total retail	1,259,000	312,000	396,000	1,967,000	420,429,000	422,396,000	0
Total past due loans	$1,520,000	$ 681,000	$ 840,000	$3,041,000	$ 3,213,317,000	$ 3,216,358,000	$ 0

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of December 31, 2019:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$ 0	$ 0	$ 0	$ 0	$ 846,551,000	$ 846,551,000	$ 0
Vacant land, land development, and residential construction	191,000	0	0	191,000	55,928,000	56,119,000	0
Real estate – owner occupied	0	0	134,000	134,000	578,869,000	579,003,000	0
Real estate – non-owner occupied	0	0	0	0	835,346,000	835,346,000	0
Real estate – multi-family and residential rental	0	0	0	0	124,525,000	124,525,000	0
Total commercial	191,000	0	134,000	325,000	2,441,219,000	2,441,544,000	0
Retail:							
Home equity and other	171,000	65,000	20,000	256,000	75,118,000	75,374,000	0
1- 4 family mortgages	745,000	29,000	529,000	1,303,000	338,446,000	339,749,000	0
Total retail	916,000	94,000	549,000	1,559,000	413,564,000	415,123,000	0
Total past due loans	$1,107,000	$ 94,000	$ 683,000	$1,884,000	$2,854,783,000	$2,856,667,000	$ 0

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans with no related allowance recorded were as follows as of December 31, 2020:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$ 6,242,000	$ 6,242,000		$ 7,874,000
Vacant land, land development and residential construction	0	0		187,000
Real estate – owner occupied	14,782,000	14,593,000		5,361,000
Real estate – non-owner occupied	341,000	341,000		227,000
Real estate – multi-family and residential rental	0	0		3,000
Total commercial	21,365,000	21,176,000		13,652,000
Retail:				
Home equity and other	1,072,000	987,000		1,216,000
1-4 family mortgages	4,455,000	2,575,000		2,447,000
Total retail	5,527,000	3,562,000		3,663,000
Total with no related allowance recorded	$26,892,000	$24,738,000		$17,315,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans with an allowance recorded and total impaired loans were as follows as of December 31, 2020:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$ 343,000	$ 343,000	$ 53,000	$ 971,000
Vacant land, land development and residential construction	0	0	0	77,000
Real estate – owner occupied	763,000	734,000	77,000	578,000
Real estate – non-owner occupied	162,000	162,000	8,000	100,000
Real estate – multi-family and residential rental	0	0	0	0
Total commercial	1,268,000	1,239,000	138,000	1,726,000
Retail:				
Home equity and other	300,000	283,000	241,000	421,000
1-4 family mortgages	698,000	698,000	172,000	595,000
Total retail	998,000	981,000	413,000	1,016,000
Total with an allowance recorded	$ 2,266,000	$ 2,220,000	$ 551,000	$ 2,742,000
Total impaired loans:				
Commercial	$ 22,633,000	$ 22,415,000	$ 138,000	$ 15,378,000
Retail	6,525,000	4,543,000	413,000	4,679,000
Total impaired loans	$ 29,158,000	$ 26,958,000	$ 551,000	$ 20,057,000

(Continued)

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans with no related allowance recorded were as follows as of December 31, 2019:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$ 8,129,000	$ 8,129,000		$11,610,000
Vacant land, land development and residential construction	85,000	85,000		89,000
Real estate – owner occupied	715,000	667,000		1,520,000
Real estate – non-owner occupied	178,000	178,000		131,000
Real estate – multi-family and residential rental	29,000	9,000		44,000
Total commercial	9,136,000	9,068,000		13,394,000
Retail:				
Home equity and other	1,279,000	1,209,000		1,203,000
1-4 family mortgages	3,272,000	1,968,000		2,078,000
Total retail	4,551,000	3,177,000		3,281,000
Total with no related allowance recorded	$13,687,000	$12,245,000		$16,675,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans with an allowance recorded and total impaired loans were as follows as of December 31, 2019:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$ 460,000	$ 458,000	$ 202,000	$ 5,709,000
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	1,078,000	1,078,000	982,000	1,672,000
Real estate – non-owner occupied	0	0	0	80,000
Real estate – multi-family and residential rental	0	0	0	54,000
Total commercial	1,538,000	1,536,000	1,184,000	7,515,000
Retail:				
Home equity and other	502,000	485,000	356,000	658,000
1-4 family mortgages	358,000	356,000	83,000	660,000
Total retail	860,000	841,000	439,000	1,318,000
Total with an allowance recorded	$ 2,398,000	$ 2,377,000	$ 1,623,000	$ 8,833,000
Total impaired loans:				
Commercial	$10,674,000	$10,604,000	$ 1,184,000	$20,909,000
Retail	5,411,000	4,018,000	439,000	4,599,000
Total impaired loans	$16,085,000	$14,622,000	$ 1,623,000	$25,508,000

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated fair value. Interest income recognized on accruing troubled debt restructurings totaled $1.3 million in 2020 and 2019, and $1.1 million during 2018. Interest income recognized on nonaccrual loans totaled less than $0.1 million in 2020, 2019 and 2018, reflecting the collection of interest at the time of principal pay-off. Lost interest income on nonaccrual loans totaled $0.2 million in 2020, $0.1 million in 2019, and $0.3 million in 2018.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Quality Indicators. We utilize a comprehensive grading system for our commercial loans. All commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed and, if appropriate, re-graded at various intervals thereafter. The risk assessment for retail loans is primarily based on the type of collateral.

Loans by credit quality indicators were as follows as of December 31, 2020:

Commercial credit exposure – credit risk profiled by internal credit risk grades:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4 (1)	$ 828,706,000	$ 22,547,000	$ 315,134,000	$ 396,700,000	$ 91,711,000
Grades 5 – 7	306,614,000	32,398,000	185,541,000	520,395,000	54,111,000
Grades 8 – 9	10,103,000	110,000	29,278,000	341,000	273,000
Total commercial	$ 1,145,423,000	$ 55,055,000	$ 529,953,000	$ 917,436,000	$ 146,095,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Performing	61,378,000	358,447,000
Nonperforming	242,000	2,329,000
Total retail	$ 61,620,000	$ 360,776,000

(1) Included in Commercial and Industrial Loans Grades 1 – 4 are $365 million of loans originated under the Paycheck Protection Program.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans by credit quality indicators were as follows as of December 31, 2019:

Commercial credit exposure – credit risk profiled by internal credit risk grades:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$ 521,920,000	$ 26,065,000	$ 351,671,000	$ 563,087,000	$ 85,152,000
Grades 5 – 7	309,824,000	29,716,000	220,980,000	272,124,000	39,203,000
Grades 8 – 9	14,807,000	338,000	6,352,000	135,000	170,000
Total commercial	$ 846,551,000	$ 56,119,000	$ 579,003,000	$ 835,346,000	$ 124,525,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Performing	75,119,000	337,856,000
Nonperforming	255,000	1,893,000
Total retail	$ 75,374,000	$ 339,749,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

Grade 1. “Exceptional” Loans with this rating contain very little, if any, risk.

Grade 2. “Outstanding” Loans with this rating have excellent and stable sources of repayment and conform to bank policy and regulatory requirements.

Grade 3. “Very Good” Loans with this rating have strong sources of repayment and conform to bank policy and regulatory requirements. These are loans for which repayment risks are acceptable.

Grade 4. “Good” Loans with this rating have solid sources of repayment and conform to bank policy and regulatory requirements. These are loans for which repayment risks are modest.

Grade 5. “Acceptable” Loans with this rating exhibit acceptable sources of repayment and conform with most bank policies and all regulatory requirements. These are loans for which repayment risks are satisfactory.

Grade 6. “Monitor” Loans with this rating are considered to have emerging weaknesses which may include negative current cash flow, high leverage, or operating losses. Generally, if further deterioration is observed, these credits will be downgraded to the criticized asset report.

Grade 7. “Special Mention” Loans with this rating have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan at some future date.

Grade 8. “Substandard” Loans with this rating are inadequately protected by current sound net worth, paying capacity of the obligor, or of the pledged collateral, if any. A Substandard loan normally has one or more well-defined weaknesses that jeopardize the repayment of the debt. They are characterized by the distinct possibility of loss if the deficiencies are not corrected.

Grade 9. “Doubtful” Loans with this rating exhibit all the weaknesses inherent in the Substandard classification and where collection or liquidation in full is highly questionable and improbable.

Grade 10. “Loss” Loans with this rating are considered uncollectable, and of such little value that continuance as an active asset is not warranted.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and timeliness of scheduled payments. We have a policy of requesting and reviewing periodic financial statements from commercial loan customers and employ a disciplined and formalized review of the existence of collateral and its value. The primary risk element with respect to each residential real estate loan and consumer loan is the timeliness of scheduled payments. We have a reporting system that monitors past due loans and have adopted policies to pursue creditors’ rights in order to preserve our collateral position.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The allowance for loan losses and recorded investments in loans for the year-ended December 31, 2020 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$ 21,070,000	$ 2,749,000	$ 70,000	$ 23,889,000
Provision for loan losses	12,835,000	1,226,000	(11,000)	14,050,000
Charge-offs	(613,000)	(225,000)	0	(838,000)
Recoveries	487,000	379,000	0	866,000
Ending balance	$ 33,779,000	$ 4,129,000	$ 59,000	$ 37,967,000
Ending balance: individually evaluated for impairment	$ 138,000	$ 413,000	$ 0	$ 551,000
Ending balance: collectively evaluated for impairment	$ 33,641,000	$ 3,716,000	$ 59,000	$ 37,416,000
Total loans (*):				
Ending balance	$2,428,703,000	$422,396,000		$2,851,099,000
Ending balance: individually evaluated for impairment	$ 22,415,000	$ 4,543,000		$ 26,958,000
Ending balance: collectively evaluated for impairment	$2,406,288,000	$417,853,000		$2,824,141,000

(*) Excludes $365 million in loans originated under the Paycheck Protection Program.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The allowance for loan losses and recorded investments in loans for the year-ended December 31, 2019 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$ 19,619,000	$ 2,717,000	$ 44,000	$ 22,380,000
Provision for loan losses	1,578,000	146,000	26,000	1,750,000
Charge-offs	(455,000)	(428,000)	0	(883,000)
Recoveries	328,000	314,000	0	642,000
Ending balance	$ 21,070,000	$ 2,749,000	$ 70,000	$ 23,889,000
Ending balance: individually evaluated for impairment	$ 1,230,000	$ 459,000	$ 0	$ 1,689,000
Ending balance: collectively evaluated for impairment	$ 19,840,000	$ 2,290,000	$ 70,000	$ 22,200,000
Total loans:				
Ending balance	$2,441,544,000	$415,123,000		$2,856,667,000
Ending balance: individually evaluated for impairment	$ 10,604,000	$ 4,018,000		$ 14,622,000
Ending balance: collectively evaluated for impairment	$2,430,940,000	$411,105,000		$2,842,045,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The allowance for loan losses and recorded investments in loans for the year-ended December 31, 2018 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$ 16,747,000	$ 2,661,000	$ 93,000	$ 19,501,000
Provision for loan losses	958,000	191,000	(49,000)	1,100,000
Charge-offs	(674,000)	(776,000)	0	(1,450,000)
Recoveries	2,588,000	641,000	0	3,229,000
Ending balance	$ 19,619,000	$ 2,717,000	$ 44,000	$ 22,380,000
Ending balance: individually evaluated for impairment	$ 550,000	$ 539,000	$ 0	$ 1,089,000
Ending balance: collectively evaluated for impairment	$ 19,069,000	$ 2,178,000	$ 44,000	$ 21,291,000
Total loans:				
Ending balance	$2,360,106,000	$392,979,000		$2,753,085,000
Ending balance: individually evaluated for impairment	$ 19,291,000	$ 4,617,000		$ 23,908,000
Ending balance: collectively evaluated for impairment	$2,340,815,000	$388,362,000		$2,729,177,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the year-ended December 31, 2020 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Commercial:			
Commercial and industrial	13	$ 6,914,000	$ 7,717,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	8	14,663,000	14,663,000
Real estate – non-owner occupied	2	319,000	318,000
Real estate – multi-family and residential rental	0	0	0
Total commercial	23	21,896,000	22,698,000
Retail:			
Home equity and other	16	451,000	452,000
1-4 family mortgages	6	151,000	148,000
Total retail	22	602,000	600,000
Total	45	$ 22,498,000	$ 23,298,000

Loans modified as troubled debt restructurings during the year-ended December 31, 2019 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Commercial:			
Commercial and industrial	5	$ 435,000	$ 435,000
Vacant land, land development and residential construction	1	87,000	87,000
Real estate – owner occupied	2	1,669,000	1,669,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total commercial	8	2,191,000	2,191,000
Retail:			
Home equity and other	20	295,000	296,000
1-4 family mortgages	8	310,000	310,000
Total retail	28	605,000	606,000
Total	36	$ 2,796,000	$ 2,797,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due during the year-ended December 31, 2020 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	0	0
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	0	$ 0

The following loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due during the year-ended December 31, 2019 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	0	0
Retail:		
Home equity and other	1	20,000
1-4 family mortgages	2	106,000
Total retail	3	126,000
Total	3	$ 126,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for loans categorized as troubled debt restructurings during the year-ended December 31, 2020 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 8,587,000	$ 85,000	$ 1,145,000	$ 178,000	$ 7,000
Charge-Offs	0	0	0	0	0
Payments	(11,260,000)	(85,000)	(3,765,000)	(585,000)	(7,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	9,087,000	0	17,417,000	887,000	0
Ending Balance	$ 6,414,000	$ 0	$ 14,797,000	$ 480,000	$ 0

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 1,415,000	$ 724,000
Charge-Offs	0	0
Payments	(881,000)	(68,000)
Transfers to ORE	0	0
Net Additions/Deletions	612,000	150,000
Ending Balance	$ 1,146,000	$ 806,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for loans categorized as troubled debt restructurings during the year-ended December 31, 2019 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 14,138,000	$ 0	$ 3,100,000	$ 210,000	$ 24,000
Charge-Offs	0	0	0	0	0
Payments	(20,364,000)	(2,000)	(3,820,000)	(32,000)	(17,000)
Transfers to ORE	0	0	(97,000)	0	0
Net Additions/Deletions	14,813,000	87,000	1,962,000	0	0
Ending Balance	$ 8,587,000	$ 85,000	$ 1,145,000	$ 178,000	$ 7,000

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 1,402,000	$ 578,000
Charge-Offs	(18,000)	0
Payments	(272,000)	(162,000)
Transfers to ORE	0	0
Net Additions/Deletions	303,000	308,000
Ending Balance	$ 1,415,000	$ 724,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for loans categorized as troubled debt restructurings during the year-ended December 31, 2018 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 3,990,000	$ 383,000	$ 2,026,000	$ 237,000	$ 41,000
Charge-Offs	(505,000)	0	0	0	0
Payments	(792,000)	(383,000)	(6,663,000)	(27,000)	(17,000)
Transfers to ORE	0	0	(93,000)	0	0
Net Additions/Deletions	11,445,000	0	7,830,000	0	0
Ending Balance	$ 14,138,000	$ 0	$ 3,100,000	$ 210,000	$ 24,000

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 1,346,000	$ 539,000
Charge-Offs	(30,000)	0
Payments	(323,000)	(41,000)
Transfers to ORE	(82,000)	0
Net Additions/Deletions	491,000	80,000
Ending Balance	$ 1,402,000	$ 578,000

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The allowance related to loans categorized as troubled debt restructurings was as follows:

	December 31, 2020	December 31, 2019
Commercial:		
Commercial and industrial	$ 53,000	$ 202,000
Vacant land, land development, and residential construction	0	0
Real estate – owner occupied	59,000	982,000
Real estate – non-owner occupied	8,000	0
Real estate – multi-family and residential rental	0	0
Total commercial	120,000	1,184,000
Retail:		
Home equity and other	202,000	311,000
1-4 family mortgages	145,000	83,000
Total retail	347,000	394,000
Total related allowance	$ 467,000	$ 1,578,000

In general, our policy dictates that a renewal or modification of an 8- or 9-rated commercial loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a highly questionable ability on our part to collect principal. We believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans renewed or modified were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation.

NOTE 4 - PREMISES AND EQUIPMENT, NET

Year-end premises and equipment were as follows:

	2020	2019
Land and improvements	$ 16,533,000	$ 17,039,000
Buildings	56,114,000	52,847,000
Furniture and equipment	21,522,000	22,712,000
	94,169,000	92,598,000
Less: accumulated depreciation	35,210,000	35,271,000
Total premises and equipment	$ 58,959,000	$ 57,327,000

Future lease payments at December 31, 2020 totaled $3.4 million, comprised of $0.6 million in one year, $1.2 million in one to three years, $0.5 million in three to five years and $1.1 million in over five years. Future lease payments at December 31, 2019 totaled $3.8 million, comprised of $0.6 million in one year, $1.1 million in one to three years, $0.9 million in three to five years and $1.2 million in over five years. Depreciation expense totaled $5.2 million in 2020, $3.9 million in 2019, and $3.6 million in 2018.

NOTE 5 – MORTGAGE LOAN SERVICING

Mortgage loans serviced for others are not reported as assets in the Consolidated Balance Sheets. The year-end aggregate unpaid principal balances of mortgage loans serviced for others were as follows:

	2020	2019
Mortgage loan portfolios serviced for:		
Federal Home Loan Mortgage Corporation	$ 1,030,211,000	$ 711,643,000
Federal Home Loan Bank	8,717,000	15,317,000
Total mortgage loans serviced for others	$ 1,038,928,000	$ 726,960,000

Custodial escrow balances, which are reported as deposits on the Consolidated Balance Sheets, maintained in connection with serviced loans were $11.8 million and $6.4 million as of December 31, 2020 and December 31, 2019, respectively.

Activity for capitalized mortgage loan servicing rights during 2020 and 2019 was as follows:

	2020	2019
Balance at beginning of year	$ 4,652,000	$ 4,436,000
Additions	6,467,000	1,962,000
Amortized to expense	(2,930,000)	(1,746,000)
Balance at end of year	$ 8,189,000	$ 4,652,000

We determined that no valuation allowance was necessary as of December 31, 2020 or December 31, 2019. The estimated fair value of mortgage servicing rights was $10.0 million and $7.4 million as of December 31, 2020 and December 31, 2019, respectively. The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. During 2020, fair value was determined using a discount rate of 7.75%, a weighted average constant prepayment rate of 14.0%, depending on the stratification of the specific right, and a weighted average delinquency rate of 0.40%. During 2019, fair value was determined using a discount rate of 10.0%, a weighted average constant prepayment rate of 15.3%, depending on the stratification of the specific right, and a weighted average delinquency rate of 0.32%.

The weighted average amortization period was 6.1 years and 5.3 years as of December 31, 2020 and December 31, 2019, respectively. Forecasted amortization as of December 31, 2020 is as follows:

2021	$ 1,724,000
2022	1,476,000
2023	1,241,000
2024	1,026,000
2025	834,000
Thereafter	1,888,000

NOTE 6 – CORE DEPOSIT INTANGIBLE ASSET, NET

The gross carrying amount of core deposit intangible assets totaled $17.5 million as of December 31, 2020 and December 31, 2019. As of December 31, 2020, the accumulated amortization on core deposit intangible assets was $15.1 million, providing for a net carry balance of $2.4 million. As of December 31, 2019, the accumulated amortization on core deposit intangible assets was $13.7 million, providing for a net carry balance of $3.8 million.

The scheduled amortization expense on core deposit intangible assets in future periods is:

2021	$ 1,086,000
2022	768,000
2023	450,000
2024	132,000

NOTE 7 – DEPOSITS

Deposits at year-end are summarized as follows:

	December 31, 2020		December 31, 2019		Percent Increase
	Balance	%	Balance	%	(Decrease)
Noninterest-bearing checking	$ 1,433,403,000	42.0%	$ 924,916,000	34.4%	55.0%
Interest-bearing checking	473,053,000	13.9	332,373,000	12.3	42.3
Money market	611,912,000	17.9	509,368,000	18.9	20.1
Savings	338,070,000	9.9	269,318,000	10.0	25.5
Time, under $100,000	165,548,000	4.9	198,123,000	7.4	(16.4)
Time, $100,000 and over	342,633,000	10.0	322,827,000	12.0	6.1
Total local deposits	3,364,619,000	98.6	2,556,925,000	95.0	31.6
Out-of-area time, $100,000 and over	46,934,000	1.4	133,459,000	5.0	(64.8)
Total deposits	$ 3,411,553,000	100.0%	$ 2,690,384,000	100.0%	26.8%

Out-of-area time deposits consist of deposits obtained from depositors outside of our primary market areas exclusively through deposit brokers.

The following table depicts the maturity distribution for time deposits at year-end:

	2020	2019
In one year or less	$ 327,246,000	$ 360,395,000
In one to two years	139,801,000	173,512,000
In two to three years	39,801,000	82,480,000
In three to four years	25,577,000	16,019,000
In four to five years	22,690,000	22,003,000
Total certificates of deposit	$ 555,115,000	$ 654,409,000

NOTE 7 – DEPOSITS (Continued)

The following table depicts the maturity distribution for time deposits with balances of $100,000 or more at year-end:

	2020	2019
Up to three months	$ 79,500,000	$ 100,635,000
Three months to six months	79,373,000	59,838,000
Six months to twelve months	77,363,000	93,691,000
Over twelve months	153,331,000	202,122,000
Total certificates of deposit	$ 389,567,000	$ 456,286,000

Total time deposits of more than $250,000 totaled $272 million and $320 million at year-end 2020 and 2019, respectively.

NOTE 8 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Information regarding securities sold under agreements to repurchase at year-end is summarized below:

	2020	2019
Outstanding balance at year-end	$ 118,365,000	$ 102,675,000
Weighted average interest rate at year-end	0.12%	0.17%
Average daily balance during the year	$ 132,880,000	$ 105,234,000
Weighted average interest rate during the year	0.12%	0.24%
Maximum daily balance during the year	$ 173,186,000	$ 133,411,000

Securities sold under agreements to repurchase (“repurchase agreements”) generally have original maturities of less than one year. Repurchase agreements are treated as financings, and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the repurchase agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements are secured by securities with an aggregate fair value equal to the aggregate outstanding balance.

NOTE 9 - FEDERAL HOME LOAN BANK ADVANCES

Federal Home Loan Bank of Indianapolis ("FHLBI") advances totaled $394 million at December 31, 2020, and were expected to mature at varying dates from November 2021 through June 2027, with fixed rates of interest from 0.55% to 3.18% and averaging 2.06%. FHLBI advances totaled $354 million at December 31, 2019, and were expected to mature at varying dates from April 2020 through June 2025, with fixed rates of interest from 1.36% to 3.18% and averaging 2.45%. In June 2020, we executed a blend and extend transaction with the FHLBI to extend the duration of the FHLBI advance portfolio as part of our interest rate risk management program. We prepaid seven advances aggregating $70.0 million with maturities ranging from August 2020 through October 2021 and fixed interest rates from 1.36% to 2.84% and averaging 1.97%, using the proceeds from seven new advances aggregating $70.0 million with maturities ranging from June 2024 through June 2027 and fixed interest rates from 0.55% to 1.18% and averaging 0.84%. Prepayment fees totaling $0.9 million were embedded into the fixed rates on the newly obtained advances, equating to 0.22% of the 0.84% average rate of the new advances.

Each advance is payable at its maturity date, and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank under a blanket lien arrangement. Our borrowing line of credit as of December 31, 2020 totaled $754 million, with remaining availability based on collateral of $354 million.

Scheduled maturities as of December 31, 2020:

2021	$	20,000,000
2022		94,000,000
2023		80,000,000
2024		80,000,000
2025		50,000,000
Thereafter		70,000,000

NOTE 10 - FEDERAL INCOME TAXES

The consolidated income tax expense is as follows:

	2020	2019	2018
Current expense	$ 14,945,000	$ 10,978,000	$ 10,170,000
Deferred expense	(4,141,000)	26,000	(372,000)
Change in valuation allowance	(94,000)	0	0
Tax expense	$ 10,710,000	$ 11,004,000	$ 9,798,000

NOTE 10 - FEDERAL INCOME TAXES (Continued)

A reconciliation of the differences between the federal income tax expense recorded and the amount computed by applying the federal statutory rate to income before income taxes is as follows:

	2020	2019	2018
Tax at statutory rate	$ 11,518,000	$ 12,697,000	$ 10,883,000
Increase (decrease) from			
Tax-exempt interest	(681,000)	(644,000)	(620,000)
Bank owned life insurance	(238,000)	(804,000)	(201,000)
Change in valuation allowance	(94,000)	0	0
Other	205,000	(245,000)	(264,000)
Tax expense	$ 10,710,000	$ 11,004,000	$ 9,798,000

The statutory tax rate was 21% for 2020, 2019 and 2018.

Significant components of deferred tax assets and liabilities as of December 31, 2020 and 2019 are as follows:

	2020	2019
Deferred income tax assets		
Allowance for loan losses	$ 7,973,000	$ 5,017,000
Deferred compensation	511,000	577,000
Stock compensation	541,000	720,000
Nonaccrual loan interest income	211,000	239,000
Deferred loan fees	924,000	104,000
Capital loss carryforward	0	94,000
Fair value write-downs on foreclosed properties	537,000	26,000
Other	938,000	683,000
Deferred tax asset before valuation allowance	11,635,000	7,460,000
Valuation allowance	0	(94,000)
Deferred tax asset after valuation allowance	11,635,000	7,366,000
Deferred income tax liabilities		
Depreciation	1,175,000	1,743,000
Prepaid expenses	297,000	269,000
Core deposit intangible	498,000	787,000
Mortgage loan servicing rights	1,720,000	977,000
Unrealized gain on securities	1,458,000	982,000
Business combination adjustments	2,142,000	2,058,000
Other	521,000	485,000
Deferred tax liability	7,811,000	7,301,000
Total net deferred tax asset	$ 3,824,000	$ 65,000

NOTE 10 - FEDERAL 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 benefits related to such assets will not be realized. At December 31, 2019, we carried a valuation allowance of $0.1 million against capital loss carryforwards generated by the disposal of certain capital investments acquired in our merger with Firstbank. The $0.1 million of capital loss carryforwards expired at December 31, 2020 and we no longer carry this asset or the valuation allowance against it.

We had no unrecognized tax benefits at any time during 2020 or 2019 and do not anticipate any significant increase in unrecognized tax benefits during 2021. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income tax accounts; no such accruals existed at any time during 2020 or 2019. Our U.S. federal income tax returns are no longer subject to examination for all years before 2017.

NOTE 11 – STOCK-BASED COMPENSATION

Stock-based compensation plans are used to provide directors and employees with an increased incentive to contribute to our long-term performance and growth, to align the interests of directors and employees with the interests of our shareholders through the opportunity for increased stock ownership and to attract and retain directors and employees. During 2014 and 2015, stock option and restricted stock grants were provided to certain employees from the Stock Incentive Plan of 2006. During the years 2016 through 2019, restricted stock grants were provided to certain employees from the Stock Incentive Plan of 2016. During 2020, restricted stock grants were provided to certain employees from the Stock Incentive Plan of 2020. Stock option grants were provided to certain employees during 2016 from the Stock Incentive Plan of 2016. Stock grants to directors as retainer payments during the years 2016 through 2019 were from the Stock Incentive Plan of 2016, while stock grants to directors as retainer payments during 2020 were from the Stock Incentive Plan of 2020. The Stock Incentive Plan of 2006 expired on January 18, 2016, and was effectively replaced with the Stock Incentive Plan of 2016 that was approved by shareholders in May, 2016. The Stock Incentive Plan of 2016 was effectively replaced with the Stock Incentive Plan of 2020 that was approved by shareholders in May, 2020.

Under the Stock Incentive Plan of 2006, the Stock Incentive Plan of 2016 and the Stock Incentive Plan of 2020, incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards. Incentive awards that are stock options or stock appreciation rights are granted with an exercise price not less than the closing price of our common stock on the date of grant. Price, vesting and expiration date parameters are determined by Mercantile's Compensation Committee on a grant-by-grant basis. No payments are required from employees for restricted stock awards. The restricted stock awards granted during the years 2014 through 2020 fully vest after three years and, in the case of performance-based restricted stock issued to executive officers in 2018, 2019 and 2020, are subject to the attainment of pre-determined performance goals. The stock options granted during 2014, 2015 and 2016, which were at 110% of the market price on the date of grant, fully vest after two years and expire after seven years. At year-end 2020, there were approximately 361,000 shares authorized for future incentive awards.

In conjunction with the Firstbank merger, we issued Mercantile stock options in replacement of all outstanding Firstbank stock option grants that had been previously issued to Firstbank employees under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 and the Firstbank Corporation 2006 Stock Compensation Plan. In general, stock option grants for 50 shares or less fully vested after one year from date of grant, while stock option grants for more than 50 shares vested over a five-year period at 20% of the grant per annum starting one year from date of grant. The stock option grants expire ten years from date of grant. There were approximately 282,200 Mercantile stock options issued as a result of the merger, with about 258,400 of the stock option grants fully vested and exercisable on the date of merger. The remaining 23,800 stock option grants vested during 2015.

NOTE 11 – STOCK-BASED COMPENSATION (Continued)

A summary of restricted stock activity from grants issued during the past three years is as follows:

	2020		2019		2018	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Nonvested at beginning of year	262,260	$ 34.91	262,967	$ 33.97	239,637	$ 32.37
Granted	121,518	24.65	84,596	35.29	91,400	31.82
Vested	(85,445)	37.08	(81,772)	32.19	(55,792)	25.14
Forfeited	(35,997)	33.71	(3,531)	34.85	(12,278)	31.62
Nonvested at end of year	262,336	$ 29.42	262,260	$ 34.91	262,967	$ 33.97

Of the restricted stock shares granted in 2020, 2019 and 2018, a total of 31,295 shares, 23,596 shares and 24,633 shares, respectively, are performance-based awards made to our Named Executive Officers at the target level and are subject to the attainment of pre-determined performance goals. Of the forfeited shares during 2020, a total of 13,709 shares and 14,681 shares reflect reductions in performance-based grants to our Named Executive Officers that were awarded in 2019 and 2018, respectively. These forfeitures were based on an analysis of the pre-determined performance goals, taking into account actual performance since the grant date and forecasts for the remainder of the three-year performance period.

A summary of stock option activity during the past three years is as follows:

	2020		2019		2018	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	10,700	$ 30.25	18,900	$ 23.92	30,908	$ 18.67
Granted	0	NA	0	NA	0	NA
Exercised	(1,000)	5.19	(8,200)	15.69	(12,008)	10.38
Forfeited or expired	0	NA	0	NA	0	NA
Outstanding at end of year	9,700	$ 32.83	10,700	$ 30.25	18,900	$ 23.92
Options exercisable at year-end	9,700	$ 32.83	10,700	$ 30.25	18,900	$ 23.92

The fair value of each stock option award is estimated on the date of grant using a closed option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities on our common stock. Historical data is used to estimate stock option expense and post-vesting termination behavior. The expected term of stock options granted is based on historical data and represents the period of time that stock options granted are expected to be outstanding, which takes into account that the stock options are not transferable. The risk-free interest rate for the expected term of the stock option is based on the U.S. Treasury yield curve in effect at the time of the stock option grant. No stock option grants were made during the past three years.

NOTE 11 – STOCK-BASED COMPENSATION (Continued)

Options at year-end 2020 were as follows:

	Outstanding			Exercisable	
Range of Exercise Prices	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
$22.00 - $23.00	1,000	0.9	$ 22.15	1,000	22.15
$27.00 - $28.00	2,200	1.9	27.66	2,200	27.66
$36.00 - $37.00	6,500	2.9	36.22	6,500	36.22
Outstanding at year end	9,700	2.4	$ 32.83	9,700	32.83

Information related to options outstanding at year-end 2020, 2019 and 2018 is as follows:

	2020	2019	2018
Minimum exercise price	$ 22.15	$ 5.19	$ 5.19
Maximum exercise price	36.22	36.22	36.22
Average remaining option term (years)	2.4	3.2	3.4

Information related to stock option grants and exercises during 2020, 2019 and 2018 is as follows:

	2020	2019	2018
Aggregate intrinsic value of stock options exercised	$ 17,000	$ 157,000	$ 317,000
Cash received from stock option exercises	3,000	126,000	141,000
Tax benefit realized from stock option exercises	0	0	0
Weighted average per share fair value of stock options granted	NA	NA	NA

The aggregate intrinsic value of in-the-money stock options issued under Mercantile plans outstanding and exercisable at December 31, 2020 was less than $0.1 million. Shares issued as a result of the exercise of stock option grants have been authorized and were previously unissued shares.

NOTE 11– STOCK-BASED COMPENSATION (Continued)

On May 25, 2017, we granted about 12,000 shares of common stock to our Corporate, Bank and Regional Advisory Boards of Directors for retainer payments for the period of June 1, 2017 through May 31, 2018. The associated $0.4 million cost was expensed on a straightline basis over the respective twelve month period. On May 24, 2018, we granted about 11,000 shares of common stock to our Corporate, Bank and Regional Advisory Boards of Directors for retainer payments for the period of June 1, 2018 through May 31, 2019. The associated $0.4 million cost was expensed on a straightline basis over the respective twelve month period. On October 25, 2018, we granted about 1,000 shares of common stock to newly appointed Bank Board members for retainer payments for the period of October 1, 2018 through May 31, 2019. The associated less than $0.1 million cost was expensed over the respective eight-month period. On May 23, 2019, we granted about 12,000 shares of common stock to our Corporate, Bank and Regional Advisory Boards of Directors for retainer payments for the period of June 1, 2019 through May 31, 2020. The associated $0.4 million cost was expensed on a straightline basis over the respective twelve month period. On June 1, 2020, we granted about 16,000 shares of common stock to our Corporate, Bank and Regional Advisory Boards of Directors for retainer payments for the period of June 1, 2020 through May 31, 2021. The associated $0.3 million cost is being expensed on a straightline basis over the respective twelve month period. On August 27, 2020, we granted about 2,000 shares of common stock to newly appointed Corporate and Bank Board members for retainer payments for the period of September 1, 2020 through May 31, 2021. The associated less than $0.1 million cost is being expensed over the respective nine-month period.

NOTE 12 – RELATED PARTIES

Certain directors and executive officers of our bank, including their immediate families and companies in which they are principal owners, were loan customers of our bank. At year-end 2020 and 2019, our bank had $122 million and $115 million in loan commitments to directors and executive officers, of which $108 million and $104 million were outstanding at year-end 2020 and 2019, respectively, as reflected in the following table.

	2020	2019
Beginning balance	$ 104,043,000	$ 92,033,000
New loans	13,823,000	16,662,000
Repayments	(9,824,000)	(4,652,000)
Ending balance	$ 108,042,000	$ 104,043,000

Paycheck Protection Program loans to related companies of our directors totaled $0.3 million as of December 31, 2020.

Related party deposits and repurchase agreements totaled $19.4 million and $15.0 million at year-end 2020 and 2019, respectively.

NOTE 13 – COMMITMENTS AND OFF-BALANCE-SHEET RISK

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are conditional commitments issued by our bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on management's credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. There was no liability balance for these instruments as of December 31, 2020 and 2019.

At year-end 2020 and 2019, the rates on existing off-balance sheet instruments were substantially equivalent to current market rates, considering the underlying credit standing of the counterparties.

Our maximum exposure to credit losses for loan commitments and standby letters of credit outstanding at year-end was as follows:

	2020	2019
Commercial unused lines of credit	$ 1,019,496,000	$ 776,493,000
Unused lines of credit secured by 1 – 4 family residential properties	59,396,000	60,858,000
Credit card unused lines of credit	72,495,000	58,199,000
Other consumer unused lines of credit	30,707,000	18,135,000
Commitments to make loans	227,558,000	101,961,000
Standby letters of credit	20,543,000	22,798,000
Total commitments	$ 1,430,195,000	$ 1,038,444,000

Commitments to make loans generally reflect our binding obligations to existing and prospective customers to extend credit, including line of credit facilities secured by accounts receivable and inventory, and term debt secured by either real estate or equipment. In most instances, line of credit facilities are for a one-year term and are at a floating rate tied to the Wall Street Journal Prime Rate or the 30-Day Libor rate. For term debt secured by real estate, customers are generally offered a floating rate tied to the Wall Street Journal Prime Rate or the 30-Day Libor rate, and a fixed rate currently ranging from 3.00% to 5.00%. These credit facilities generally balloon within five years, with payments based on amortizations ranging from 10 to 20 years. For term debt secured by non-real estate collateral, customers are generally offered a floating rate tied to the Wall Street Journal Prime Rate or the 30-Day Libor rate, and a fixed rate currently ranging from 3.50% to 5.00%. These credit facilities generally mature and fully amortize within three to seven years.

NOTE 13 – COMMITMENTS AND OFF-BALANCE-SHEET RISK (Continued)

The following instruments are considered financial guarantees under current accounting guidance. These instruments are carried at fair value.

	2020		2019	
	Contract Amount	Carrying Value	Contract Amount	Carrying Value
Standby letters of credit	$ 20,543,000	$ 138,000	$ 22,798,000	$ 160,000

The Federal Reserve Board reduced reserve requirements for all depository institutions to zero percent effective March 26, 2020; as a result, we did not have a reserve requirement as of December 31, 2020. We were required to have $10.7 million of cash on hand or on deposit with the Federal Reserve Bank of Chicago to meet regulatory reserve and clearing requirements at December 31, 2019.

NOTE 14 – BENEFIT PLANS

We have a 401(k) benefit plan that covers substantially all of our employees. The percent of our matching contributions to the 401(k) benefit plan is determined annually by the Board of Directors. The matching contribution had been 4.25% since January 1, 2014; effective April 1, 2018, the matching contribution was increased to 5.00%. Matching contributions, if made, are immediately vested. Our 2020, 2019 and 2018 matching 401(k) contributions charged to expense were $1.9 million, $1.7 million and $1.6 million, respectively.

We have a deferred compensation plan in which all persons serving on the Board of Directors may defer all or portions of their annual retainer and meeting fees, with distributions to be paid upon termination of service as a director or specific dates selected by the director. We also have a non-qualified deferred compensation program in which selected officers may defer all or portions of salary and bonus payments. The deferred amounts, totaling $2.4 million and $2.7 million as of December 31, 2020 and 2019, respectively, are categorized as other liabilities in the Consolidated Balance Sheets, and are paid interest at a rate equal to the Wall Street Journal Prime Rate. Interest expense was $0.1 million during 2020, 2019 and 2018.

The Mercantile Bank Corporation Employee Stock Purchase Plan of 2014 is a non-compensatory plan intended to encourage full- and part-time employees of Mercantile and its subsidiaries to promote our best interests and to align employees' interests with the interests of our shareholders by permitting employees to purchase shares of our common stock through regular payroll deductions. Shares are purchased on the last business day of each calendar quarter at a price equal to the consolidated closing bid price of our common stock reported on The Nasdaq Stock Market. A total of 250,000 shares of common stock may be issued under the existing plan; however, the number of shares may be adjusted to reflect any stock dividends and other changes in our capitalization. The number of shares issued totaled 2,264 and 1,507 in 2020 and 2019, respectively. As of December 31, 2020, there were approximately 239,000 shares available under our current plan.

NOTE 15 – DERIVATIVES AND HEDGING ACTIVITIES

We are exposed to certain risks arising from both business operations and economic conditions. We principally manage the exposure to a wide variety of operational risks through core business activities. Economic risks, including interest rate, liquidity and credit risk, are primarily administered via the amount, sources and duration of assets and liabilities. Derivative financial instruments may also be used to assist in managing economic risks.

Derivatives not designated as hedges are not speculative and result from a service provided to certain commercial loan borrowers. We execute interest rate swaps with commercial banking customers desiring longer-term fixed rate loans, while simultaneously entering into interest rate swaps with a correspondent bank to offset the impact of the interest rate swaps with the commercial banking customers. The net result is the desired floating rate loans and a minimization of the risk exposure of the interest rate swap transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the commercial banking customer interest rate swaps and the offsetting interest rate swaps with the correspondent bank are recognized directly to earnings.

The fair value of derivative instruments as of December 31, 2020 are reflected in the following table. No interest rate swaps were outstanding as of December 31, 2019.

	Notional Amount	Balance Sheet Location	Fair Value
Derivative Assets			
Interest rate swaps	$ 33,731,000	Other Assets	$ 1,003,000
Derivative Liabilities			
Interest rate swaps	33,731,000	Other Liabilities	1,027,000

The effect of interest rate swaps that are not designated as hedging instruments resulted in noninterest expense of less than $0.1 million during the year-ended December 31, 2020. There were no such instruments outstanding during 2019.

The fair value of interest rate swaps in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk related to these agreements, was $1.0 million as of December 31, 2020. Cash collateral totaling $1.1 million was provided to the counterparty correspondent bank as of December 31, 2020.

Interest rate swaps entered into with commercial loan customers had notional amounts aggregating $33.7 million as of December 31, 2020. Associated credit exposure is generally mitigated by securing the interest rates swaps with the underlying collateral of the loan instrument that has been hedged.

NOTE 16 – FAIR VALUES OF FINANCIAL INSTRUMENTS

Carrying amount, estimated fair value and level within the fair value hierarchy of financial instruments were as follows at year-end (dollars in thousands):

	Level in Fair Value Hierarchy	2020 Carrying Amount	2020 Fair Value	2019 Carrying Amount	2019 Fair Value
Financial assets					
Cash	Level 1	$ 16,953	$ 16,953	$ 16,430	$ 16,430
Cash equivalents	Level 2	609,053	609,053	217,301	217,301
Securities available for sale	(1)	387,347	387,347	334,655	334,655
Federal Home Loan Bank stock	(2)	18,002	18,002	18,002	18,002
Loans, net	Level 3	3,155,503	3,294,522	2,827,800	2,887,168
Loans held for sale	Level 2	22,888	24,029	4,978	4,978
Mortgage servicing rights	Level 2	8,189	10,006	4,652	7,375
Accrued interest receivable	Level 2	10,861	10,861	9,944	9,944
Financial liabilities					
Deposits	Level 2	3,411,553	3,397,768	2,690,384	2,600,452
Securities sold under agreements to repurchase	Level 2	118,365	118,365	102,675	102,675
Federal Home Loan Bank advances	Level 2	394,000	410,881	354,000	361,887
Subordinated debentures	Level 2	47,563	47,574	46,881	46,140
Accrued interest payable	Level 2	2,313	2,313	3,949	3,949

(1) See Note 17 for a description of the fair value hierarchy as well as a disclosure of levels for classes of financial assets and liabilities.
(2) It is not practical to determine the fair value of FHLBI stock due to transferability restrictions; therefore, fair value is estimated at carrying amount.

Carrying amount is the estimated fair value for cash and cash equivalents, FHLBI stock, accrued interest receivable and payable, noninterest-bearing checking accounts and securities sold under agreements to repurchase. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. Fair value for loans is based on an exit price model as required by ASU 2016-01, taking into account inputs such as discounted cash flows, probability of default and loss given default assumptions. Fair value for deposit accounts other than noninterest-bearing checking accounts is based on discounted cash flows using current market rates applied to the estimated life. The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. The fair values of subordinated debentures and FHLBI advances are based on current rates for similar financing. The fair value of off-balance sheet items is estimated to be nominal.

NOTE 17 – FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The price of the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

We are required to use valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect our own estimates about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. In that regard, we utilize a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that we have 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 in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be derived from or corroborated by observable market data by correlation or other means.

Level 3: Significant unobservable inputs that reflect our own estimates about the assumptions that market participants would use in pricing an asset or liability.

The following is a description of our valuation methodologies used to measure and disclose the fair values of our financial assets and liabilities on a recurring or nonrecurring basis:

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency debt obligations, mortgage-backed securities issued or guaranteed by U.S. Government agencies, and municipal general obligation and revenue bonds. Level 3 securities include bonds issued by certain relatively small municipalities located within our markets that have very limited marketability due to their size and lack of ratings from a recognized rating service. We carry these bonds at historical cost, which we believe approximates fair value, unless our periodic financial analysis or other information that becomes known to us necessitates an impairment. There was no such impairment as of December 31, 2020 or 2019. We have no Level 1 securities available for sale.

NOTE 17 – FAIR VALUE MEASUREMENTS (Continued)

Mortgage loans held for sale. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market, as determined by outstanding commitments from investors, and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of December 31, 2020 and 2019, we determined the fair value of our mortgage loans held for sale to be $24.0 million and $5.0 million, respectively.

Loans. We do not record loans at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans to reflect partial write-downs or specific reserves that are based on the observable market price or current estimated value of the collateral. These loans are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off. The fair values of impaired loans are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

Foreclosed assets. At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans to foreclosed and repossessed assets, establishing a new cost basis. We subsequently adjust estimated fair value on foreclosed assets on a nonrecurring basis to reflect write-downs based on revised fair value estimates. The fair values of parcels of other real estate owned are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

Derivatives. We measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2020 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	$242,141,000	$ 0	$242,141,000	$ 0
Mortgage-backed securities	24,890,000	0	24,890,000	0
Municipal general obligation bonds	107,824,000	0	107,058,000	766,000
Municipal revenue bonds	11,992,000	0	11,992,000	0
Other investments	500,000	0	500,000	0
Total	$387,347,000	$ 0	$386,581,000	$ 766,000

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2020. The $1.3 million reduction in Level 3 municipal general obligation bonds during 2020 reflects the scheduled maturities of such bonds.

NOTE 17 – FAIR VALUE MEASUREMENTS (Continued)

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2019 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	$186,410,000	$ 0	$186,410,000	$ 0
Mortgage-backed securities	42,470,000	0	42,470,000	0
Municipal general obligation bonds	101,079,000	0	99,029,000	2,050,000
Municipal revenue bonds	4,196,000	0	4,196,000	0
Other investments	500,000	0	500,000	0
Total	$334,655,000	$ 0	$332,605,000	$ 2,050,000

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2019. The $1.7 million reduction in Level 3 municipal general obligation bonds during 2019 reflects the scheduled maturities of such bonds.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2020 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 2,880,000	$ 0	$ 0	$ 2,880,000
Foreclosed assets	701,000	0	0	701,000
Total	$ 3,581,000	$ 0	$ 0	$ 3,581,000

NOTE 17 – FAIR VALUE MEASUREMENTS (Continued)

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2019 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 1,107,000	$ 0	$ 0	$ 1,107,000
Foreclosed assets	452,000	0	0	452,000
Total	$ 1,559,000	$ 0	$ 0	$ 1,559,000

The carrying values are based on the estimated value of the property or other assets. Fair value estimates of collateral on impaired loans and foreclosed assets are reviewed periodically. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside appraisals and internal evaluations based on identifiable trends within our markets, such as sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address current distressed market conditions. For real estate dependent loans and foreclosed assets, we generally assign a 15% to 25% discount factor for commercial-related properties, and a 25% to 50% discount factor for residential-related properties. In a vast majority of cases, we assign a 10% discount factor for estimated selling costs.

NOTE 18 – EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

	2020	2019	2018
Basic			
Net income attributable to common shares	$ 44,138,000	$ 49,456,000	$ 42,024,000
Weighted average common shares outstanding	16,268,689	16,405,159	16,600,612
Basic earnings per common share	$ 2.71	$ 3.01	$ 2.53
Diluted			
Net income attributable to common shares	$ 44,138,000	$ 49,456,000	$ 42,024,000
Weighted average common shares outstanding for basic earnings per common share	16,268,689	16,405,159	16,600,612
Add: Dilutive effects of share-based awards	630	3,976	5,804
Average shares and dilutive potential common shares	16,269,319	16,409,135	16,606,416
Diluted earnings per common share	$ 2.71	$ 3.01	$ 2.53

Stock options for approximately 9,000, 7,000 and 7,000 shares of common stock were antidilutive and were not included in determining dilutive earnings per share in 2020, 2019 and 2018, respectively.

NOTE 19 – SUBORDINATED DEBENTURES

We have five business trusts that are wholly-owned subsidiaries of Mercantile, four of which were assumed by Mercantile in conjunction with the Firstbank merger. A fair value discount of $15.0 million was recorded at the time of the merger, which is being amortized at $0.7 million annually over the following 21.5 years. Each of the trusts was formed to issue Preferred Securities that were sold in private sales, as well as selling Common Securities to Mercantile. The proceeds from the Preferred and Common Securities sales were used by the trusts to purchase Floating Rate Notes issued by Mercantile. The rates of interest, interest payment dates, call features and maturity dates of each Floating Rate Note are identical to its respective Preferred Securities. The net proceeds from the issuance of the Floating Rate Notes were used for a variety of purposes, including contributions to our bank as capital to provide support for asset growth and the funding of stock repurchase programs and certain acquisitions.

The only significant assets of our trusts are the Floating Rate Notes, and the only significant liabilities of our trusts are the Preferred Securities. The Floating Rate Notes are categorized on our Consolidated Balance Sheets as subordinated debentures and the interest expense is recorded on our Consolidated Statements of Income under interest expense on other borrowings.

On January 26, 2016, we closed on a repurchase of trust preferred securities that were auctioned as part of a pooled collateralized debt obligation (“Fund”). The Fund owned $11.0 million of the $32.0 million in trust preferred securities that had been issued by Mercantile Bank Capital Trust I. The $11.0 million in trust preferred securities was retired upon the repurchase, resulting in a commensurate reduction in the related Floating Rate Junior Subordinate Note, leaving $21.0 million outstanding.

NOTE 19 – SUBORDINATED DEBENTURES (Continued)

The following table depicts our five business trusts as of December 31, 2020:

Trust Name	Preferred Securities Outstanding	Interest Rate	Maturity Date
Mercantile Bank Capital Trust I	$21,000,000	3 Month Libor + 218 bps	September 16, 2034
Firstbank Capital Trust I	$10,000,000	3 Month Libor + 199 bps	October 18, 2034
Firstbank Capital Trust II	$10,000,000	3 Month Libor + 127 bps	April 7, 2036
Firstbank Capital Trust III	$7,500,000	3 Month Libor + 135 bps	July 30, 2037
Firstbank Capital Trust IV	$7,500,000	3 Month Libor + 135 bps	July 30, 2037

NOTE 20 - REGULATORY MATTERS

We are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At year-end 2020 and 2019, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2020 that we believe have changed our bank's categorization.

NOTE 20 - REGULATORY MATTERS (Continued)

Our actual capital levels (dollars in thousands) and minimum required levels were:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2020						
Total capital (to risk weighted assets)						
Consolidated	$ 468,113	13.8%	$ 271,325	8.0%	$ NA	NA
Bank	457,203	13.5	271,196	8.0	338,995	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	430,146	12.7	203,494	6.0	NA	NA
Bank	419,236	12.4	203,397	6.0	271,196	8.0
Common equity (to risk weighted assets)						
Consolidated	384,658	11.3	152,621	4.5	NA	NA
Bank	419,236	12.4	152,548	4.5	220,347	6.5
Tier 1 capital (to average assets)						
Consolidated	430,146	9.8	176,053	4.0	NA	NA
Bank	419,236	9.5	175,999	4.0	219,999	5.0
2019						
Total capital (to risk weighted assets)						
Consolidated	$ 429,038	13.1%	$ 262,141	8.0%	$ NA	NA
Bank	424,917	13.0	262,088	8.0	327,610	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	405,148	12.4	196,606	6.0	NA	NA
Bank	401,027	12.2	196,566	6.0	262,088	8.0
Common equity (to risk weighted assets)						
Consolidated	360,342	11.0	147,454	4.5	NA	NA
Bank	401,027	12.2	147,425	4.5	212,947	6.5
Tier 1 capital (to average assets)						
Consolidated	405,148	11.3	143,689	4.0	NA	NA
Bank	401,027	11.2	143,670	4.0	179,588	5.0

(Continued)

NOTE 20 - REGULATORY MATTERS (Continued)

Under the final BASEL III capital rules that became effective on January 1, 2015, there is a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not meet this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in cash dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement was phased in over three years beginning in 2016. The capital buffer requirement raised the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5% and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. We believe that, as of December 31, 2020, our bank meets all capital adequacy requirements under the BASEL III capital rules on a fully phased-in basis.

Federal and state banking laws and regulations place certain restrictions on the amount of dividends our bank can transfer to Mercantile and on the capital levels that must be maintained. At year-end 2020, under the most restrictive of these regulations, our bank could distribute $85.7 million to Mercantile as dividends without prior regulatory approval. Our and our bank’s ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on March 18, 2020 to shareholders of record as of March 6, 2020. On April 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on June 17, 2020 to shareholders of record as of June 5, 2020. On July 16, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on September 16, 2020 to shareholders of record as of September 4, 2020. On October 15, 2020, our Board of Directors declared a cash dividend on our common stock in the amount of $0.28 per share that was paid on December 16, 2020 to shareholders of record as of December 4, 2020.

On January 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of $0.29 per share that will be paid on March 17, 2021 to shareholders of record as of March 5, 2021.

In May 2019, we announced that our Board of Directors had authorized a program to repurchase up to $20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. During the first quarter of 2020, we repurchased approximately of 222,000 for $6.3 million, at an average price per share of $28.25. After electing to temporarily cease stock repurchases in March 2020 to preserve capital for lending and other purposes while we assessed the potential impacts of the Coronavirus Pandemic, we reinstated the buyback program during the fourth quarter of 2020. Fourth quarter repurchases totaled approximately 14,000 shares for $0.3 million, at an average weighted price per share of $22.05. Availability under our current repurchase plan totals about $10.0 million. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan or a new plan, which would also likely be funded from cash dividends paid to us from our bank.

Our consolidated capital levels as of December 31, 2020 and 2019 include $45.5 million and $44.8 million, respectively, of trust preferred securities. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core capital elements that may be included in Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than $15.0 billion. At December 31, 2020 and 2019, all $45.5 million and $44.8 million, respectively, of the trust preferred securities were included as Tier 1 capital of Mercantile.

NOTE 21 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

At December 31, 2020, accumulated other comprehensive income, net of tax effects (as applicable), consisted of a net unrealized gain on available for sale securities of $5.5 million. At December 31, 2019, accumulated other comprehensive income, net of tax effects (as applicable), consisted of a net unrealized gain on available for sale securities of $3.7 million.

NOTE 22 - QUARTERLY FINANCIAL DATA (Unaudited)

	Interest Income	Net Interest Income	Net Income	Earnings per Share Basic	Earnings per Share Diluted
2020					
First quarter	$37,935,000	$30,317,000	$10,673,000	$ 0.65	$ 0.65
Second quarter	37,164,000	30,571,000	8,697,000	0.54	0.54
Third quarter	35,594,000	29,509,000	10,686,000	0.66	0.66
Fourth quarter	37,620,000	31,849,000	14,082,000	0.86	0.86
2019					
First quarter	$38,637,000	$30,645,000	$11,824,000	$ 0.72	$ 0.72
Second quarter	39,820,000	31,116,000	11,715,000	0.71	0.71
Third quarter	40,316,000	31,605,000	12,600,000	0.77	0.77
Fourth quarter	39,564,000	31,168,000	13,317,000	0.81	0.81

NOTE 23 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY) CONDENSED FINANCIAL STATEMENTS

CONDENSED BALANCE SHEETS

	2020	2019
ASSETS		
Cash and cash equivalents	$ 12,746,000	$ 6,045,000
Investment in bank subsidiary	458,830,000	439,946,000
Other assets	18,934,000	18,032,000
Total assets	$ 490,510,000	$ 464,023,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities	$ 1,393,000	$ 581,000
Subordinated debentures	47,563,000	46,881,000
Shareholders' equity	441,554,000	416,561,000
Total liabilities and shareholders' equity	$ 490,510,000	$ 464,023,000

(Continued)

NOTE 23 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY) CONDENSED FINANCIAL STATEMENTS (Continued)

CONDENSED STATEMENTS OF INCOME

	2020	2019	2018
Income			
Interest and dividends from subsidiaries	$ 32,588,000	$ 22,246,000	$ 33,832,000
Total income	32,588,000	22,246,000	33,832,000
Expenses			
Interest expense	2,268,000	3,153,000	2,999,000
Other operating expenses	4,441,000	4,804,000	4,424,000
Total expenses	6,709,000	7,957,000	7,423,000
Income before income tax benefit and equity in undistributed net income of subsidiary	25,879,000	14,289,000	26,409,000
Federal income tax benefit	(1,173,000)	(1,718,000)	(1,610,000)
Equity in undistributed net income of subsidiary	17,086,000	33,449,000	14,005,000
Net income	$ 44,138,000	$ 49,456,000	$ 42,024,000
Comprehensive income	$ 45,929,000	$ 61,390,000	$ 38,646,000

NOTE 23 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY) CONDENSED FINANCIAL STATEMENTS (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

	2020	2019	2018
Cash flows from operating activities			
Net income	$ 44,138,000	$ 49,456,000	$ 42,024,000
Adjustments to reconcile net income to net cash from operating activities:			
Equity in undistributed net income of subsidiary	(17,086,000)	(33,449,000)	(14,005,000)
Stock-based compensation expense	2,325,000	2,931,000	2,410,000
Stock grants to directors for retainer fees	394,000	375,000	441,000
Change in other assets	(227,000)	2,387,000	1,384,000
Change in other liabilities	812,000	(1,924,000)	(187,000)
Net cash from operating activities	30,356,000	19,776,000	32,067,000
Cash flows from investing activities			
Net capital investment into subsidiaries	0	0	0
Net cash for investing activities	0	0	0
Cash flows from financing activities			
Stock option exercises, net of cashless exercises	3,000	128,000	108,000
Employee stock purchase plan	49,000	50,000	52,000
Dividend reinvestment plan	814,000	729,000	1,165,000
Repurchase of common shares	(6,591,000)	(7,183,000)	(5,943,000)
Cash dividends on common stock	(17,930,000)	(17,108,000)	(27,500,000)
Net cash for financing activities	(23,655,000)	(23,384,000)	(32,118,000)
Net change in cash and cash equivalents	6,701,000	(3,608,000)	(51,000)
Cash and cash equivalents at beginning of period	6,045,000	9,653,000	9,704,000
Cash and cash equivalents at end of period	$ 12,746,000	$ 6,045,000	$ 9,653,000

EXHIBIT INDEX

EXHIBIT NO.	EXHIBIT DESCRIPTION
3.1	Our Articles of Incorporation are incorporated by reference to exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009
3.2	Our Amended and Restated By-laws dated as of February 26, 2015 are incorporated by reference to exhibit 3.1 to our Current Report on Form 8-K filed February 26, 2015
4.1	Instruments defining the Rights of Security Holders – reference is made to Exhibits 3.1 and 3.2. In accordance with Regulation S-K Item 601(b)(4), Mercantile Bank Corporation is not filing copies of instruments defining the rights of holders of long-term debt because none of those instruments authorizes debt in excess of 10% of the total assets of Mercantile Bank Corporation and its subsidiaries on a consolidated basis. Mercantile Bank Corporation hereby agrees to furnish a copy of any such instrument to the Securities and Exchange Commission upon request.
10.1	Form of Mercantile Bank of Michigan Split Dollar Agreement that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank is incorporated by reference to exhibit 10.33 of our Form 10-K for the year ended December 31, 2005*
10.2	Form of Notice of Grant of Incentive Stock Option and Stock Option Agreement for incentive stock options granted after 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.41 of our Form 10-K for the year ended December 31, 2007*
10.3	Mercantile Bank Corporation Employee Stock Purchase Plan of 2014 is incorporated by reference to exhibit 4(b) of our Registration Statement on Form S-8 that became effective on June 27, 2014
10.4	Form of Restricted Stock Award Agreement, incorporated by reference to exhibit 10.1 of our Form 8-K filed November 18, 2016*
10.5	Form of Stock Option Agreement, incorporated by reference to exhibit 10.2 of our Form 8-K filed November 18, 2016*
10.6	2018 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 25, 2018*
10.7	Amended and Restated Employment Agreement of Robert B. Kaminski, Jr. dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.1 of our Form 8-K filed December 3, 2018*
10.8	Amended and Restated Employment Agreement of Charles E. Christmas dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.2 of our Form 8-K filed December 3, 2018*
10.9	Amended and Restated Employment Agreement of Raymond E. Reitsma dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.3 of our Form 8-K filed December 3, 2018*
10.10	Amended and Restated Employment Agreement of Robert T. Worthington dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.4 of our Form 8-K filed December 3, 2018*
10.11	Amended and Restated Employment Agreement of Lonna L. Wiersma dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.5 of our Form 8-K filed December 3, 2018*

EXHIBIT NO.	EXHIBIT DESCRIPTION
10.12	Amended and Restated Change in Control Agreement of Robert B. Kaminski, Jr. dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.6 of our Form 8-K filed December 3, 2018*
10.13	Amended and Restated Change in Control Agreement of Charles E. Christmas dated November 29, 2018, effective December 31, 2018, incorporated by reference to exhibit 10.7 of our Form 8-K filed December 3, 2018*
10.14	Form of Performance Based Restricted Stock Award Agreement, incorporated by reference to exhibit 10.8 of our Form 8-K filed December 3, 2018*
10.15	2019 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 24, 2019*
10.16	Mercantile Bank Corporation Stock Incentive Plan of 2020, incorporated by reference to Appendix A to Mercantile's Definitive Proxy Statement on Schedule 14A filed April 9, 2020*
10.17	Form of Performance-Based Restricted Stock Award Agreement, in connection with the Mercantile Bank Corporation Stock Incentive Plan of 2020*
10.18	2020 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed November 19, 2020*
10.19	Director Fee Summary*
21	Subsidiaries of the company
23	Consent of BDO USA, LLP
31	Rule 13a-14(a) Certifications
32.1	Section 1350 Chief Executive Officer Certification
32.2	Section 1350 Chief Financial Officer Certification
101	The following information from Mercantile's Annual Report on Form 10-K for the year ended December 31, 2020, formatted in Inline XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements
104	Cover Page Interactive Data File (formatted as Inline XBRL and contained in Exhibit 101)

* Management contract or compensatory plan.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 5, 2021.

MERCANTILE BANK CORPORATION

/s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 5, 2021.

/s/ David M. Cassard
David M. Cassard, Director

/s/ Michael S. Davenport
Michael S. Davenport, Director

/s/ Michelle L. Eldridge
Michelle L. Eldridge, Director

/s/ Jeff A. Gardner
Jeff A. Gardner, Director

/s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
Director, President and Chief Executive Officer
(principal executive officer)

/s/ Michael H. Price
Michael H. Price, Chairman of the Board

/s/ David B. Ramaker
David B. Ramaker, Director

/s/ Charles E. Christmas
Charles E. Christmas, Executive Vice President,
Chief Financial Officer and Treasurer
(principal financial and accounting officer)

CORPORATE INFORMATION

MERCANTILE BANK OF MICHIGAN
2020 STRATEGIC PLANNING TEAM

Mark S. Augustyn
Senior Vice President
Chief Lending Officer

Charles E. Christmas
Executive Vice President
Chief Financial Officer

Amy W.M. Kam
Vice President
Executive Administrator

Robert B. Kaminski, Jr.
Chief Executive Officer

David L. Miller
Senior Vice President
Training and Marketing Director

Douglas J. Ouellette
Senior Vice President
Chief Community Banking Officer

Raymond E. Reitsma
President

John R. Schulte
Senior Vice President
Chief Information Officer

Tara M. Randall
Senior Vice President
Retail Banking Director

Scott P. Setlock
Senior Vice President
Mortgage and Consumer Lending
Department Head

Lonna L. Wiersma
Senior Vice President
Human Resource Director

Robert T. Worthington
Senior Vice President
Chief Operating Officer and General Counsel

MERCANTILE BANK CORPORATION
SHAREHOLDER INFORMATION

Annual Meeting
The Corporation's Annual Meeting of Shareholders
will be held virtually.
Thursday, May 27, 2021 at 9:00 am EDT

Corporation Headquarters
310 Leonard Street NW
Grand Rapids, MI 49504
616.406.3000 or 800.453.8700

Legal Counsel
Dickinson Wright, PLLC
500 Woodward Avenue, Suite 4000
Detroit, MI 48226
www.dickinson-wright.com

Independent Certified Public Accountants
BDO USA, LLP
200 Ottawa Avenue NW, Suite 300
Grand Rapids, MI 49503

Investor Relations
Lambert & Co.
47 Commerce Avenue SW
Grand Rapids, MI 49503
www.lambert.com

Common Stock Listing
NASDAQ Global Select Market
Symbol: MBWM

Stock Registrar and Transfer Agent
Computershare Investor Services
P.O. Box 505000
Louisville, KY 40233-5000
Shareholder Inquiries 800.733.5001
www.computershare.com/investor

SEC Form 10-K
Copies of the Corporation's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, are available to shareholders without charge upon written request.

Please mail your request to:
Charles E. Christmas
Mercantile Bank Corporation
310 Leonard Street NW
Grand Rapids, MI 49504

Mercantile®
Bank Corporation

002CSNB901

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