

2021 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



Since its founding, Mercantile has maintained a commitment to excellence in all that we do in support of our customers and communities, which continues to enhance value for our shareholders. This has never been more evident than in the performance of our company in 2021.

Despite the ongoing challenges caused by the COVID-19 pandemic, 2021 was an incredible year for our company. Performance metrics improved across the board for Mercantile, as our team of stellar employees pivoted with every twist and turn to ensure that clients' needs were met and our strategic goals were kept in focus throughout the year. As the books were closed on 2021, we were pleased to see that the diligent work of our team allowed our company to deliver another year of strong financial results for our shareholders.

Building relationships is at the heart of our strong performance and the success of our culture. The relentless work of our team members to identify needs, craft solutions and build deep relationships that stand the test of time is our winning formula. So many organizations claim to be relationship based, then fail to listen to what their constituents are saying.

▲ At Mercantile, we pride ourselves on being great listeners, asking questions and adding value to forge the foundation of mutually beneficial relationships.

Driving our strong financial performance once again in 2021 was the ability of the Mercantile team to generate meaningful new client acquisition across all of our product lines. This is most emphatically illustrated in the growth of the core commercial loan portfolio. In 2021, commercial loans increased


20% (excluding the effect of Paycheck Protection Program (PPP) loan forgiveness activities) over the prior year. Throughout the year, loan pipelines remained robust as Mercantile's relationship focused approach continued to resonate with existing and new clients in the markets we serve.

As 2021 began, the Federal Government rolled out phase two of the PPP. Following up Mercantile's 2020 performance in PPP of 2,171 loans funded for a total of \$554 million, our lending teams helped commercial borrowers gain approval from the Small Business Administration (SBA) and funded another 1,196 loans for \$208 million during 2021.

▲ We are very proud of the fact that we were able to help so many companies successfully maneuver through the many challenges brought about by the pandemic.

During the balance of 2021, Mercantile worked with our clients to assist them with their forgiveness applications and by year end, the majority of them had submitted and received their forgiveness determinations from the SBA.

While the commercial lending function had another fantastic year, equally as impressive was the performance of our retail mortgage team. Growth of our mortgage banking income has been a primary strategic initiative over the last several years. About five years ago, we realized that this initiative presented us with a significant opportunity to enhance the company's noninterest income. New leadership was installed, our lending platform was updated and our compensation structure moved to a commission-based approach for the lending team.



▲ **Momentum continues to build as production has increased and Mercantile has become an attractive landing spot for high-performing mortgage lenders in our markets.**

In 2016, Mercantile earned \$3.9 million in mortgage banking income on production of \$163 million. In 2021, our team generated mortgage banking income of nearly \$30 million on production of \$952 million. New lending talent brought onto the team generally consists of seasoned bankers who have many years of experience serving their markets. This experience is serving us well as we have been able to increase the purchase activity percentage of our production in 2021 as loan interest rates shifted away from the extreme attractiveness for clients in the refinance market that had been the case since the start of the pandemic. In 2020, home purchase activity comprised 34% of Mercantile's mortgage production. In 2021, that percentage increased to 52%.

Talent acquisition has also enabled our company to enter new markets over the past two years. In 2020 we opened mortgage lending offices in Midland, Michigan and Cincinnati, Ohio. In 2021 we opened a mortgage lending office in Petoskey, Michigan. The key to this expansion is the identification and hiring of mortgage lending professionals who are a cultural fit for the Mercantile relationship-focused approach to banking.


Similarly, new talent has been added to the commercial lending team over the past year. Experienced lenders have come on board the Mercantile team in Grand Rapids and Lansing, Michigan as well as in Traverse City, Michigan, as we venture into a new market. Once again, the strong reputation, lending

platform and department leadership of Mercantile made our company a great new home for these lenders.

Mortgage banking revenue has clearly been the largest contributor to the growth of our noninterest income, but we have been able to grow other areas of fee income as well. Our strategic focus on these areas has resulted in significant progress in the growth of our Treasury Services revenue, including credit and debit card income, service charges on deposits and payroll service fees. The combined growth rate of these revenue sources was over 17% compared to 2020.

In early 2021, Mercantile introduced an interest rate swap program that provides the opportunity for certain commercial clients to lock in a desired long-term fixed interest rate on their term loan or mortgage loan. This also allows Mercantile another tool to manage its long-term interest rate risk while fulfilling a customer need. In 2021, this program provided Mercantile with over \$6.8 million in income, with the potential for additional opportunities in 2022 and beyond.

Mercantile also experienced significant growth in its local deposit base in 2021. Buoyed by government stimulus programs during the pandemic for both businesses and consumers, along with reduced overall spending during this same period, many customers continued to enjoy an increased level of cash on hand. As new clients were brought into the Bank, our focus on building deep relationships not only produced loan originations, it also generated business opportunities in all other business lines, including deposits. For most of 2021, the Bank's excess liquidity was in the \$500 million to \$700 million range. It is our expectation that the level of overnight deposits will decline throughout 2022 in light of continued



loan growth and robust loan pipelines, along with paying off maturing wholesale funds.

Investment in technology has been a priority for Mercantile since the founding of the organization in 1997. Over the years, we have been a leader amongst our peers regarding introduction of new technology to our clients. Periodic lobby closures necessitated by the pandemic over the last two years have allowed us to demonstrate the ability to effectively engage and serve our clients' needs in remote fashion through alternative delivery channels. Additionally, in the past few years Mercantile has deployed sixteen video banking machines (Live ATM's) in our markets. This technology allows customers visiting our locations to have a live video chat with our Customer Call Center and conduct most of their desired transactions in a quick and efficient manner. Live ATM's enable us to more efficiently assign staffing and allow the potential for easy extension of banking hours when the demand warrants. Our electronic and mobile banking products continue to provide our customers with the tools to handle their banking needs at their convenience. On the commercial side, Mercantile's treasury management products continually evolve with seamless integration to allow our clients to effectively manage their cash flow. Innovative products such as our in-house Human Capital Management product complement our other treasury products very well.

▲ We listen to our clients, understand and analyze their needs and craft solutions that fulfill those needs.

As technology continues to advance at a seemingly accelerated pace Mercantile remains committed to introducing new solutions to our clients ensuring they have

the best financial resources at their disposal. This is yet another way that Mercantile provides meaningful value as a trusted and dependable financial partner.

The year 2021 saw the continued development of our programs in Environmental, Social and Governance (ESG). We firmly believe that the basic elements of ESG help define us and our core values. To help identify best practices and craft strategies that address all aspects of ESG, the Bank formed an Environmental, Social and Governance Committee. This committee initiated the development of new policies such as the Human Rights Policy and Environmental Policy. Efforts such as ensuring the energy efficiency of our facilities, especially new construction, are now part of regular practice and procedure. Electric vehicle chargers were installed at a Mercantile facility on a pilot basis for use by our employees and customers.

Diversity, Equity and Inclusion (DEI) programs at Mercantile gained momentum from the initiatives that began as a result of the events surrounding racial injustice in our country in 2020. The Mercantile team was eager to continue the conversations on DEI that included a monthly virtual Lead and Learn series which brought in various guest speakers to discuss topics related to DEI. This series has prompted some very meaningful conversations among staff members individually and our company as a whole. We strive to do our part to help make the communities where we live and work more inclusive, celebrating our differences and respecting the individuality of everyone. To all of us at Mercantile Bank, maintaining the role as a strong community partner is one of the most important attributes of our company. Our team members are fully engaged in the communities in which they live and work. Despite restrictions resulting



from the pandemic, the staff volunteered thousands of hours in support of hundreds of organizations in various capacities throughout 2021. Our employees frequently assume leadership roles in charitable organizations in a board capacity, serving on committees or volunteering for special projects or fundraisers. In 2021, we donated nearly \$800,000 to nonprofit organizations and causes throughout our markets. We donated ownership of Mercantile facilities in Ionia, Michigan and Lakeview, Michigan for use by those communities. We also committed \$250,000 for homebuyer assistance in conjunction with our mortgage loan programs. Additionally, in December Mercantile was pleased to announce the formation and initial funding of The Mercantile Bank Foundation. This entity will enhance our charitable giving program as we work to further support the communities within our markets, and provide a consistent level of giving throughout the business cycle.

In many instances Mercantile uses its collective expertise and other resources to assist customers and community members obtain financial support.

▲ In 2021, we assisted four nonprofit organizations in obtaining a total of approximately \$2 million in Affordable Housing Program (AHP) grants from the Federal Home Loan Bank of Indianapolis (FHLBI).

We also topped \$1 million in total cumulative historical Neighborhood Impact Program (NIP) grants to homeowners for home improvement and repairs in a collaboration with the City of Grand Rapids and the FHLBI.


The outstanding work of the Mercantile team was recognized once again in

numerous ways. For the 17th year in a row, we were voted one of West Michigan's Best and Brightest Companies to Work For[®]. Mercantile was recognized by Corp! Magazine in their Salute to Diversity Award for the second year in a row. The Michigan Bankers Association recognized Mercantile with its Financial Literacy Award and the 2021 Innovator Award.

The strong performance of Mercantile is made possible by the excellent work of our team. The culture that has been established by Mercantile attracts employees who have a passion for helping customers and each other. Building relationships is the centerpiece of how banking is executed in our company. We have formal training programs that include everything from the technical aspects of each position to illustration of The Mercantile Way, where employees are exposed to the principles of our culture. Core and specialty training programs are planned for the entire staff each year, covering everyone from the newest team member to the most long-term employee. The training programs provide a tailor-made plan ensuring proficiency in a myriad of pertinent bank-related topics.

To ensure the continued flow of homegrown talent into our organization, Mercantile has ongoing outreach to colleges and high schools in our communities. For many years, Mercantile has maintained a robust summer internship program that brings college and even some high school students into various Bank departments to work for a period three to nine months. These students are assigned duties and work alongside regular Mercantile employees to gain knowledge about banking and the functions of a specific department.

Another educational program we initiated in 2021 is our Mentoring, Aspiring, Preparing (M.A.P.) program in conjunction with Grand Valley



State University (GVSU). This is a leadership development program that is designed to provide four years of professional and personal development in concert with a student's college curriculum. Participants will gain first-hand experience in a wide variety of careers available in banking while working towards their degree at GVSU. High priority is given to students from historically marginalized and underrepresented groups for entry into the program.

Another collaboration with GVSU is the Mercantile Bank Business Scholarship program specifically established for students of color. In order to assist younger community members learn more about careers in the financial services industry, and to support high performing students with the cost of their college education, we were excited to introduce this program in 2021. Commencing with the initial class of students in 2021, Mercantile established a scholarship program whereby every year, four high-performing incoming freshmen at Grand Valley State University are selected for a \$15,000 annual award. If the student continues on for four years at GVSU, the scholarship will total \$60,000 over the course of their college career. Mercantile Bank established the program to promote diversity, equity and inclusion and to encourage and support students in the Seidman College of Business at GVSU. This program provides mentorship experiences, professional development resources and opportunities for high school age students who are members of historically marginalized and underrepresented groups to learn more about careers in banking.

2022 will mark the 25th anniversary of the founding of Mercantile Bank in Grand Rapids. While the journey for our company has been a proud story of success, we approach each

new year as an opportunity to continue helping our clients reach their financial aspirations and dreams. The Mercantile team is fully engaged in its ongoing support of existing and prospective clients and we continually explore the needs of our customers and communities, and then develop new and innovative products and services to fulfill those needs.

▲ The ongoing success of The Mercantile Way has been the key driver in building shareholder value for nearly twenty-five years, and we look forward to rewarding our shareholders in 2022 and beyond.

In 2021, two of our longtime Directors retired from the Board of Mercantile Bank Corporation and Mercantile Bank of Michigan. Edward Clark joined our Board in 1998. Upon his retirement Ed was a member of our Corporate Board as well as the Bank Board. Doyle Hayes joined our Board in 2001. At retirement in 2021 Doyle was a Director of our Bank Board. Both men provided our management teams with invaluable guidance, counsel and support over their many years of affiliation with our company. We wish them the best as they retire from service to Mercantile.

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

2021 BOARD OF DIRECTORS



David M. Cassard
Retired
Real Estate Executive



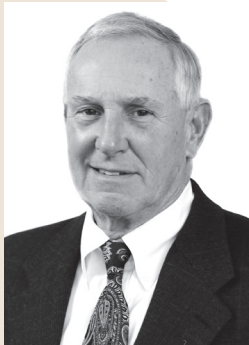
Michelle L. Eldridge
Owner
Clear Ridge Wealth
Management



Michael S. Davenport
Owner
Jireh Metal Products, Inc.



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



Jeff A. Gardner, CPM
Owner
Superior Property
Management of
St. Joseph



David B. Ramaker
Retired
Banking Executive



Michael H. Price
Chairman of the Board
Retired
Banking Executive

2021 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,
Chief Operating Officer
and President of Mercantile Bank



Lonna L. Wiersma
Senior Vice President
Human Resource Director
of Mercantile Bank
(Retired March 4, 2022)



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



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Mercantile and its staff were bestowed the following awards:

- West Michigan's Best & Brightest Companies to Work For® (17 years in a row)
- Corp! Magazine Salute to Diversity Award — Diversity Focused Company (2 years in a row)
- Greater Ottawa County United Way — Community Builder Award
- Heart of West Michigan United Way — Gold Award (5 years in a row)
- Market Van Buren — Business Resilience Leader of the Year
- Michigan Bankers Association Financial Literacy Award
- Michigan Bankers Association Innovator Award

MERCBANK.COM

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, 2021**

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 \$466 million. As of February 25, 2022, there were issued and outstanding 15,841,400 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 26, 2022 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, 2021.

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 ("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. 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 opened residential mortgage loan production offices in Midland, Michigan and in the Cincinnati, Ohio metropolitan area during 2020 and Petoskey, Michigan during 2021.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns 22 automated teller machines ("ATM") and 19 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 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.

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.

Human Capital

As of December 31, 2021, we employed 585 full-time and 71 part-time persons. Our human capital is the most valuable asset we have and we believe embracing human diversity makes us a better financial institution. The collective sum of the individual differences, life experiences, knowledge, inventiveness, innovation, self-expression, unique capabilities and talent that our employees invest in their work represents a significant part of not only our culture, but our reputation and our achievements as well. We embrace and encourage our employees' differences in age, color, disability, ethnicity, family or marital status, gender identity or expression, language, national origin, physical and mental ability, political affiliation, race, religion, sexual orientation, socio-economic status, veteran status and other characteristics that make our employees unique.

Talent Acquisition. We hire people who are able to connect, listen and deliver the best solutions to our customers and communicate with integrity every time. We are devoted to attracting and retaining the best talent in the markets we serve and have implemented HireReach's evidence-based selection process with all branch new hires. The system utilizes a standardized, consistent process and relevant quantitative data to facilitate a multidimensional assessment of job candidates to create better matches between workers and jobs, decrease time-to-hire, reduce first-year turnover, increase workforce diversity and boost productivity. We believe in leading through example in our communities and are proud to be part of a cohort of 15 local companies that have adopted this evidence-based hiring process to help increase diversity in the workforce.

Employee Safety and Health. The prioritization of our people is reflected in the robust employee benefits and compensation packages offered to our staff, including health and wellness insurance plans and incentives, a 401(k) plan with matching contributions, dedicated internship programs for young professionals in finance and business, employee stock ownership plan participation, as well as clothing, home office and fitness equipment interest-free loans. Approximately 91% of our eligible employees participate in our benefit plans and employees pay about 21% less than local benchmarks for family health savings account plans. We offer our team paid-off time for vacations, holidays, sick time and bereavement, along with pay-it-forward initiatives and paid volunteer time. In addition, with obstacles in maintaining balance between work responsibilities and personal time, we have enabled staff to pursue a safe and healthy work-life balance by increasing paid time off benefits for our employees.

Diversity and Inclusion. We believe in respecting, recognizing and valuing the importance of Diversity, Equity and Inclusion ("DEI") as a natural part of our culture. Our exceptional team members are committed to maintaining an environment of personal growth and development. Our employees subscribe to a common goal: To make this financial institution the best 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 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. All employees are required to attend and complete foundational DEI training, and regular expanded learning opportunities are provided. Throughout 2021, monthly live webinars were offered to our staff as well as recorded video access to a wide variety of DEI topics along with resources such as books, group discussions and supervisor support materials.

In further support of our inclusion efforts, we have a Diversity Council comprised of members representing diverse perspectives across departments and viewpoints. The Diversity Council is designed to bring together ideas and experiences from various backgrounds to help develop respect and an appreciation for differences among employees.

Climate Change

We define sustainability as the leveraging of combined abilities to ensure our ongoing impact on people, the environment and our success is always focused on upholding long-lasting, positive results. From an efficient branch footprint to utilizing the latest technology, we are continuously focused on seeking new and better ways to be more productive with our time and energy while remaining good stewards of the resources with which we are entrusted. In each of our facilities, we follow LEED green certification guidelines wherever possible, evaluating all facilities for opportunities to incorporate energy efficient updates and space planning for new construction, renovations or expansion projects. All of our new construction includes low-flow devices as well as LED lighting to enhance our efficiency of utility usage. Over the course of the past three years, we have reduced our utility expense by almost \$0.2 million, with water usage reduced by 10%, natural gas by 12% and electricity by 23%. We are actively seeking engagements for renewable energy sources. All renovation and expansion projects involve the donation of former office furniture to non-profit organizations.

We continue to promote the reduction of mail and paper usage through customer eStatement adoption. The eStatement adoption rate continues to grow, and we were nearing 60% adoption at year-end 2021. Our online accounts payable system has also enabled us to significantly reduce paper and printing, and saves time. Every effort is made to recycle all paper, and we continue to offer community paper shredding events. Additionally, we have implemented recycling stations at all of our office locations to divert cardboard, plastic and metal items from landfills. Water bottle refill stations also aid to reduce plastic bottle usage.

Our Environmental, Social and Governance (“ESG”) Committee supports our ongoing commitment to environmental, health and safety, corporate social responsibility, corporate governance, sustainability and other public policy matters relevant to our organization. The ESG Committee is a cross-functional management committee that assists executive management in: 1) setting general strategies relating to ESG matters; 2) developing, implementing and monitoring initiatives and policies based on those strategies; 3) recommending communications with employees, investors and shareholders with respect to ESG matters; and 4) monitoring and assessing developments relating to, and improving our understanding of, ESG matters. The ESG committee meets formally at least quarterly, and during 2021 developed various policies that were subsequently approved by the Board of Directors, including: Environmental Policy; Diversity, Equity and Inclusion Policy; Human Rights Policy; and the Supplier Diversity Program Policy. These policies are available on our website, along with an application for diverse suppliers. Also during 2021, we installed two electric vehicle chargers and launched a “green” vehicle loan product to support customer purchases of electric, hybrid or fuel-efficient vehicles.

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 \$5.0 million require approval by the Officers Loan Committee, and loan requests exceeding \$15.0 million, up to the legal lending limit of approximately \$97.7 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.

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 typically have had 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 had an interest rate that is fixed to maturity or is tied to the Wall Street Journal Prime Rate or 30-Day Libor Rate. Effective January 1, 2022, we replaced the 30-Day Libor Rate with the CBM Term SOFR Rate for all new floating rate commercial loan commitments. It is expected that currently outstanding commercial loans tied to the 30-Day Libor Rate will convert to an equivalent fallback SOFR Rate on or about June 30, 2023.

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 58% of total commercial loans outstanding during 2021. 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, 2021, loans placed in nonaccrual status totaled \$2.3 million, or 0.1% of total loans, compared to \$3.4 million, or 0.1% of total loans, at December 31, 2020. Loans past due 90 days or more and still accruing interest totaled \$0.2 million at year-end 2021. We had no such loans outstanding as of December 31, 2020.

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

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 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 continued to experience an unprecedented economic environment whereby a sizable portion of the economy had been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus was provided to businesses, individuals and state and local governments and financial institutions offered businesses and individuals payment relief options, economic forecasts were regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we elected to postpone the adoption of CECL until January 1, 2022, and continued to use our incurred loan loss reserve model as permitted through December 31, 2021.

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. 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.

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.

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, there remains a high level of uncertainty due to the potential spread of new variants and surges in cases, 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 61% of our total commercial loans, or about 53% 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.

Direct and indirect effects of climate change may adversely affect us.

Climate change presents immediate and long-term risks to us and to our customers and communities, with risks expected to increase over time. Climate change refers to risk of life and property damage occurring due to naturally occurring events induced by human behavior and is divided into physical risk and indirect risk. Physical risk refers to results of severe weather, such as floods, hurricanes, rising sea levels, fires and water availability. Indirect risk refers to how changes in regulation, conscious consumer choices, competition for sustainable products, and reduced demand for goods or services that produce significant green-house gas emissions may have on the results and operations of a company. Physical effects of climate change to our offices, branches or personnel could have an immediate adverse effect on our operations and financial condition, whereas indirect consequences may result in increased expenditures to comply with climate-related regulations.

Similarly, physical effects could have a severe impact on the business and operations of our customers and vendors. Furthermore, consumer choices and shareholder demands could require our customers to invest more in cleaner energy manufacturing and procurement and to compete with innovative new products that generate lower emissions, which may or may not be successful. If our customers are not able to keep up with evolving climate change effects, it could ultimately have an adverse effect on our business and results of operations. Lastly, like other financial institutions, we also run a reputational risk of financing businesses that are responsible for significant green-house gas emissions or are related to carbon-based energy sources. While our risk management framework monitors various types of risks and applies risk mitigation techniques including for environmental risks, and while we have been conscious of our own carbon footprint and have established an ESG Committee, introduction of new climate-related legislation and related compliance costs as well as the unpredictable effects of climate change on us or our customers could have a negative impact on our business, financial condition and results of operations, even if temporary in nature.

The adoption of the Secured Overnight Funding Rate may adversely affect interest income or expense, and may be more volatile than other benchmark or market interest rates.

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.

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 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. The ICE Benchmark Administration concluded the consultation on its intent to cease publication of one week and two-month U.S. dollar Libor on December 31, 2021 and to extend the publication of all remaining U.S. dollar Libor tenors until June 30, 2023 for legacy contracts.

Effective January 1, 2022, we replaced the 30-Day Libor Rate with the CBM Term SOFR Rate for all new floating rate commercial loan commitments. It is expected that currently outstanding commercial loans tied to the 30-Day Libor Rate will convert to an equivalent fallback SOFR Rate on or about June 30, 2023.

The FRBNY, that originally started publishing SOFR, states that it obtains information from DTCC Solutions LLC, an affiliate of DTCC. FRBNY currently publishes SOFR daily on its website at <https://apps.newyorkfed.org/markets/autorates/sofr>. FRBNY states on its publication page for SOFR that use of SOFR is subject to important disclaimers, limitations and indemnification obligations, including that FRBNY may alter the methods of calculations, publication schedule, rate revision practices or availability of SOFR at any time without notice. The foregoing Internet website is an inactive textual reference only, meaning that the information contained on the website is not part of this filing or incorporated by reference herein.

Since the initial publication of SOFR, daily changes in the rate have, on occasion, been more volatile than daily changes in comparable benchmark or market interest rates, and SOFR over time may bear little or no relation to the historical actual or historical indicative data. In addition, the return on and value of SOFR-linked instruments may fluctuate more than floating rate securities that are linked to less volatile interest rates.

Changes in SOFR could adversely affect the amount of interest that accrues on SOFR-linked instruments.

Because SOFR is published by the FRBNY based on data received from other sources, we have no control over its determination, calculation or publication. There can be no assurance that SOFR will not be discontinued or fundamentally altered in a manner that is materially adverse to the interests of investors in SOFR-linked instruments. If the manner in which SOFR is calculated is changed, that change may result in a change in the amount of interest that accrues on the SOFR-linked instruments. In addition, the interest rate on SOFR-linked instruments may for any day not be adjusted for any modification or amendments to SOFR for that day that the FRBNY may publish if the interest rate for that day has already been determined prior to such determination. There is no assurance that changes in SOFR could not have a material adverse effect on the yield on, value of, and market for SOFR-linked instruments.

Further, SOFR is a relatively new interest rate, and the FRBNY or any successor, as administrator of SOFR, may make methodological or other changes that could change the value of SOFR, including changes related to the methodology by which SOFR is calculated, eligibility criteria applicable to the transactions used to calculate SOFR or timing related to the publication of SOFR. If the manner in which SOFR is calculated is changed, the change may result in a reduction of the amount of interest payable on loans we have made to customers. The administrator of SOFR may withdraw, modify, suspend or discontinue the calculation or dissemination of SOFR in its sole discretion and without notice, and has no obligation to consider the interests of investors in calculating, withdrawing, modifying, amending, suspending or discontinuing SOFR.

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-3 of this Annual Report and "Note 1 – Summary of Significant Accounting Policies" beginning on page F-42 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 light of the evolving risks to economic activity posed by the Coronavirus Pandemic, the FOMC took five separate actions in March, 2020 impacting the federal funds rate. 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 the conclusion of its meeting on January 26, 2022, the FOMC issued the following statement:

Indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have improved in recent months but are being affected by the recent sharp rise in COVID-19 cases. Job gains have been solid in recent months, and the unemployment rate has declined substantially. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation. Risks to the economic outlook remain, including from new variants of the virus.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to keep the target range for the federal funds rate at 0 to 0.25 percent. With inflation above 2 percent and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate. The Committee decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March. Beginning in February, the Committee will increase its holdings of Treasury securities by at least \$20 billion per month and of agency mortgage-backed securities by at least \$10 billion per month. The Federal Reserve’s ongoing purchases and holdings of securities will continue to foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee’s goals. The Committee’s assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

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 changes 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. 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, financial condition or results of operations.

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.

We are subject to federal banking capital regulations. These regulations, among other things, establish minimum requirements to qualify as a “well-capitalized” institution. If our bank were to fail to maintain its status of “well-capitalized” under the applicable regulatory capital regulations, we may be subjected to a consent agreement requiring us to bring our bank back to a “well-capitalized” status. Such an agreement may impose restrictions on our activities. If we were to fail to enter into such an agreement, or fail to comply with the terms of such agreement, the Federal Reserve may impose more severe restrictions on our activities, including requiring us to cease and desist activities permitted under the Bank Holding Company Act of 1956. The current regulatory environment is fluid, with requirements frequently being introduced or amended. It is possible that increases in regulatory capital requirements and changes in how regulatory capital is calculated could cause us to increase our capital levels by issuing additional securities that qualify as regulatory capital, thus potentially diluting our existing shareholders, or by taking other actions, such as selling 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

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

We have issued both trust preferred securities and subordinated notes. In the event of our liquidation, the holders of our debt securities would receive a distribution of our available assets before distributions are made to holders 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 debt or equity securities, through public or private offerings, in order to raise additional capital. Any such issuance of equity securities 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 by issuing debt or equity securities 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 decrease in our credit rating or 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 2021 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 residential mortgage loan production offices in Petoskey, Michigan and the Cincinnati, Ohio metropolitan area. We have larger banking facilities in 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 ten 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.

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, 2022, 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.

	<u>High</u>		<u>Low</u>		<u>Dividend</u>
2021					
First Quarter	\$ 34.47	\$	26.75	\$	0.29
Second Quarter	33.41		29.65		0.29
Third Quarter	33.18		28.51		0.30
Fourth Quarter	37.33		32.13		0.30
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

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 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.29 per share that was paid on March 17, 2021 to shareholders of record as of March 5, 2021. On April 15, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.29 per share that was paid on June 16, 2021 to shareholders of record as of June 4, 2021. On July 15, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.30 per share that was paid on September 15, 2021 to shareholders of record as of September 3, 2021. On October 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.30 per share that was paid on December 15, 2021 to shareholders of record as of December 3, 2021.

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 13, 2022, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.31 per share that will be paid on March 16, 2022 to shareholders of record as of March 4, 2022.

Issuer Purchases of Equity Securities

In May 2021, 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. This program replaces a similar \$20.0 million program that had been announced in May 2019 that was nearing exhaustion.

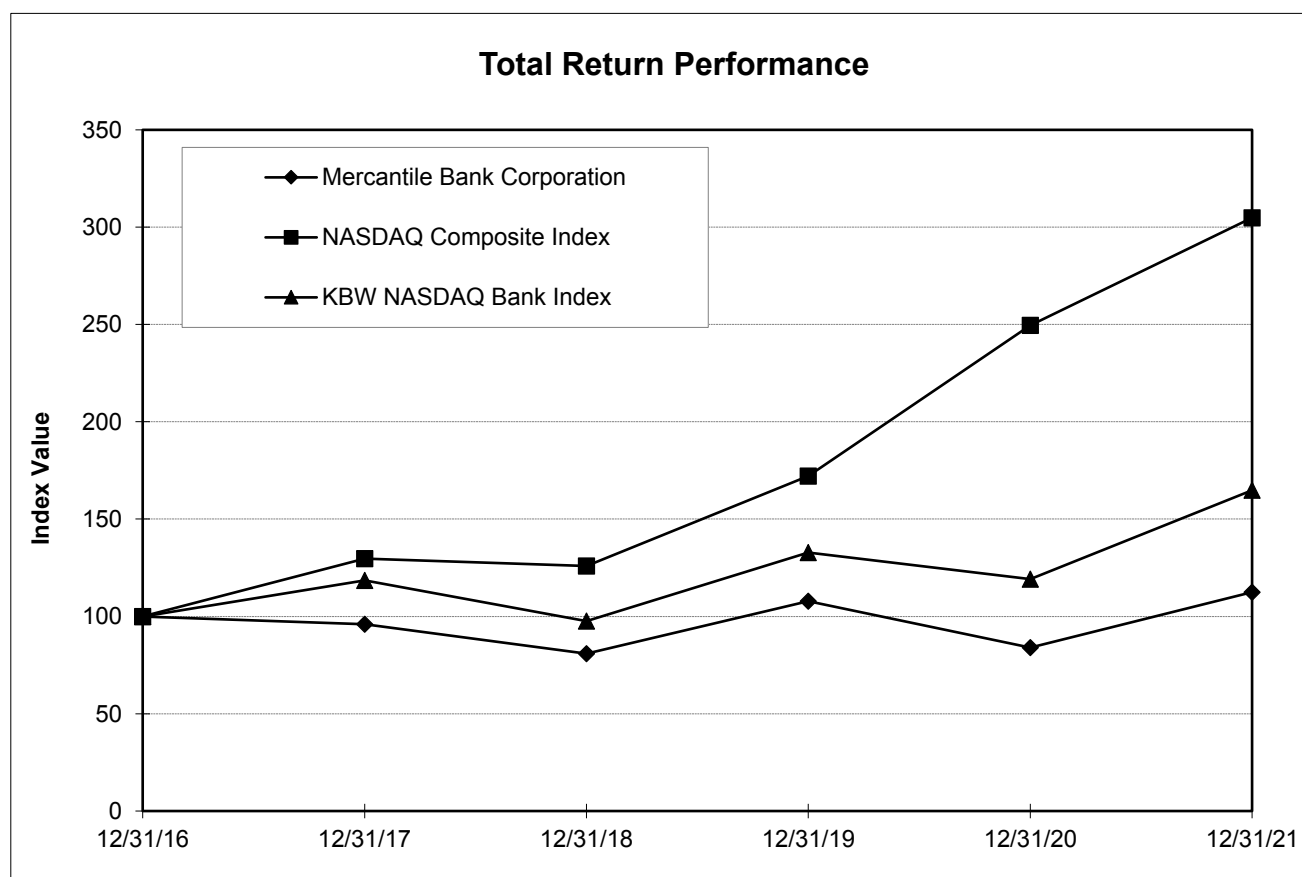
During 2021, we repurchased approximately 683,000 shares for \$21.4 million, or a weighted average all-in cost per share of \$31.29. The stock buybacks were funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan or a new plan, which would also likely be funded from cash dividends paid to us from our bank. 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. As of December 31, 2021, availability under the current plan equaled \$6.8 million.

Repurchases made during the fourth quarter of 2021 are detailed in the table below.

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	47,418	\$ 33.35	47,418	\$ 6,818,000
November 1 – 30	0	NA	0	6,818,000
December 1 – 31	0	NA	0	6,818,000
Total	47,418	\$ 33.35	47,418	\$ 6,818,000

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, 2016 through December 31, 2021. The following is based on an investment of \$100 on December 31, 2016 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.



<i>Index</i>	<i>Period Ending</i>					
	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21
Mercantile Bank Corporation	100.00	95.98	80.88	107.83	84.06	112.47
NASDAQ Composite Index	100.00	129.64	125.96	172.18	249.51	304.85
KBW Bank NASDAQ Index	100.00	118.59	97.58	132.84	119.14	164.80

Item 6. Reserved.

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, 2021, 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, 2021.

There have been no significant changes in our internal control over financial reporting during the quarter ended December 31, 2021, 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, 2021. 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, 2021. Refer to page F-33 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 26, 2022 Annual Meeting of Shareholders (the “Proxy Statement”), a copy of which will be filed with the Securities and Exchange Commission before April 30, 2022, 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, 2021, relating to compensation plans under which equity securities are authorized for issuance.

<u>Plan Category</u>	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	7,700	\$ 34.89	187,000 (1)
Equity compensation plans not approved by security holders	0	0	0
Total	7,700	\$ 34.89	187,000

(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, 2021 and 2020

Consolidated Statements of Income for each of the three years in the period ended December 31, 2021

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2021

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2021

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2021

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, 2021 and 2020

MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION

December 31, 2021 and 2020

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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; increasing rates of inflation and slower growth rates; 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 financial service companies; changes in banking regulation or actions by bank regulators; changes in prices, levies, and assessments; the impact of technological advances; potential cyber-attacks, information security breaches and other criminal activities on our computer systems; litigation liabilities; governmental and regulatory policy changes; the outcomes of existing or future 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, and the failure to meet client expectations and other facts; adoption of SOFR and changes in the method of determining SOFR; direct and indirect climate change matters; changes in the national and local economies, including the ongoing disruption to financial market and other economic activity caused by the Coronavirus Pandemic; and other 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.

Discussions of 2019 items and year-to-year comparisons between 2020 and 2019 that are not included in this Form 10-K can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2020.

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.

Allowance For Loan Losses: 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 2021, we placed most weight on the period starting January 1, 2011 through December 31, 2021. 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 included 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 during 2020, which increased to \$6.5 million as of December 31, 2021 given the significant core commercial loan and residential mortgage loan growth during the year.

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 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 continued to experience an unprecedented economic environment whereby a sizable portion of the economy had been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus was provided to businesses, individuals and state and local governments and financial institutions offered businesses and individuals payment relief options, economic forecasts were regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we elected to postpone the adoption of CECL until January 1, 2022, and continued to use our incurred loan loss reserve model as permitted through December 31, 2021.

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 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.

We performed a qualitative assessment as of October 1, 2021 for which we evaluated 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 the period; therefore, no further testing was required. Due to stressed economic and market conditions throughout 2020, we assessed goodwill for impairment as of March 31, 2020, June 30, 2020, September 30, 2020, and October 1, 2020. No impairments were recorded in 2021 or 2020.

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 ("our bank"), and Mercantile Insurance Center, Inc. ("our insurance company"), a subsidiary 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

There remains a significant amount of stress and uncertainty across national and global economies due to the ongoing pandemic of coronavirus disease 2019 ("Covid-19") caused by severe acute respiratory syndrome coronavirus 2 (the "Coronavirus Pandemic"). 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, including supply chain disruptions and inflationary pressures.

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 had 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") reflected 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 provided 100% guaranteed loans to cover specific operating costs. 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 interest rate on the loan is fixed at 1.00%, with the financial institution receiving a loan origination fee from the Small Business Administration. The loan origination fees, net of the direct origination costs, are accreted into interest income on loans using the level yield methodology. The program ended on August 8, 2020. We originated approximately 2,200 loans aggregating \$554 million. As of December 31, 2021, we recorded forgiveness transactions on all but ten loans aggregating \$1.3 million. Net loan origination fees of \$3.7 million were recorded during 2021.

The Consolidated Appropriations Act, 2021 authorized an additional \$284 billion in Second Draw PPP loans ("Second Draw"). The program ended on May 31, 2021. Under the Second Draw, we originated approximately 1,200 loans aggregating \$208 million. As of December 31, 2021, we recorded forgiveness transactions on about 1,000 loans aggregating \$169 million. Net loan origination fees of \$7.1 million were recorded during 2021.

- Individual Economic Impact Payments

The Internal Revenue Service has made three rounds of Individual Economic Impact Payments via direct deposit or mailed checks. In general, and subject to adjusted gross income limitations, qualifying individuals have received payments of \$1,200 in April 2020, \$600 in January 2021 and \$1,400 in March 2021.

- 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 deferrals 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 deferrals. 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 received 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 deferral. Under the latter program, the amount equal to the three payments was added to the original deferral note which had nine months remaining to maturity; however, the original 0% interest rate was 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-2020, nearly 750 borrowers with loan balances aggregating \$719 million participated in the commercial loan deferral program. As of December 31, 2021, we had no loans in the commercial loan deferral program.

For retail borrowers, we offered 90-day (three payments) principal and interest payment deferrals, with deferred amounts added to the end of the loan. As of September 30, 2020, we had processed 260 principal and interest payment deferrals with loan balances totaling \$23.8 million. As of December 31, 2021, only eight borrowers with loan balances aggregating \$0.4 million remained in the retail loan payment deferral program.

FINANCIAL OVERVIEW

We recorded net income of \$59.0 million, or \$3.69 per basic and diluted share, for 2021, compared to net income of \$44.1 million, or \$2.71 per basic and diluted share, for 2020. Costs and a charitable contribution related to the formation and initial funding of The Mercantile Bank Foundation decreased net income during 2021 by \$3.2 million, or \$0.20 per diluted share. Excluding these costs, diluted earnings per share increased \$1.18, or over 43%, during 2021 compared to 2020.

Commercial loans increased \$156 million during 2021, reflecting the combined net growth of core commercial loans and net activity under the PPP. Core commercial loans increased \$481 million, or almost 20% during 2021, while PPP loans declined \$325 million, comprised of \$209 million in Second Draw PPP loans extended and \$534 million in forgiveness transactions. As a percentage of total core commercial loans, commercial and industrial loans and owner occupied commercial real estate ("CRE") loans combined equaled 57.1% at December 31, 2021, compared to 53.9% at year-end 2020. The new commercial loan pipeline remains strong, and at December 31, 2021, we had \$182 million in unfunded loan commitments on commercial construction and development loans that are in the construction phase.

The overall quality of our loan portfolio remains strong, with nonperforming loans equaling 0.07% of total loans as of December 31, 2021. Accruing loans past due 30 to 89 days remain very low, and we had no foreclosed properties at year-end 2021. Gross loan charge-offs totaled \$1.0 million during 2021, while recoveries of prior period loan charge-offs totaled \$2.7 million, providing for net loan recoveries of \$1.7 million, or 0.05% for the year.

We recorded a negative loan loss provision expense of \$4.3 million during 2021, compared to a provision expense of \$14.1 million during 2020. The negative provision expense recorded during 2021 primarily reflects reduced allowance allocations associated with the economic and business conditions environmental factor, depicting improvement in both current and forecasted economic conditions, and the recording of net loan recoveries, which combined more than offset required allowance allocations necessitated by the strong net core commercial loan growth. The economic and business conditions environmental factor was upgraded during both the second and fourth quarters of 2021, resulting in an aggregate allowance reduction of \$7.3 million related to these factors. The relatively large provision expense recorded during 2020 primarily reflected the onset of stressed conditions related to the Coronavirus Pandemic, including two separate downgrades of the economic and business conditions environmental factor, the introduction of the Covid-19 pandemic environmental factor to address the unique challenges and uncertainties associated with the Coronavirus Pandemic, and certain commercial loan downgrades.

Interest-earning balances, primarily consisting of funds deposited at the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate risk sensitivity. During 2021, the average balance of these funds equaled \$671 million, or 14.9% of average earning assets, compared to \$357 million, or 9.2% of average earning assets, during 2020. Typically, we maintain our interest-earning balances at approximately \$75 million, or about 2% of average earning assets. The elevated levels during 2021 and 2020 primarily reflect increased local deposits stemming from federal government stimulus programs and reduced business and consumer investing and spending. The excess level of interest-earning balances had a negative impact of approximately 40 basis points on our 2021 net interest margin.

Total deposits increased \$672 million during 2021, and are up \$1.4 billion since year-end 2019, equating to growth rates of almost 20% and over 51%, respectively. Growth in noninterest-bearing checking accounts comprised about 38% of the growth in 2021, and approximately 54% of the growth since year-end 2019.

Net interest income increased \$1.8 million during 2021 compared to 2020. Both interest income and interest expense were impacted during 2021 by the Federal Open Market Committee's ("FOMC") federal funds rate cuts totaling 150 basis points in March 2020 and a historically low interest rate environment since that time; however, growth in earning assets, especially core commercial loans, and income associated with the PPP, has provided for the increase in net interest income. Interest income declined \$4.8 million during 2021 compared to 2020, while interest expense was down \$6.6 million during the same time periods.

Noninterest income was \$56.2 million during 2021, compared to \$45.2 million during 2020. The improved level mainly resulted from ongoing strength in our mortgage banking function and fee income generated from a commercial lending interest rate swap program that was introduced in late 2020. In addition, a gain of \$1.1 million was recognized from the sale of a branch during 2021.

Noninterest expense was \$111 million during 2021, compared to \$98.5 million during 2020. Growth in salary expense, in large part reflecting merit and market adjustments, totaled \$2.4 million in 2021. Expense associated with our bonus and stock-based compensation programs increased \$2.8 million in 2021, primarily reflecting the strong 2021 operating performance. Health insurance costs were up \$1.1 million in 2021, generally reflecting the Coronavirus Pandemic environment.

FINANCIAL CONDITION

Our total assets increased \$820 million during 2021, and totaled \$5.26 billion as of December 31, 2021. Total loans increased \$260 million, interest-earning deposits were up \$353 million and securities available for sale increased \$205 million. Total deposits increased \$672 million, securities sold under agreements to repurchase ("sweep accounts") were up \$79.1 million, and net proceeds from the issuance of subordinated notes totaled \$73.6 million. In large part, increased local deposits exceeded growth in the loan and securities portfolios, with the excess funds maintained with the Federal Reserve Bank of Chicago.

Earning Assets

Average earning assets equaled 93.9% of average total assets during 2021, compared to 93.5% during 2020. The loan portfolio continued to comprise a majority of earning assets, followed by interest-earning deposits and securities. Average total loans equaled 73.7% of average earning assets during 2021, compared to 81.9% in 2020, while average interest-earning deposits and average securities comprised 14.9% and 11.4% of average earning assets during 2021 and 9.2% and 8.9% during 2020, respectively.

Our loan portfolio has historically been primarily comprised of commercial loans. Commercial loans increased \$156 million during 2021, and at December 31, 2021 totaled \$2.95 billion, or 85.4% of our loan portfolio. As of December 31, 2020, the commercial loan portfolio comprised 87.5% of total loans. The increase in commercial loans reflects the combined net growth of core commercial loans and net activity under the PPP. Core commercial loans increased \$481 million, or almost 20% during 2021, while PPP loans declined \$325 million, comprised of \$209 million in Second Draw PPP loans extended and \$534 million in forgiveness transactions. Core commercial and industrial loans increased \$317 million, non-owner occupied CRE loans grew \$110 million, owner occupied CRE loans were up \$35.8 million and multi-family and residential rental loans increased \$30.5 million, while vacant land, land development and residential construction loans declined \$11.8 million. As a percentage of total core commercial loans, commercial and industrial loans and owner occupied CRE loans combined equaled 57.1% at December 31, 2021, compared to 53.9% at year-end 2020. We believe our commercial loan portfolio remains well diversified.

As of December 31, 2021, availability on commercial construction and development loans that are in the construction phase totaled \$182 million, with most of the funds expected to be drawn over the next 12 to 18 months. Our current pipeline reports indicate continued strong commercial loan funding opportunities in future periods, including \$212 million in new lending commitments, a majority of which we expect to be accepted and funded over the next 12 to 18 months. 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 2021 at approximately 40%, compared to our historical average of about 50% prior to the Coronavirus Pandemic.

Residential mortgage loans increased \$105 million during 2021, totaling \$443 million, or 12.8% of total loans, at December 31, 2021. As of December 31, 2020, the residential mortgage portfolio comprised 10.6% of total loans. Activity within the residential mortgage loan function remained very active throughout 2021, primarily reflecting refinance transactions spurred by low residential mortgage loan rates, strength in home 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. We originated \$952 million in residential mortgage loans during 2021, compared to \$864 million in 2020, an increase of over 10%. The production composition during 2021 was split almost evenly between refinance and purchase transactions, compared to 2020 when approximately 66% of production was comprised of refinance transactions. Residential mortgage loans originated for sale, generally consisting of longer-term fixed rate residential mortgage loans, totaled \$644 million during 2021, or about 68% of the total residential mortgage loans originated, compared to approximately 78% in 2020. Residential mortgage loans originated not sold are generally comprised of adjustable rate residential mortgage loans. We remain 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 \$1.1 million during 2021, and at December 31, 2021 totaled \$60.5 million, or 1.8% of total loans. As of December 31, 2020, the other consumer-related loan portfolio comprised 1.9% of total loans. We expect this loan portfolio segment to decline in dollar amount and as a percent of total loans in future periods as scheduled principal payments exceed origination volumes.

The following table summarizes our loan portfolio:

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>	<u>12/31/18</u>	<u>12/31/17</u>
Commercial:					
Commercial & Industrial *	\$1,137,419,000	\$1,145,423,000	\$ 846,551,000	\$ 822,723,000	\$ 753,764,000
Land Development & Construction	43,239,000	55,055,000	56,119,000	44,885,000	29,873,000
Owner Occupied Commercial Real Estate	565,758,000	529,953,000	579,003,000	548,619,000	526,328,000
Non-Owner Occupied Commercial Real Estate	1,027,415,000	917,436,000	835,346,000	816,282,000	791,685,000
Multi-Family & Residential Rental	<u>176,593,000</u>	<u>146,095,000</u>	<u>124,525,000</u>	<u>127,597,000</u>	<u>101,918,000</u>
Total Commercial	<u>2,950,424,000</u>	<u>2,793,962,000</u>	<u>2,441,544,000</u>	<u>2,360,106,000</u>	<u>2,203,568,000</u>
Retail:					
1-4 Family Mortgages	442,547,000	337,888,000	334,771,000	307,540,000	254,559,000
Home Equity & Other Consumer Loans	<u>60,488,000</u>	<u>61,620,000</u>	<u>75,374,000</u>	<u>85,439,000</u>	<u>100,425,000</u>
Total Retail	<u>503,035,000</u>	<u>399,508,000</u>	<u>410,145,000</u>	<u>392,979,000</u>	<u>354,984,000</u>
Total Loans	<u>\$3,453,459,000</u>	<u>\$3,193,470,000</u>	<u>\$2,851,689,000</u>	<u>\$2,753,085,000</u>	<u>\$2,558,552,000</u>

(*) For December 31, 2021, and December 31, 2020, includes \$40.1 million and \$365 million in loans originated under the Paycheck Protection Program, respectively.

The following table presents total loans outstanding as of December 31, 2021, according to scheduled repayments of principal on fixed rate loans and repricing frequency on variable rate loans. Floating rate commercial loans that are currently at interest rate floors, representing approximately 50% of total commercial loans at year-end 2021, are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.

	<u>Less Than One Year</u>	<u>One Through Five Years</u>	<u>More Than Five Years</u>	<u>Total</u>
Construction and land development	\$ 60,436,000	\$ 139,781,000	\$106,976,000	\$ 307,193,000
Real estate - residential properties	42,264,000	112,963,000	309,114,000	464,341,000
Real estate - multi-family properties	24,181,000	20,868,000	57,363,000	102,412,000
Real estate - commercial properties	409,129,000	796,853,000	224,031,000	1,430,013,000
Commercial and industrial	662,221,000	368,338,000	103,655,000	1,134,214,000
Consumer	<u>1,735,000</u>	<u>12,958,000</u>	<u>593,000</u>	<u>15,286,000</u>
Total loans	<u>\$1,199,966,000</u>	<u>\$1,451,761,000</u>	<u>\$801,732,000</u>	<u>\$3,453,459,000</u>
Fixed rate loans	\$ 530,975,000	\$1,356,949,000	\$579,573,000	\$2,467,497,000
Floating rate loans	<u>668,991,000</u>	<u>94,812,000</u>	<u>222,159,000</u>	<u>985,962,000</u>
Total loans	<u>\$1,199,966,000</u>	<u>\$1,451,761,000</u>	<u>\$801,732,000</u>	<u>\$3,453,459,000</u>

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 \$2.5 million (0.1% of total assets) as of December 31, 2021, compared to \$4.1 million (0.1% of total assets) as of December 31, 2020. The volume of nonperforming assets has remained under 0.3% of total assets since year-end 2015, and under 0.1% over the past three 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

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>	<u>12/31/18</u>	<u>12/31/17</u>
Residential Real Estate:					
Land Development	\$ 32,000	\$ 35,000	\$ 34,000	\$ 0	\$ 0
Construction	0	0	0	0	0
Owner Occupied / Rental	<u>1,768,000</u>	<u>2,519,000</u>	<u>2,104,000</u>	<u>3,157,000</u>	<u>3,381,000</u>
	1,800,000	2,554,000	2,138,000	3,157,000	3,381,000
Commercial Real Estate:					
Land Development	0	0	0	0	35,000
Construction	0	0	0	0	0
Owner Occupied	0	619,000	134,000	950,000	2,241,000
Non-Owner Occupied	<u>0</u>	<u>22,000</u>	<u>0</u>	<u>0</u>	<u>0</u>
	0	641,000	134,000	950,000	2,276,000
Non-Real Estate:					
Commercial Assets	662,000	172,000	0	17,000	1,444,000
Consumer Assets	<u>6,000</u>	<u>17,000</u>	<u>12,000</u>	<u>17,000</u>	<u>42,000</u>
	668,000	189,000	12,000	34,000	1,486,000
Total	<u>\$ 2,468,000</u>	<u>\$ 3,384,000</u>	<u>\$ 2,284,000</u>	<u>\$ 4,141,000</u>	<u>\$ 7,143,000</u>

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>	<u>12/31/18</u>	<u>12/31/17</u>
Residential Real Estate:					
Land Development	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Construction	0	0	0	0	0
Owner Occupied / Rental	<u>0</u>	<u>88,000</u>	<u>260,000</u>	<u>398,000</u>	<u>193,000</u>
	0	88,000	260,000	398,000	193,000
Commercial Real Estate:					
Land Development	0	0	0	0	0
Construction	0	0	0	0	0
Owner Occupied	0	613,000	192,000	413,000	2,031,000
Non-Owner Occupied	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>36,000</u>
	0	613,000	192,000	413,000	2,067,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
	0	0	0	0	0
Total	<u>\$ 0</u>	<u>\$ 701,000</u>	<u>\$ 452,000</u>	<u>\$ 811,000</u>	<u>\$ 2,260,000</u>

The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

	<u>2021</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>
Beginning balance	\$ 3,384,000	\$ 2,284,000	\$ 4,141,000	\$ 7,143,000	\$ 5,939,000
Additions	1,187,000	3,361,000	698,000	2,909,000	7,604,000
Returns to performing status	(165,000)	(105,000)	(126,000)	(175,000)	(232,000)
Principal payments	(1,711,000)	(1,701,000)	(2,140,000)	(5,028,000)	(4,234,000)
Loan charge-offs	<u>(227,000)</u>	<u>(455,000)</u>	<u>(289,000)</u>	<u>(708,000)</u>	<u>(1,934,000)</u>
Total	<u>\$ 2,468,000</u>	<u>\$ 3,384,000</u>	<u>\$ 2,284,000</u>	<u>\$ 4,141,000</u>	<u>\$ 7,143,000</u>

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

	<u>2021</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>
Beginning balance	\$ 701,000	\$ 452,000	\$ 811,000	\$ 2,260,000	\$ 469,000
Additions	30,000	758,000	462,000	1,114,000	4,401,000
Sale proceeds	(397,000)	(485,000)	(792,000)	(2,380,000)	(677,000)
Valuation write-downs	<u>(334,000)</u>	<u>(24,000)</u>	<u>(29,000)</u>	<u>(183,000)</u>	<u>(1,933,000)</u>
Total	<u>\$ 0</u>	<u>\$ 701,000</u>	<u>\$ 452,000</u>	<u>\$ 811,000</u>	<u>\$ 2,260,000</u>

Gross loan charge-offs totaled \$1.0 million during 2021, while recoveries of prior period loan charge-offs totaled \$2.7 million, providing for net loan recoveries of \$1.7 million, or 0.05% 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.

The following table summarizes changes in the allowance for the past five years. For the years 2019, 2018, and 2017, 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.

	<u>2021</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>
Loans outstanding at year-end	<u>\$ 3,453,459,000</u>	<u>\$ 3,193,470,000</u>	<u>\$ 2,609,747,000</u>	<u>\$ 2,451,324,000</u>	<u>\$ 2,167,404,000</u>
Daily average balance of loans outstanding during the year	<u>\$ 3,324,612,000</u>	<u>\$ 3,190,742,000</u>	<u>\$ 2,575,819,000</u>	<u>\$ 2,291,901,000</u>	<u>\$ 2,052,534,000</u>
Balance of allowance for loans at beginning of year (*)	\$ 37,967,000	\$ 23,889,000	\$ 21,554,000	\$ 19,133,000	\$ 17,868,000
Loans charged-off:					
Commercial, financial and agricultural	(909,000)	(614,000)	(455,000)	(367,000)	(2,272,000)
Construction and land development	0	0	0	(61,000)	(20,000)
Residential real estate	(92,000)	(129,000)	(361,000)	(551,000)	(687,000)
Instalment loans to individuals	(43,000)	(96,000)	(67,000)	(210,000)	(204,000)
Total charge-offs	<u>(1,044,000)</u>	<u>(839,000)</u>	<u>(883,000)</u>	<u>(1,189,000)</u>	<u>(3,183,000)</u>
Recoveries of previously charged-off loans:					
Commercial, financial and agricultural	1,537,000	488,000	302,000	1,757,000	1,445,000
Construction and land development	92,000	0	24,000	832,000	129,000
Residential real estate	1,036,000	314,000	239,000	531,000	131,000
Instalment loans to individuals	75,000	65,000	63,000	90,000	102,000
Total recoveries	<u>2,740,000</u>	<u>867,000</u>	<u>628,000</u>	<u>3,210,000</u>	<u>1,807,000</u>
Net loan (charge-offs) recoveries	1,696,000	28,000	(255,000)	2,021,000	(1,376,000)
Provision for loan losses	<u>(4,300,000)</u>	<u>14,050,000</u>	<u>1,867,000</u>	<u>400,000</u>	<u>2,641,000</u>
Balance of allowance for loans at end of year	<u>\$ 35,363,000</u>	<u>\$ 37,967,000</u>	<u>\$ 23,166,000</u>	<u>\$ 21,554,000</u>	<u>\$ 19,133,000</u>
Ratio of net loan (charge-offs) recoveries to average loans outstanding during the year	<u>0.05%</u>	<u>0.01%</u>	<u>(0.01%)</u>	<u>(0.09%)</u>	<u>(0.07%)</u>
Ratio of allowance to loans outstanding at year-end	<u>1.02%</u>	<u>1.18%</u>	<u>0.89%</u>	<u>0.88%</u>	<u>0.88%</u>

(*) 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, and 2017, 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.

	<u>12/31/21</u>		<u>12/31/20</u>		<u>12/31/19</u>		<u>12/31/18</u>		<u>12/31/17</u>	
	<u>Amount</u>	<u>Loan Portfolio</u>	<u>Amount</u>	<u>Loan Portfolio</u>	<u>Amount</u>	<u>Portfolio</u>	<u>Amount</u>	<u>Portfolio</u>	<u>Amount</u>	<u>Portfolio</u>
Commercial, financial and agricultural	\$30,224	77.3%	\$33,235	79.6%	\$20,599	76.0%	\$19,228	86.7%	\$15,616	77.8%
Construction and land development	2,324	8.9	813	7.2	340	9.0	270	2.0	1,260	7.6
Residential real estate	2,524	13.4	3,595	12.7	1,863	14.2	1,778	10.0	1,758	13.3
Instalment loans to individuals	246	0.4	265	0.5	294	0.8	234	1.3	406	1.3
Unallocated	45	0.0	59	0.0	70	0.0	44	0.0	93	0.0
Total	<u>\$35,363</u>	<u>100.0%</u>	<u>\$37,967</u>	<u>100.0%</u>	<u>\$23,166</u>	<u>100.0%</u>	<u>\$21,554</u>	<u>100.0%</u>	<u>\$19,133</u>	<u>100.0%</u>

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

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>	<u>12/31/18</u>	<u>12/31/17</u>
Ratio of allowance to nonperforming loans	1,432.9%	1,122.0%	1,045.9%	540.4%	273.0%

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 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 continued to experience an unprecedented economic environment whereby a sizable portion of the economy had been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus was provided to businesses, individuals and state and local governments and financial institutions offered businesses and individuals payment relief options, economic forecasts were regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we elected to postpone the adoption of CECL until January 1, 2022, and continued to use our incurred loan loss reserve model as permitted through December 31, 2021.

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 included 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 during 2020, which increased to \$6.5 million as of December 31, 2021 given the significant core commercial loan and residential mortgage loan growth during the year.

We recorded a negative loan loss provision expense of \$4.3 million during 2021, compared to a provision expense of \$14.1 million during 2020. The negative provision expense recorded during 2021 primarily reflects reduced allowance allocations associated with the economic and business conditions environmental factor, depicting improvement in both current and forecasted economic conditions, and the recording of net loan recoveries, which combined more than offset required allowance allocations necessitated by the strong net core commercial loan growth. The economic and business conditions environmental factor was upgraded during both the second and fourth quarters of 2021, resulting in an aggregate allowance reduction of \$7.3 million. The relatively large provision expense recorded during 2020 primarily reflected the onset of stressed conditions related to the Coronavirus Pandemic, including two separate downgrades of the economic and business conditions environmental factor, the introduction of the Covid-19 pandemic environmental factor to address the unique challenges and uncertainties associated with the Coronavirus Pandemic, and certain commercial loan downgrades.

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 2021 we placed most weight on the period starting January 1, 2011 through December 31, 2021. 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.

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 \$35.4 million as of December 31, 2021, or 1.0% of total loans outstanding. The allowance for loans equaled 1.2% of total loans at year-end 2020. As of December 31, 2021, the allowance for loans was comprised of \$34.9 million in general reserves relating to non-impaired loans and \$0.5 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 \$17.5 million at December 31, 2021, consisting of \$0.8 million that are on nonaccrual status and \$16.7 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 \$0.5 million as of December 31, 2021 had been subject to previous partial charge-offs aggregating \$0.5 million over the past eleven years. As of December 31, 2021, there were no specific reserves allocated to impaired loans that had been subject to a previous partial charge-off.

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

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>	<u>12/31/18</u>	<u>12/31/17</u>
Performing	\$ 16,728,000	\$ 23,133,000	\$ 11,788,000	\$ 19,223,000	\$ 6,128,000
Nonperforming	<u>746,000</u>	<u>510,000</u>	<u>353,000</u>	<u>229,000</u>	<u>2,434,000</u>
Total	<u>\$ 17,474,000</u>	<u>\$ 23,643,000</u>	<u>\$ 12,141,000</u>	<u>\$ 19,452,000</u>	<u>\$ 8,562,000</u>

Securities available for sale increased \$205 million during 2021, totaling \$593 million as of December 31, 2021. The securities portfolio equaled 11.4% of average earning assets during 2021, compared to 8.9% during 2020. Purchases of U.S. Government agency bonds totaled \$218 million during 2021, in part reflecting the reinvestment of proceeds from called U.S. Government agency bonds that totaled \$61.9 million. Purchases of U.S. Government agency guaranteed mortgage-backed securities totaled \$28.8 million during 2021, consisting of investments in Community Reinvestment Act-qualified securities, in part reflecting the reinvestment of \$10.5 million from principal paydowns on U.S. Government agency guaranteed mortgage-backed securities. Purchases of municipal bonds totaled \$51.8 million during 2021; proceeds from matured and called municipal bonds totaled \$8.0 million. No bonds were sold during 2021. At December 31, 2021, the securities portfolio was comprised of U.S. Government agency bonds (66%), municipal bonds (27%) and U.S. Government agency guaranteed mortgage-backed securities (7%). 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, 2021 totaled \$593 million, including a net unrealized loss of \$4.7 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:

	12/31/21		12/31/20		12/31/19	
	Carrying Value	Percent	Carrying Value	Percent	Carrying Value	Percent
U.S. Government agency debt obligations	\$390,371,000	65.9%	\$242,141,000	62.5%	\$186,410,000	55.7%
Mortgage-backed securities	41,803,000	7.0	24,890,000	6.4	42,470,000	12.7
Municipal general obligations	137,594,000	23.2	107,824,000	27.9	101,079,000	30.2
Municipal revenue bonds	22,475,000	3.8	11,992,000	3.1	4,196,000	1.3
Other investments	500,000	0.1	500,000	0.1	500,000	0.1
Totals	<u>\$592,743,000</u>	<u>100.0%</u>	<u>\$387,347,000</u>	<u>100.0%</u>	<u>\$334,655,000</u>	<u>100.0%</u>

Federal Home Loan Bank of Indianapolis (“FHLBI”) stock totaled \$18.0 million as of December 31, 2021, unchanged from the balance at December 31, 2020. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We have regularly received quarterly cash dividends, and we expect a cash dividend will continue to be paid 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, 2021, 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	\$ 89,000	2.06%
Over one through five years	137,646,000	0.61
Over five through ten years	208,258,000	1.30
Over ten years	44,378,000	1.80
	<u>390,371,000</u>	<u>1.11</u>
Obligations of states and political subdivisions:		
One year or less	11,370,000	1.92
Over one through five years	47,142,000	2.03
Over five through ten years	77,351,000	2.36
Over ten years	24,206,000	2.35
	<u>160,069,000</u>	<u>2.23</u>
Mortgage-backed securities	41,803,000	1.85
Other investments	500,000	3.75
Totals	<u>\$ 592,743,000</u>	<u>1.47%</u>

Interest-earning deposit balances, primarily consisting of funds deposited with the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate risk sensitivity. The average balance of these funds equaled \$671 million, or 14.9% of average earning assets, during 2021, compared to \$357 million, or 9.2% of average earning assets, during 2020, and a more typical \$115 million, or 3.5% of average earning assets, during 2019. The elevated level during 2021 and 2020 primarily reflects increased local deposits stemming from federal government stimulus programs and reduced business and consumer investing and spending. Although we expect the level of interest-earning deposit balances to gradually decline during 2022, the level will likely remain elevated throughout the year and into 2023.

Non-Earning Assets

Cash and due from bank balances averaged 1.4% of total assets during 2021, similar to the average levels during 2020, and no significant changes are expected in future periods. Net premises and equipment declined \$1.7 million during 2021, equaling \$57.3 million as of December 31, 2021, or 1.1% of total assets. Increases were recorded during 2021 from remodeling and new lease activities, while declines of a similar total were recorded from the sales of a branch facility (along with the associated loans and deposits) and former branch offices, along with depreciation expense.

We had no foreclosed or repossessed assets at December 31, 2021, compared to \$0.7 million at December 31, 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 \$672 million during 2021, totaling \$4.08 billion as of December 31, 2021. Local deposits increased \$695 million, while out-of-area deposits decreased \$23.0 million. As a percent of total deposits, out-of-area deposits declined from 1.4% at December 31, 2020 to 0.6% as of year-end 2021. FHLBI advances decreased \$20.0 million during 2021, totaling \$374 million as of December 31, 2021.

Noninterest-bearing checking accounts and interest-bearing checking accounts increased \$245 million and \$65.8 million, respectively, during 2021, in large part reflecting federal government stimulus programs, especially the PPP, as well as lower business investing and spending. Money market deposit accounts grew \$428 million during 2021, of which \$314 million was during the last two quarters. A portion of the growth reflects federal government stimulus programs and lower business and consumer investing and spending; however, we believe a large portion of the growth during the third and fourth quarters, consisting of large additional deposits by several existing account holders, are temporary and will be withdrawn over the next three months to six months. Savings deposits increased \$56.3 million, primarily reflecting the impact of federal government stimulus programs and lower consumer investing and spending. Local time deposits decreased \$100 million during 2021, in large part reflecting the maturity and withdrawal of funds from certain municipal customers and time deposits that were opened as part of a special time deposit campaign we ran in early 2019. The \$23.0 million reduction in out-of-area time deposits during 2021 reflects maturities that were not replaced as the funds were no longer needed.

Total local deposits have increased \$1.50 billion since December 31, 2019. Noninterest-bearing checking accounts have grown \$753 million during this time period, while interest-bearing checking accounts and money market deposit accounts are up \$206 million and \$531 million, respectively. The increases in these transactional deposit products largely reflect federal government stimulus programs, especially the PPP, as well as lower business investing and spending. Deposit growth associated with new commercial lending relationships has also been notable. Savings deposits are up \$125 million over the past two years, primarily reflecting the impact of federal government stimulus programs and lower consumer investing and spending.

Sweep accounts increased \$79.1 million during 2021, totaling \$197 million as of December 31, 2021. 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. The average balance of sweep accounts equaled \$159 million during 2021, with a high balance of \$209 million and a low balance of \$113 million. 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 declined \$20.0 million during 2021, reflecting maturities that were not replaced as the funds were no longer needed. FHLBI advances aggregated \$374 million as of December 31, 2021. 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 2021 totaled \$889 million, with remaining availability based on collateral of \$509 million.

On December 15, 2021, we entered into Subordinated Note Purchase Agreements with certain institutional accredited investors pursuant to which we issued and sold \$75.0 million in aggregate principal amount of its 3.25% fixed-to-floating rate subordinated notes (“Notes”). The Notes have a stated maturity of January 30, 2032, are redeemable by us at our option, in whole or in part, on or after January 30, 2027 on any interest payment date at a redemption price of 100% of the principal amount of the Notes being redeemed. The Notes are not subject to redemption at the option of the holder. The Notes will bear interest at a fixed rate of 3.25% per year until January 29, 2027. Commencing on January 30, 2027 and through the stated maturity date of January 30, 2032, the interest rate will reset quarterly at a variable rate equal to the then-current Three-Month Term SOFR plus 212 basis points. On December 15, 2021, we injected \$70.0 million of the issuance proceeds to our bank as an increase to equity capital.

On January 14, 2022, we issued an additional \$15.0 million of its Notes to certain institutional accredited investors, reflecting an expansion of the \$75.0 million issuance completed on December 15, 2021. The additional \$15.0 million issuance was completed on the same terms as the prior offering and under the existing indenture. On January 14, 2022, we injected \$15.0 million of the issuance proceeds to our bank as an increase to equity capital.

Shareholders’ equity increased \$15.0 million during 2021, totaling \$457 million as of December 31, 2021. Positively impacting shareholders’ equity was net income of \$59.0 million, while negatively affecting shareholders’ equity were cash dividends on our common stock totaling \$18.5 million and share repurchases aggregating \$21.4 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 \$5.1 million. Negatively impacting shareholders’ equity during 2021 was a \$9.2 million after-tax decline in the market value of available for sale securities.

RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2021 and 2020

Summary

We recorded net income of \$59.0 million, or \$3.69 per basic and diluted share, for 2021, compared to net income of \$44.1 million, or \$2.71 per basic and diluted share, for 2020. Costs and a charitable contribution related to the formation and initial funding of The Mercantile Bank Foundation decreased net income during 2021 by approximately \$3.2 million, or \$0.20 per diluted share. Excluding the impacts of these transactions, diluted earnings per share increased \$1.18, or 43.5%, during 2021 compared to 2020.

The higher level of net income during 2021 compared to 2020 resulted from a lower provision for loan losses and increased noninterest income and net interest income, which more than offset higher noninterest expense. A negative loan loss provision expense was recorded during 2021, primarily reflecting reduced allocations associated with the economic and business conditions environmental factor and the recording of net loan recoveries during the year. Growth in noninterest income during 2021 mainly reflected an increased level of fee income generated from an interest rate swap program that was introduced during the fourth quarter of 2020. Increases in all other key fee income categories also contributed to the higher level of noninterest income. The increase in net interest income during 2021 resulted from the positive impact of earning asset growth, which more than offset the negative impact of a lower net interest margin. Noninterest expense increased in 2021 compared to 2020 primarily due to higher compensation costs and the previously mentioned formation expenses and initial funding contribution associated with The Mercantile Bank Foundation.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2021 and 2020:

	2021	2020
Return on average assets	1.23%	1.07%
Return on average shareholders' equity	13.11%	10.32%
Average shareholders' equity to average assets	9.38%	10.34%

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 \$144 million and \$19.4 million during 2021, respectively, providing for net interest income of \$124 million. During 2020, interest income and interest expense equaled \$149 million and \$26.1 million, respectively, providing for net interest income of \$122 million. In comparing 2021 with 2020, interest income decreased 3.2%, interest expense was down 25.5%, and net interest income increased 1.5%. 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 \$1.8 million increase in net interest income in 2021 compared to 2020 resulted from a higher level of average earning assets, which more than offset a decreased net interest margin. During 2021, the net interest margin equaled 2.76%, down from 3.17% during 2020 due to a lower yield on average earning assets, which more than offset a reduction in the cost of funds. During 2021, earning assets averaged \$4.51 billion, representing an increase of \$643 million, or 16.6%, from the \$3.87 billion average during 2020. Average interest-earning deposits increased \$315 million, average securities were up \$170 million, and average loans increased \$158 million. The decreased yield on average earning assets mainly resulted from a change in earning asset mix, reflecting an increase in low-yielding interest-earning deposits. A significant volume of excess on-balance sheet liquidity, which initially surfaced in the second quarter of 2020 as a result of the Covid-19 environment and persisted during the remainder of 2020 and full year 2021, negatively impacted the yield on average earning assets by 46 basis points and 27 basis points during 2021 and 2020, respectively, and the net interest margin by 39 basis points and 22 basis points during the respective periods. The excess funds, consisting primarily of low-yielding deposits with the Federal Reserve Bank of Chicago, are mainly a product of continuing local deposit growth and PPP loan forgiveness activities. Lower yields on commercial loans and securities also contributed to the decreased yield on average earning assets. The reduced yield on commercial loans primarily resulted from lower interest rates on variable-rate commercial loans resulting from the FOMC significantly decreasing the targeted federal funds rate by 150 basis points in March of 2020, along with the origination of new loans and renewal of maturing loans in the lower interest rate environment. The decreased yield on securities mainly depicted a lower level of accelerated discount accretion on called U.S. Government agency bonds and reduced yields on newly purchased agency bonds, reflecting the declining interest rate environment. The cost of funds declined from 0.67% during 2020 to 0.43% during 2021, primarily due to a change in funding mix, consisting of an increase in lower-costing non-time deposits as a percentage of total funding sources, and decreased rates paid on local time deposits, reflecting the declining interest rate environment.

The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2021, 2020 and 2019. 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 2021, 2020 and 2019 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 2021, 2020 and 2019 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,								
	2 0 2 1			2 0 2 0			2 0 1 9		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Taxable securities	\$ 390,720	\$ 5,127	1.31%	\$ 236,097	\$ 7,740	3.28%	\$ 259,221	\$ 7,919	3.05%
Tax-exempt securities	122,748	2,626	2.14	106,935	2,538	2.37	100,291	2,471	2.46
Total securities	513,468	7,753	1.51	343,032	10,278	3.00	359,512	10,390	2.89
Loans	3,324,611	135,048	4.06	3,167,065	137,399	4.34	2,844,606	145,816	5.13
Interest-earning deposits	671,351	933	0.14	356,501	876	0.25	114,527	2,371	2.07
Total earning assets	4,509,430	143,734	3.19	3,866,598	148,553	3.84	3,318,645	158,577	4.78
Allowance for loan losses	(38,003)			(30,164)			(23,914)		
Cash and due from banks	69,084			58,345			53,151		
Other non-earning assets	260,623			238,789			213,763		
Total assets	<u>\$4,801,134</u>			<u>\$4,133,568</u>			<u>\$3,561,645</u>		
Interest-bearing checking accounts	\$ 498,119	\$ 1,469	0.29%	\$ 392,053	\$ 1,263	0.32%	\$ 315,735	\$ 529	0.17%
Savings deposits	378,312	146	0.04	297,825	185	0.06	276,852	319	0.12
Money market accounts	756,715	1,617	0.21	542,967	1,968	0.36	485,044	5,664	1.17
Time deposits	472,925	5,882	1.24	590,421	11,568	1.96	644,904	14,752	2.29
Total interest-bearing deposits	2,106,071	9,114	0.43	1,823,266	14,984	0.82	1,722,535	21,264	1.23
Short-term borrowings	158,855	170	0.11	137,658	173	0.13	106,630	295	0.28
Federal Home Loan Bank advances	392,575	8,177	2.08	386,896	8,571	2.22	369,688	8,977	2.43
Other borrowings	52,984	1,971	3.72	49,792	2,339	4.70	49,427	3,267	6.61
Total interest-bearing liabilities	2,710,485	19,432	0.72	2,397,612	26,067	1.09	2,248,280	33,803	1.50
Checking accounts	1,620,480			1,291,542			902,180		
Other liabilities	19,998			16,909			16,272		
Total liabilities	4,350,963			3,706,063			3,166,732		
Average equity	450,171			427,505			394,913		
Total liabilities and equity	<u>\$4,801,134</u>			<u>\$4,133,568</u>			<u>\$3,561,645</u>		
Net interest income		<u>\$124,302</u>			<u>\$122,486</u>			<u>\$124,774</u>	
Rate spread			<u>2.47%</u>			<u>2.75%</u>			<u>3.28%</u>
Net interest margin			<u>2.76%</u>			<u>3.17%</u>			<u>3.76%</u>

	Years ended December 31,					
	2021 over 2020			2020 over 2019		
	Total	Volume	Rate	Total	Volume	Rate
Increase (decrease) in interest income						
Taxable securities	\$(2,613,000)	\$ 3,482,000	\$ (6,095,000)	\$ (179,000)	\$ (735,000)	\$ 556,000
Tax exempt securities	88,000	353,000	(265,000)	67,000	160,000	(93,000)
Loans	(2,351,000)	6,644,000	(8,995,000)	(8,417,000)	15,451,000	(23,868,000)
Interest-earning deposit balances	57,000	548,000	(491,000)	(1,495,000)	1,894,000	(3,389,000)
Net change in tax-equivalent interest income	(4,819,000)	11,027,000	(16,846,000)	(10,024,000)	16,770,000	(26,794,000)
Increase (decrease) in interest expense						
Interest-bearing demand deposits	206,000	320,000	(114,000)	734,000	152,000	582,000
Savings deposits	(39,000)	42,000	(81,000)	(134,000)	23,000	(157,000)
Money market accounts	(351,000)	619,000	(970,000)	(3,696,000)	607,000	(4,303,000)
Time deposits	(5,686,000)	(2,006,000)	(3,680,000)	(3,184,000)	(1,180,000)	(2,004,000)
Short-term borrowings	(3,000)	25,000	(28,000)	(122,000)	70,000	(192,000)
Federal Home Loan Bank advances	(394,000)	124,000	(518,000)	(406,000)	405,000	(811,000)
Other borrowings	(368,000)	143,000	(511,000)	(928,000)	24,000	(952,000)
Net change in interest expense	(6,635,000)	(733,000)	(5,902,000)	(7,736,000)	101,000	(7,837,000)
Net change in tax-equivalent net interest income	\$ 1,816,000	\$11,760,000	\$ (9,944,000)	\$ (2,288,000)	\$ 16,669,000	\$ 18,957,000

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 \$4.8 million during 2021 from that earned in 2020, totaling \$144 million in 2021 compared to \$149 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. The lower yield on average earning assets mainly resulted from a change in earning asset mix. During 2021 and 2020, earning assets had an average yield (tax equivalent-adjusted basis) of 3.19% and 3.84%, respectively. On average, lower-yielding interest-earning deposits represented 14.9% of earning assets during 2021, up from 9.2% during 2020, while higher-yielding loans represented 73.7% of earning assets during 2021, down from 81.9% during 2020. The significant increase in interest-earning deposits during 2021 primarily reflected ongoing local deposit growth stemming from federal government stimulus programs and lower business and consumer investing and spending and PPP loan forgiveness activities, which outpaced loan growth and an expanded securities portfolio. A decreased yield on commercial loans, primarily reflecting reduced interest rates on variable-rate loans stemming from FOMC rate cuts and the lower interest rate environment, and a decreased yield on securities, mainly reflecting a reduced level of accelerated discount accretion on called U.S. Government agency bonds and the lower interest rate environment, also contributed to the decreased yield on average earning assets. Accelerated discount accretion on called U.S. Government agency bonds totaling \$3.0 million was recorded as interest income during 2020; accelerated discount accretion totaled less than \$0.1 million during 2021. 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 \$2.4 million in 2021 compared to the level earned in 2020; a decrease in loan yield from 4.34% in 2020 to 4.06% in 2021 resulted in a \$9.0 million decline in interest income, while growth in the loan portfolio during 2021 resulted in a \$6.6 million increase in interest income. The lower yield on loans mainly resulted from a decreased yield on commercial loans, which equaled 4.09% during 2021, down from 4.35% during 2020 primarily due to the aforementioned FOMC rate cuts during March of 2020 and the lower interest rate environment.

Interest income generated from the securities portfolio decreased \$2.5 million in 2021 compared to the level earned in 2020; a decrease in the yield on securities from 3.00% during 2020 to 1.51% during 2021 resulted in a \$6.3 million reduction in interest income, while growth in the average balance of the securities portfolio during 2021 resulted in an increase in interest income of \$3.8 million. The decreased yield on securities mainly reflected a lower level of accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income during 2021 and the decreased interest rate environment. Interest income on interest-earning deposits was up slightly in 2021 compared to the level earned in 2020 as an increase in interest income stemming from growth in these balances was substantially offset by a decrease in interest income resulting from a lower yield on these balances, reflecting the decreased interest rate environment. The increase in average interest-earning deposits during 2021 primarily resulted from continuing local deposit growth and PPP loan forgiveness activities.

Interest expense is generated from interest-bearing deposits and borrowed funds. Interest expense decreased \$6.6 million during 2021 from that expensed in 2020, totaling \$19.4 million in 2021 compared to \$26.0 million in the previous year. The decrease in interest expense largely resulted from a lower cost of funds. During 2021 and 2020, interest-bearing liabilities had a weighted average rate of 0.72% and 1.09%, respectively; a decrease in interest expense of \$5.9 million was recorded during 2021 due to the reduced cost of funds. The lower average cost of interest-bearing liabilities mainly resulted from decreased costs of local deposits and borrowings and a change in funding mix. The cost of time deposits declined from 1.96% during 2020 to 1.24% during 2021 primarily 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 interest-bearing non-time deposit accounts decreased from 0.28% during 2020 to 0.20% during 2021, primarily reflecting lower interest rates paid on money market accounts; the reduced interest rates mainly reflected the decreased interest rate environment. The cost of borrowed funds decreased from 1.93% during 2020 to 1.71% during 2021, mainly reflecting lower costs of FHLBI advances and subordinated debentures, along with a change in borrowing mix. The cost of FHLBI advances was 2.08% during 2021, down from 2.22% during 2020, primarily reflecting the impact of a blend and extend transaction that was executed in June of 2020 and the declining interest rate environment. 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%.

The cost of subordinated debentures was 3.80% during 2021, down from 4.80% during 2020 due to decreases in the 90-Day Libor Rate. Average lower-cost sweep accounts represented 26.3% and 23.1% of average total borrowings during 2021 and 2020, respectively, while average higher-cost FHLBI advances represented 65.0% and 67.4% of average total borrowings during the respective 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 2021 compared to 2020.

A lower average rate paid on interest-bearing non-time deposits during 2021 resulted in a \$1.2 million decrease in interest expense, while a \$400 million increase in the average balance of these deposits equated to a \$1.0 million increase in interest expense. A lower average rate paid on time deposits during 2021 resulted in a \$3.7 million decrease in interest expense, while a \$117 million decrease in the average balance of time deposits equated to a \$2.0 million reduction in interest expense. Interest expense related to short-term borrowings, which are comprised entirely of sweep accounts, during 2021 remained virtually unchanged compared to the prior year as a lower level of expense resulting from a slight decrease in the average rate paid on these funds was substantially offset by a higher level of expense stemming from an increase in the average balance of these funds. A lower average rate paid on average FHLBI advances during 2021 resulted in a \$0.5 million reduction in interest expense, while a \$5.7 million increase in the average balance of advances resulted in a \$0.1 million increase in interest expense. A decreased average rate paid on other borrowings during 2021 resulted in a \$0.5 million decline in interest expense, while a \$3.2 million increase in average other borrowings equated to a \$0.1 million increase in interest expense.

Provision for Loan Losses

A negative loan loss provision expense of \$4.3 million was recorded in 2021, compared to a provision expense of \$14.1 million recorded in 2020. The negative provision expense recorded during 2021 mainly reflected reduced allocations associated with the economic and business conditions environmental factor, depicting improvement in both current and forecasted economic conditions, and the recording of net loan recoveries during the year, which more than offset required reserve allocations necessitated by net growth in core commercial loans. 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 commercial 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.

During 2021, loan charge-offs totaled \$1.0 million, while recoveries of prior-period loan charge-offs equaled \$2.7 million, providing for net loan recoveries of \$1.7 million, or 0.05% of average total loans. 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. The allowance for loans, as a percentage of total loans, was 1.0% as of December 31, 2021, and 1.2% as of December 31, 2020.

Noninterest Income

Noninterest income during 2021 was \$56.2 million, compared to \$45.2 million during 2020. Noninterest income during 2021 included a \$1.1 million gain on the sale of a branch facility, a \$0.6 million recovery of loan collection costs, and \$0.5 million in gains on the sales of former branch facilities. Excluding the impacts of these transactions, noninterest income increased \$8.9 million, or 19.8%, during 2021 compared to 2020. The higher level of noninterest income primarily resulted from increased fee income generated from an interest rate swap program that was implemented during the fourth quarter of 2020. The interest rate swap program provides certain commercial borrowers with a longer-term fixed-rate option and assists Mercantile in managing associated longer-term interest rate risk. Growth in credit and debit card income, mortgage banking income, service charges on accounts, and payroll processing fees also contributed to the increased level of noninterest income. Mortgage banking income remained robust in 2021 as ongoing strength in purchase mortgage originations and a higher gain on sale rate more than offset the negative impacts of a decline in refinance activity and a reduced mortgage loan sold percentage. Residential mortgage loan originations totaled \$952 million during 2021, approximately 10% higher than originations during 2020. Purchase transactions totaled \$494 million during 2021, compared to \$297 million during 2020, representing an increase of \$197 million, or approximately 66%. Refinance transactions totaled \$458 million during 2021, compared to \$567 million during 2020, representing a decrease of \$109 million, or approximately 19%. Residential mortgage loans originated for sale, generally consisting of longer-term fixed rate residential mortgage loans, totaled \$644 million, or approximately 68% of total mortgage loans originated, during 2021. During 2020, residential mortgage loans originated for sale totaled \$672 million, or approximately 78% of total mortgage loans originated.

Noninterest Expense

Noninterest expense totaled \$111 million during 2021, compared to \$98.5 million during 2020. Overhead costs during 2021 included expenses and a charitable contribution associated with the formation and initial funding of The Mercantile Bank Foundation totaling \$4.0 million and net losses on sales and write-downs of former branch facilities aggregating \$0.6 million, while overhead costs during the prior year included write-downs of former branch facilities totaling \$1.4 million. Excluding these transactions, noninterest expense increased \$9.2 million, or 9.5%, during 2021 compared to 2020. The higher level of expense primarily resulted from increased compensation costs, mainly reflecting increased regular salary expense largely stemming from annual employee merit pay increases, higher stock-based compensation expense, an increased bonus accrual, larger signing bonus payments, and increased residential mortgage lender commissions and related incentives. FDIC deposit insurance premiums increased \$0.7 million in 2021 compared to 2020, mainly reflecting an increased assessment base and rate. Health insurance costs were up \$1.1 million in 2021 compared to 2020 mainly due to a higher level of claims, a large portion of which resulted from the treatment of Covid-19 related medical conditions. Data processing costs increased \$0.7 million in 2021 compared to 2020, in large part reflecting higher credit and debit card and software maintenance expenses.

Federal Income Tax Expense

During 2021, we recorded income before federal income tax of \$73.7 million and a federal income tax expense of \$14.7 million, compared to income before federal income tax of \$54.8 million and a federal income tax expense of \$10.7 million during 2020. The increase in federal income tax expense in 2021 compared to 2020 resulted from the higher level of income before federal income tax. Our effective tax rate was 19.9% during 2021, compared to 19.5% during 2020.

CAPITAL RESOURCES

Shareholders' equity increased \$15.0 million during 2021, totaling \$457 million as of December 31, 2021. Positively impacting shareholders' equity was net income of \$59.0 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling \$18.5 million and share repurchases aggregating \$21.4 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 \$5.1 million. Negatively impacting shareholders' equity during 2021 was a \$9.2 million after-tax decline 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, 2021, our bank's total risk-based capital ratio was 13.6%, compared to 13.5% at December 31, 2020. Our bank's total regulatory capital increased \$94.6 million during 2021, primarily reflecting the net impact of net income totaling \$65.1 million, a \$70.0 million equity capital injection from us in association with the \$75.0 million issuance of subordinated notes and cash dividends paid to us aggregating \$39.0 million. Our bank's total risk-based capital ratio was also impacted by a \$659 million increase in total risk-weighted assets, in large part reflecting growth in core commercial loans, residential mortgage loans and securities. As of December 31, 2021, our bank's total regulatory capital equaled \$552 million, or \$147 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 have regularly obtained monies from wholesale funding sources. Wholesale funds, comprised of deposits from customers outside of our market areas and advances from the FHLBI, totaled \$398 million, or 8.5% of combined deposits and borrowed funds as of December 31, 2021, compared to \$441 million, or 11.2% of combined deposits and borrowed funds, as of December 31, 2020.

Sweep accounts increased \$79.1 million during 2021, totaling \$197 million as of December 31, 2021. 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. The average balance of sweep accounts equaled \$159 million during 2021, with a high balance of \$209 million and a low balance of \$113 million. 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, 2021 and during 2021 is as follows:

Outstanding balance at December 31, 2021	\$ 197,463,000
Weighted average interest rate at December 31, 2021	0.11%
Maximum daily balance twelve months ended December 31, 2021	\$ 209,093,000
Average daily balance for twelve months ended December 31, 2021	\$ 158,855,000
Weighted average interest rate for twelve months ended December 31, 2021	0.11%

FHLBI advances declined \$20.0 million during 2021, reflecting maturities that were not replaced as the funds were no longer needed. FHLBI advances aggregated \$374 million as of December 31, 2021. 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 2021 totaled \$889 million, with remaining availability based on collateral of \$509 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 2021. In contrast, our interest-earning deposit account at the Federal Reserve Bank of Chicago averaged \$633 million during 2021. 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 \$34.1 million at December 31, 2021. We did not utilize this line of credit in over ten years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2021, 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	\$3,651,296,000	\$ 0	\$ 0	\$ 0	\$3,651,296,000
Certificates of deposit	260,501,000	112,619,000	58,777,000	0	431,897,000
Short-term borrowings	197,463,000	0	0	0	197,463,000
Federal Home Loan Bank advances	94,000,000	160,000,000	80,000,000	40,000,000	374,000,000
Subordinated debentures	0	0	0	48,244,000	48,244,000
Subordinated notes	0	0	0	73,646,000	73,646,000
Other borrowed money	0	0	0	1,234,000	1,234,000
Property leases	785,000	1,365,000	273,000	1,158,000	3,581,000

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, 2021, we had a total of \$1.53 billion in unfunded loan commitments and \$33.1 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$1.32 billion were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$212 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 liquidity management.

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

	<u>12/31/21</u>	<u>12/31/20</u>	<u>12/31/19</u>
Commercial unused lines of credit	\$ 1,098,951,000	\$ 1,019,496,000	\$ 776,493,000
Unused lines of credit secured by 1-4 family residential properties	64,313,000	59,396,000	60,858,000
Credit card unused lines of credit	92,146,000	72,495,000	58,199,000
Other consumer unused lines of credit	64,876,000	30,707,000	18,135,000
Commitments to make loans	212,476,000	227,558,000	101,961,000
Standby letters of credit	<u>33,109,000</u>	<u>20,543,000</u>	<u>22,798,000</u>
Total	<u>\$ 1,565,871,000</u>	<u>\$ 1,430,195,000</u>	<u>\$ 1,038,444,000</u>

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, 2021:

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total
Assets:					
Commercial loans (1)	\$ 780,257,000	\$ 375,710,000	\$1,325,840,000	\$ 492,025,000	\$2,973,832,000
Residential real estate loans	20,790,000	21,474,000	112,963,000	309,114,000	464,341,000
Consumer loans	1,066,000	669,000	12,958,000	593,000	15,286,000
Securities (2)	21,432,000	9,362,000	197,824,000	382,127,000	610,745,000
Interest-earning deposits	914,005,000	750,000	1,000,000	0	915,755,000
Allowance for loan losses	0	0	0	0	(35,363,000)
Other assets	0	0	0	0	313,153,000
Total assets	1,737,550,000	407,965,000	1,650,585,000	1,183,859,000	\$5,257,749,000
Liabilities:					
Interest-bearing checking	538,838,000	0	0	0	538,838,000
Savings deposits	394,330,000	0	0	0	394,330,000
Money market accounts	1,040,176,000	0	0	0	1,040,176,000
Time deposits under \$100,000	23,735,000	58,190,000	50,851,000	0	132,776,000
Time deposits \$100,000 & over	68,887,000	109,689,000	120,545,000	0	299,121,000
Short-term borrowings	197,463,000	0	0	0	197,463,000
Federal Home Loan Bank advances	20,000,000	74,000,000	240,000,000	40,000,000	374,000,000
Other borrowed money	49,479,000	0	0	73,646,000	123,125,000
Noninterest-bearing checking	0	0	0	0	1,677,952,000
Other liabilities	0	0	0	0	23,409,000
Total liabilities	2,332,908,000	241,879,000	411,396,000	113,646,000	4,801,190,000
Shareholders' equity	0	0	0	0	456,559,000
Total liabilities & shareholders' equity	2,332,908,000	241,879,000	411,396,000	113,646,000	\$5,257,749,000
Net asset (liability) GAP	\$ (595,358,000)	\$ 166,086,000	\$1,239,189,000	\$1,070,213,000	
Cumulative GAP	\$ (595,358,000)	\$ (429,272,000)	\$ 809,917,000	\$1,880,130,000	
Percent of cumulative GAP to total assets	(11.3%)	(8.2%)	15.4%	35.8%	

(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, 2021.

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, 2021, 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 \$126 million in net interest income projected using our balance sheet amounts and anticipated replacement rates as of December 31, 2021. The resulting estimates are generally within our policy parameters established to manage and monitor interest rate risk.

Interest Rate Scenario	Dollar Change In Net <u>Interest Income</u>	Percent Change In Net <u>Interest Income</u>
Interest rates down 100 basis points	\$ 2,700,000	2.1%
Interest rates up 100 basis points	8,300,000	6.6
Interest rates up 200 basis points	16,600,000	13.2
Interest rates up 300 basis points	24,900,000	19.8
Interest rates up 400 basis points	33,200,000	26.3

The resulting estimates have been significantly impacted by the current interest rate and economic environments, 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 nonmaturity 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

Shareholders and Board of Directors
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, 2021 and 2020, 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, 2021, 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, 2021 and 2020, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2021, 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, 2021, 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 4, 2022 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 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) relates to accounts or disclosures that are material to the consolidated financial statements, and (2) involved our 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 a separate opinion 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 \$3,453,459,000 and related allowance for loan losses (“allowance”) balance of \$35,363,000 at December 31, 2021. 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. The calculation of this qualitative general reserve adjustment involves estimates and assumptions by management based on the qualitative environmental factors.

We identified the estimation of certain qualitative environmental factors as a critical audit matter. Management's assumptions related to certain qualitative environmental factors, which are used to adjust the quantitative historical losses (both upwards and downwards), are highly subjective and could have a significant impact on the allowance. Auditing these assumptions involves especially challenging and subjective auditor judgment.

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

- Testing the design and operating effectiveness of internal controls over the data used by management to assess certain qualitative factors and their effect on the estimation of inherent losses within the loan portfolio.
- Evaluating the reliability of the data and assumptions used by management to support their assessment of certain qualitative environmental factors by vouching to internal and external sources, including considerations of contradictory evidence.
- Evaluating the reasonableness of management's conclusion on the qualitative assessment and the resulting adjustment to the allowance.

/s/ BDO USA, LLP
BDO USA, LLP

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

Grand Rapids, Michigan
March 4, 2022

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shareholders and Board of Directors
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, 2021, 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, 2021, 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, 2021 and 2020, 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, 2021, and the related notes and our report dated March 4, 2022 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 4, 2022

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, 2021. 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, 2021, 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-32.

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, 2021 and 2020

	2021	2020
ASSETS		
Cash and due from banks	\$ 59,405,000	\$ 62,832,000
Interest-earning deposits	915,755,000	563,174,000
Total cash and cash equivalents	975,160,000	626,006,000
Securities available for sale	592,743,000	387,347,000
Federal Home Loan Bank stock	18,002,000	18,002,000
Mortgage loans held for sale	16,117,000	22,888,000
Loans	3,453,459,000	3,193,470,000
Allowance for loan losses	(35,363,000)	(37,967,000)
Loans, net	3,418,096,000	3,155,503,000
Premises and equipment, net	57,298,000	58,959,000
Bank owned life insurance	75,242,000	72,131,000
Goodwill	49,473,000	49,473,000
Core deposit intangible, net	1,351,000	2,436,000
Other assets	54,267,000	44,599,000
Total assets	\$ 5,257,749,000	\$ 4,437,344,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	\$ 1,677,952,000	\$ 1,433,403,000
Interest-bearing	2,405,241,000	1,978,150,000
Total deposits	4,083,193,000	3,411,553,000
Securities sold under agreements to repurchase	197,463,000	118,365,000
Federal Home Loan Bank advances	374,000,000	394,000,000
Subordinated debentures	48,244,000	47,563,000
Subordinated notes	73,646,000	0
Accrued interest and other liabilities	24,644,000	24,309,000
Total liabilities	4,801,190,000	3,995,790,000
Commitments and contingent liabilities (Note 13)		
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at December 31, 2021 and December 31, 2020	0	0
Common stock, no par value; 40,000,000 shares authorized; 15,839,944 shares outstanding at December 31, 2021 and 16,330,476 shares outstanding at December 31, 2020	285,752,000	302,029,000
Retained earnings	174,536,000	134,039,000
Accumulated other comprehensive gain/(loss)	(3,729,000)	5,486,000
Total shareholders' equity	456,559,000	441,554,000
Total liabilities and shareholders' equity	\$ 5,257,749,000	\$ 4,437,344,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2021, 2020 and 2019

	2021	2020	2019
Interest income			
Loans, including fees	\$ 135,048,000	\$ 137,399,000	\$ 145,816,000
Securities, taxable	5,127,000	7,740,000	7,919,000
Securities, tax-exempt	2,386,000	2,298,000	2,231,000
Other interest-earning assets	933,000	876,000	2,371,000
Total interest income	<u>143,494,000</u>	<u>148,313,000</u>	<u>158,337,000</u>
Interest expense			
Deposits	9,114,000	14,984,000	21,264,000
Short-term borrowings	170,000	173,000	295,000
Federal Home Loan Bank advances	8,177,000	8,571,000	8,977,000
Subordinated debentures and other borrowings	1,971,000	2,339,000	3,267,000
Total interest expense	<u>19,432,000</u>	<u>26,067,000</u>	<u>33,803,000</u>
Net interest income	124,062,000	122,246,000	124,534,000
Provision (benefit) for loan losses	<u>(4,300,000)</u>	<u>14,050,000</u>	<u>1,750,000</u>
Net interest income after provision for loan losses	128,362,000	108,196,000	122,784,000
Noninterest income			
Service charges on deposit and sweep accounts	5,078,000	4,578,000	4,584,000
Mortgage banking activities	29,959,000	29,346,000	8,485,000
Credit and debit card fees	7,516,000	5,973,000	5,925,000
Interest rate swap program fees	6,862,000	932,000	0
Payroll processing	1,815,000	1,745,000	1,626,000
Earnings on bank owned life insurance	1,164,000	1,214,000	3,886,000
Gain on sale of branch	1,058,000	0	0
Other income	2,768,000	1,384,000	2,450,000
Total noninterest income	<u>56,220,000</u>	<u>45,172,000</u>	<u>26,956,000</u>
Noninterest expense			
Salaries and benefits	66,447,000	59,799,000	53,833,000
Occupancy	8,088,000	7,950,000	7,061,000
Furniture and equipment rent, depreciation and maintenance	3,654,000	3,350,000	2,583,000
Data processing	11,104,000	10,440,000	9,235,000
Advertising	1,175,000	1,292,000	1,446,000
FDIC insurance costs	1,820,000	1,138,000	225,000
Charitable foundation contributions	4,020,000	0	0
Other expense	14,558,000	14,551,000	14,897,000
Total noninterest expenses	<u>110,866,000</u>	<u>98,520,000</u>	<u>89,280,000</u>
Income before federal income tax expense	73,716,000	54,848,000	60,460,000
Federal income tax expense	<u>14,695,000</u>	<u>10,710,000</u>	<u>11,004,000</u>
Net income	<u>\$ 59,021,000</u>	<u>\$ 44,138,000</u>	<u>\$ 49,456,000</u>
Earnings per common share:			
Basic	<u>\$ 3.69</u>	<u>\$ 2.71</u>	<u>\$ 3.01</u>
Diluted	<u>\$ 3.69</u>	<u>\$ 2.71</u>	<u>\$ 3.01</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2021, 2020 and 2019

	2021	2020	2019
Net income	\$ 59,021,000	\$ 44,138,000	\$ 49,456,000
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale	(11,664,000)	2,268,000	15,106,000
Total other comprehensive income (loss)	(11,664,000)	2,268,000	15,106,000
Tax effect of unrealized holding gains (losses) on securities available for sale	2,449,000	(477,000)	(3,172,000)
Total tax effect of other comprehensive income (loss)	2,449,000	(477,000)	(3,172,000)
Other comprehensive income (loss), net of tax effect	(9,215,000)	1,791,000	11,934,000
Comprehensive income	\$ 49,806,000	\$ 45,929,000	\$ 61,390,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2021, 2020 and 2019

(\$ in thousands except per share amounts)	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Total Shareholders' Equity</u>
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	<u>\$ 0</u>	<u>\$ 305,035</u>	<u>\$ 107,831</u>	<u>\$ 3,695</u>	<u>\$ 416,561</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)
Years ended December 31, 2021, 2020 and 2019

(\$ 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	<u>\$ 0</u>	<u>\$ 302,029</u>	<u>\$ 134,039</u>	<u>\$ 5,486</u>	<u>\$ 441,554</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)
Years ended December 31, 2021, 2020 and 2019

(\$ in thousands except per share amounts)	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Total Shareholders' Equity</u>
Balances, January 1, 2021	\$ 0	\$ 302,029	\$ 134,039	\$ 5,486	\$ 441,554
Employee stock purchase plan (1,481 shares)		48			48
Dividend reinvestment plan (27,562 shares)		877			877
Stock option exercises, net (2,000 shares)		50			50
Stock grants to directors for retainer fees (10,489 shares)		344			344
Stock-based compensation expense		3,784			3,784
Share repurchase program (683,191 shares)		(21,380)			(21,380)
Cash dividends (\$1.18 per common share)			(18,524)		(18,524)
Net income for 2021			59,021		59,021
Change in net unrealized gain/(loss) on securities available for sale, net of tax effect				(9,215)	(9,215)
Balances, December 31, 2021	<u>\$ 0</u>	<u>\$ 285,752</u>	<u>\$ 174,536</u>	<u>\$ (3,729)</u>	<u>\$ 456,559</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2021, 2020 and 2019

	2021	2020	2019
Cash flows from operating activities			
Net income	\$ 59,021,000	\$ 44,138,000	\$ 49,456,000
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	13,678,000	9,425,000	9,553,000
Accretion of acquired loans	(135,000)	(449,000)	(686,000)
Provision for loan losses	(4,300,000)	14,050,000	1,750,000
Deferred income tax expense (benefit)	2,020,000	(4,141,000)	26,000
Stock-based compensation expense	3,784,000	2,325,000	2,931,000
Stock grants to directors for retainer fee	344,000	394,000	375,000
Proceeds from sales of mortgage loans held for sale	686,418,000	677,634,000	261,021,000
Origination of mortgage loans held for sale	(649,245,000)	(665,992,000)	(256,767,000)
Net gain on sales of mortgage loans held for sale	(30,402,000)	(29,541,000)	(8,108,000)
Net gain from sales and valuation write-downs of foreclosed assets	(78,000)	(325,000)	(254,000)
Net gain from sale and write-downs on former bank premises	(140,000)	(27,000)	(436,000)
Net loss from sales and disposals of premises and equipment	246,000	1,514,000	294,000
Earnings on bank owned life insurance	(1,164,000)	(1,214,000)	(3,886,000)
Gain on sale of branch	(1,058,000)	0	0
Net change in:			
Accrued interest receivable	1,528,000	(917,000)	(48,000)
Other assets	(16,279,000)	(10,892,000)	(7,636,000)
Accrued interest and other liabilities	335,000	1,895,000	(2,818,000)
Net cash from operating activities	<u>64,573,000</u>	<u>37,877,000</u>	<u>44,767,000</u>
Cash flows from investing activities			
Purchases of securities available for sale	(298,708,000)	(369,682,000)	(62,084,000)
Proceeds from maturities, calls and repayments of securities available for sale	80,432,000	321,164,000	79,478,000
Purchases of Federal Home Loan Bank stock	0	0	(1,980,000)
Loan originations and payments, net	(267,899,000)	(341,461,000)	(99,620,000)
Purchases of bank owned life insurance	(2,000,000)	(700,000)	(4,500,000)
Proceeds from bank owned life insurance cash value release and death benefits	0	0	7,708,000
Net cash transferred in branch sale	(2,679,000)	0	0
Net purchases of premises and equipment and lease activity	(5,602,000)	(8,989,000)	(13,484,000)
Proceeds from sales of former bank premises	753,000	162,000	854,000
Proceeds from sales of foreclosed assets	196,000	700,000	790,000
Net cash for investing activities	<u>(495,507,000)</u>	<u>(398,806,000)</u>	<u>(92,838,000)</u>
Cash flows from financing activities			
Net (decrease) increase in time deposits	(120,512,000)	(99,294,000)	170,921,000
Net increase in all other deposits	806,796,000	820,463,000	55,755,000
Net (decrease) increase in securities sold under agreements to repurchase	79,098,000	15,690,000	(844,000)
Proceeds from Federal Home Loan Bank advances	0	60,000,000	44,000,000
Maturities of Federal Home Loan Bank advances	(20,000,000)	(20,000,000)	(40,000,000)
Net proceeds from subordinated notes issuance	73,635,000	0	0
Proceeds from stock option exercises, net of cashless exercises	50,000	3,000	128,000
Employee stock purchase plan	48,000	49,000	50,000
Dividend reinvestment plan	877,000	814,000	729,000
Repurchases of common stock	(21,380,000)	(6,591,000)	(7,183,000)
Payment of cash dividends to common shareholders	(18,524,000)	(17,930,000)	(17,108,000)
Net cash from financing activities	<u>780,088,000</u>	<u>753,204,000</u>	<u>206,448,000</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
Years ended December 31, 2021, 2020 and 2019

	2021	2020	2019
Net change in cash and cash equivalents	349,154,000	392,275,000	158,377,000
Cash and cash equivalents at beginning of period	626,006,000	233,731,000	75,354,000
Cash and cash equivalents at end of period	\$ 975,160,000	\$ 626,006,000	\$ 233,731,000
Supplemental disclosures of cash flows information			
Cash paid during the year for:			
Interest	\$ 20,352,000	\$ 27,703,000	\$ 32,103,000
Federal income taxes	17,550,000	10,950,000	11,975,000
Noncash financing and investing activities:			
Transfers from loans to foreclosed assets	30,000	146,000	337,000
Transfers from bank premises to other real estate owned	0	613,000	258,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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 (“our bank”), and of Mercantile Insurance Center, Inc. (“our insurance company”), a subsidiary 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 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.

Recent Events: There remains a significant amount of stress and uncertainty across national and global economies due to the ongoing pandemic of coronavirus disease 2019 (“Covid-19”) caused by severe acute respiratory syndrome coronavirus 2 (the “Coronavirus Pandemic”). 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, including supply chain disruptions and inflationary pressures.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 had 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 PPP reflected 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 provided 100% guaranteed loans to cover specific operating costs. 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 interest rate on the loan is fixed at 1.00%, with the financial institution receiving a loan origination fee from the Small Business Administration. The loan origination fees, net of the direct origination costs, are accreted into interest income on loans using the level yield methodology. The program ended on August 8, 2020. We originated approximately 2,200 loans aggregating \$554 million. As of December 31, 2021, we recorded forgiveness transactions on all but ten loans aggregating \$1.3 million. Net loan origination fees of \$3.7 million were recorded during 2021.

The Consolidated Appropriations Act, 2021 authorized an additional \$284 billion in Second Draw PPP loans ("Second Draw"). The program ended on May 31, 2021. Under the Second Draw, we originated approximately 1,200 loans aggregating \$208 million. As of December 31, 2021, we recorded forgiveness transactions on about 1,000 loans aggregating \$169 million. Net loan origination fees of \$7.1 million were recorded during 2021.

- Individual Economic Impact Payments
The Internal Revenue Service has made three rounds of Individual Economic Impact Payments via direct deposit or mailed checks. In general, and subject to adjusted gross income limitations, qualifying individuals have received payments of \$1,200 in April 2020, \$600 in January 2021 and \$1,400 in March 2021.
- 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.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 deferrals 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 deferrals. 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 received 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 deferral. Under the latter program, the amount equal to the three payments was added to the original deferral note which had nine months remaining to maturity; however, the original 0% interest rate was 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-2020, nearly 750 borrowers with loan balances aggregating \$719 million participated in the commercial loan deferral program. As of December 31, 2021, we had no loans in the commercial loan deferral program.

For retail borrowers, we offered 90-day (three payments) principal and interest payment deferrals, with deferred amounts added to the end of the loan. As of September 30, 2020, we had processed 260 principal and interest payment deferrals with loan balances totaling \$23.8 million. As of December 31, 2021, only eight borrowers with loan balances aggregating \$0.4 million remained in the retail loan payment deferral program.

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. It is not practical to determine the fair value of FHLBI stock due to transferability restrictions; therefore, its fair value is estimated at carrying value.

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.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 \$2.5 million and \$4.4 million, respectively, at December 31, 2021 and 2020.

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.

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.

Commercial Loan Participations: As part of our credit risk administration practices and to manage exposure limits, we engage in commercial loan participations with other financial institutions from time-to-time. In all instances, the commercial loans are participated at par with no loan yield adjustments; therefore, no gain or loss on sale, or servicing right, is recorded. We retain a large portion of the loan exposure and continue to service the lending relationship. Commercial loan participations aggregated \$24.2 million and \$18.1 million as of December 31, 2021 and 2020, respectively.

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 Consolidated Balance Sheets, were as follows:

	2021	2020
Mortgage loans held for sale	\$ 16,117,000	\$ 22,888,000
Less: Allowance to adjust to lower of cost or market	0	0
Mortgage loans held for sale, net	<u>\$ 16,117,000</u>	<u>\$ 22,888,000</u>

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 Consolidated Statements of Income. The balance of mortgage loan derivatives aggregated \$0.3 million and \$0.5 million at December 31, 2021 and 2020, respectively.

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.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 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.

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, generally based on delinquency status.

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 continued to experience an unprecedented economic environment whereby a sizable portion of the economy had been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus was provided to businesses, individuals and state and local governments and financial institutions offered businesses and individuals payment relief options, economic forecasts were regularly revised with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we elected to postpone the adoption of CECL, and have continued to use our incurred loan loss reserve model as permitted through December 31, 2021.

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Transfers of Financial Assets: 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.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 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.

Foreclosed Assets: 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 Consolidated Balance Sheets, totaled \$0 and \$0.7 million as of December 31, 2021 and 2020, respectively.

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.

We performed a qualitative assessment as of October 1, 2021 for which we evaluated 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 the period; therefore, no further testing was required. Due to stressed economic and market conditions throughout 2020, we assessed goodwill for impairment as of March 31, 2020, June 30, 2020, September 30, 2020, and October 1, 2020. No impairments were recorded in 2021 or 2020.

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.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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. Reserves for unfunded commitments are recorded as an other liability on our Consolidated Balance Sheets.

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.

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.

The following table depicts our sources of noninterest income presented in the Consolidated Statements of Income for the years ended December 31, 2021, 2020 and 2019 that are scoped within Topic 606:

	2021	2020	2019
Service charges on deposit and sweep accounts	5,078,000	4,578,000	4,584,000
Credit and debit card fees	7,516,000	5,973,000	5,925,000
Payroll processing	1,815,000	1,745,000	1,626,000
Customer service fees	878,000	785,000	759,000

Service Charges on Deposit and Sweep Accounts: We earn fees from deposit and sweep customers for account maintenance, transaction-based and overdraft services. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of the month reflecting the period over which we satisfy the performance obligation. Transaction-based fees, which includes services such as stop payment and returned item charges, are recognized at the time the transaction is executed as that is the point in time we fulfill the customer request. Service charges on deposit and sweep accounts are withdrawn from the customer account balance.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Credit and Debit Card Fees: We earn interchange income on our cardholder debit and credit card usage. Interchange income is primarily comprised of fees whenever our debit and credit cards are processed through card payment networks such as Visa. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Payroll Processing Fees: We earn fees from providing payroll processing services for our commercial clients. Fees are assessed for processing weekly or bi-weekly payroll files, reports and documents, as well as year-end tax-related files, reports and documents. Fees are recognized and collected as payroll processing services are completed for each payroll run and year-end processing activities.

Customer Service Fees: We earn fees by providing a variety of other services to our customers, such as wire transfers, check ordering, sale of cashier checks and money orders, and rental of safe deposit boxes. Generally, fees are recognized and collected daily, concurrently with the point in time we fulfill the customer request. Safe deposit box rentals are on annual contracts, with fees generally earned at the time of the contract signing or renewal.

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.

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.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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. We had no derivative instruments designated as hedges as of December 31, 2021 and 2020.

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.

Accounting Standards Updates: 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 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 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 continued to experience an unprecedented economic environment whereby a sizable portion of the economy had been significantly impacted by government-imposed activity limitations and similar reactions by businesses and individuals, substantial government stimulus was provided to businesses, individuals and state and local governments and financial institutions offered businesses and individuals payment relief options, economic forecasts were regularly updated with no economic forecast consensus. Given the high degree of uncertainty surrounding economic forecasting, we elected to postpone the adoption of CECL, and have continued to use our incurred loan loss reserve model as permitted through December 31, 2021. We adopted CECL effective January 1, 2022, which we expect to result in an allowance reduction of \$0.2 million to \$2.0 million, of which the assumption related to the Covid-19 environmental factor presents the most variability within this range. The resulting impact will be an increase to the retained earnings account on our Consolidated Balance Sheet equal to the after-tax impact of the allowance balance reduction, with the tax impact portion being recorded as a deferred tax asset in other assets on our Consolidated Balance Sheet.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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
<u>2021</u>				
U.S. Government agency debt obligations	\$398,874,000	\$ 266,000	\$ (8,769,000)	\$390,371,000
Mortgage-backed securities	41,906,000	549,000	(652,000)	41,803,000
Municipal general obligation bonds	133,894,000	4,092,000	(392,000)	137,594,000
Municipal revenue bonds	22,289,000	331,000	(145,000)	22,475,000
Other investments	500,000	0	0	500,000
	<u>\$597,463,000</u>	<u>\$ 5,238,000</u>	<u>\$ (9,958,000)</u>	<u>\$592,743,000</u>
<u>2020</u>				
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
	<u>\$380,403,000</u>	<u>\$ 7,843,000</u>	<u>\$ (899,000)</u>	<u>\$387,347,000</u>

Securities with unrealized losses at year-end 2021 and 2020, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>2021</u>						
U.S. Government agency debt obligations	\$274,287,000	\$ 5,274,000	\$110,053,000	\$ 3,495,000	\$384,340,000	\$ 8,769,000
Mortgage-backed securities	23,184,000	652,000	24,000	0	23,208,000	652,000
Municipal general obligation bonds	40,748,000	392,000	0	0	40,748,000	392,000
Municipal revenue bonds	12,843,000	137,000	414,000	8,000	13,257,000	145,000
Other investments	0	0	0	0	0	0
	<u>\$351,062,000</u>	<u>\$ 6,455,000</u>	<u>\$110,491,000</u>	<u>\$ 3,503,000</u>	<u>\$461,553,000</u>	<u>\$ 9,958,000</u>
<u>2020</u>						
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
	<u>\$119,073,000</u>	<u>\$ 899,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$119,073,000</u>	<u>\$ 899,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021, 333 debt securities with fair values totaling \$462 million had unrealized losses aggregating \$10.0 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, 2021, 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	1.92%	\$ 11,406,000	\$ 11,458,000
Due from one to five years	0.96	185,889,000	184,788,000
Due from five to ten years	1.56	288,599,000	285,609,000
Due after ten years	1.99	69,163,000	68,585,000
Mortgage-backed securities	1.85	41,906,000	41,803,000
Other investments	3.75	500,000	500,000
	1.45%	<u>\$ 597,463,000</u>	<u>\$ 592,743,000</u>

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 \$155 million and \$109 million at December 31, 2021 and December 31, 2020, respectively, with estimated market values of \$158 million and \$116 million at the respective dates. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$1.7 million and \$4.1 million at December 31, 2021 and December 31, 2020, respectively, with estimated market values of \$1.7 million and \$4.2 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 \$197 million and \$118 million at December 31, 2021 and 2020, respectively. Investments in FHLBI stock are restricted and may only be resold to, or redeemed by, the issuer.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021		December 31, 2020		Percent Increase (Decrease)
	Balance	%	Balance	%	
Commercial:					
Commercial and industrial (1)	\$1,137,419,000	32.9%	\$1,145,423,000	35.9%	(0.7%)
Vacant land, land development, and residential construction	43,239,000	1.3	55,055,000	1.7	(21.5)
Real estate – owner occupied	565,758,000	16.4	529,953,000	16.6	6.8
Real estate – non-owner occupied	1,027,415,000	29.7	917,436,000	28.7	12.0
Real estate – multi-family and residential rental	<u>176,593,000</u>	<u>5.1</u>	<u>146,095,000</u>	<u>4.6</u>	<u>20.9</u>
Total commercial	<u>2,950,424,000</u>	<u>85.4</u>	<u>2,793,962,000</u>	<u>87.5</u>	<u>5.6</u>
Retail:					
Home equity and other	60,488,000	1.8	61,620,000	1.9	(1.8)
1-4 family mortgages	<u>442,547,000</u>	<u>12.8</u>	<u>337,888,000</u>	<u>10.6</u>	<u>31.0</u>
Total retail	<u>503,035,000</u>	<u>14.6</u>	<u>399,508,000</u>	<u>12.5</u>	<u>25.9</u>
Total loans	<u>\$3,453,459,000</u>	<u>100.0%</u>	<u>\$3,193,470,000</u>	<u>100.0%</u>	<u>8.1%</u>

(1) For December 31, 2021, and December 31, 2020, includes \$40.1 million and \$365 million in loans originated under the Paycheck Protection Program, respectively.

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

	2021		2020	
	Balance	Percentage of Loan Portfolio	Balance	Percentage of Loan Portfolio
Commercial real estate loans to lessors of non-residential buildings	\$737,589,000	21.4%	\$649,162,000	20.3%

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

Year-end nonperforming loans were as follows:

	2021	2020
Loans past due 90 days or more still accruing interest	\$ 155,000	\$ 0
Nonaccrual loans	2,313,000	3,384,000
Total nonperforming loans	\$ 2,468,000	\$ 3,384,000

The recorded principal balance of nonperforming loans was as follows:

	December 31, 2021	December 31, 2020
Commercial:		
Commercial and industrial	\$ 663,000	\$ 172,000
Vacant land, land development, and residential construction	0	0
Real estate – owner occupied	0	619,000
Real estate – non-owner occupied	0	22,000
Real estate – multi-family and residential rental	0	0
Total commercial	663,000	813,000
Retail:		
Home equity and other	119,000	242,000
1-4 family mortgages	1,686,000	2,329,000
Total retail	1,805,000	2,571,000
Total nonperforming loans	\$ 2,468,000	\$ 3,384,000

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

An age analysis of past due loans is as follows as of December 31, 2021:

	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	\$ 14,000	\$ 0	\$ 193,000	\$ 207,000	\$ 1,137,212,000	\$ 1,137,419,000	\$ 155,000
Vacant land, land development, and residential construction	13,000	0	0	13,000	43,226,000	43,239,000	0
Real estate – owner occupied	0	0	0	0	565,758,000	565,758,000	0
Real estate – non-owner occupied	0	0	0	0	1,027,415,000	1,027,415,000	0
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>176,593,000</u>	<u>176,593,000</u>	<u>0</u>
Total commercial	27,000	0	193,000	220,000	2,950,204,000	2,950,424,000	155,000
Retail:							
Home equity and other	132,000	2,000	20,000	154,000	60,334,000	60,488,000	0
1- 4 family mortgages	<u>1,265,000</u>	<u>241,000</u>	<u>82,000</u>	<u>1,588,000</u>	<u>440,959,000</u>	<u>442,547,000</u>	<u>0</u>
Total retail	<u>1,397,000</u>	<u>243,000</u>	<u>102,000</u>	<u>1,742,000</u>	<u>501,293,000</u>	<u>503,035,000</u>	<u>0</u>
Total past due loans	<u>\$1,424,000</u>	<u>\$ 243,000</u>	<u>\$ 295,000</u>	<u>\$1,962,000</u>	<u>\$3,451,497,000</u>	<u>\$3,453,459,000</u>	<u>\$ 155,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>146,095,000</u>	<u>146,095,000</u>	<u>0</u>
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	<u>1,147,000</u>	<u>247,000</u>	<u>342,000</u>	<u>1,736,000</u>	<u>336,152,000</u>	<u>337,888,000</u>	<u>0</u>
Total retail	<u>1,259,000</u>	<u>312,000</u>	<u>396,000</u>	<u>1,967,000</u>	<u>397,541,000</u>	<u>399,508,000</u>	<u>0</u>
 Total past due loans	 <u>\$1,520,000</u>	 <u>\$ 681,000</u>	 <u>\$ 840,000</u>	 <u>\$3,041,000</u>	 <u>\$3,190,429,000</u>	 <u>\$3,193,470,000</u>	 <u>\$ 0</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

Impaired loans with no related allowance recorded were as follows as of December 31, 2021:

	<u>Unpaid Contractual Principal Balance</u>	<u>Recorded Principal Balance</u>	<u>Related Allowance</u>	<u>Year-To- Date Average Recorded Principal Balance</u>
With no related allowance recorded:				
Commercial:				
Commercial and industrial	\$ 2,893,000	\$ 2,818,000		\$ 3,632,000
Vacant land, land development and residential construction	0	0		0
Real estate – owner occupied	9,674,000	9,674,000		12,634,000
Real estate – non-owner occupied	0	0		131,000
Real estate – multi-family and residential rental	<u>91,000</u>	<u>91,000</u>		<u>37,000</u>
Total commercial	12,658,000	12,583,000		16,434,000
Retail:				
Home equity and other	1,173,000	1,107,000		1,096,000
1-4 family mortgages	<u>3,166,000</u>	<u>2,025,000</u>		<u>2,327,000</u>
Total retail	4,339,000	3,132,000		3,423,000
 Total with no related allowance recorded	 <u>\$16,997,000</u>	 <u>\$15,715,000</u>		 <u>\$19,857,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To- Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	\$ 2,192,000	\$ 2,192,000	\$ 266,000	\$ 1,732,000
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	761,000	761,000	84,000	803,000
Real estate – non-owner occupied	146,000	146,000	4,000	154,000
Real estate – multi-family and residential rental	0	0	0	0
Total commercial	3,099,000	3,099,000	354,000	2,689,000
Retail:				
Home equity and other	160,000	140,000	123,000	214,000
1-4 family mortgages	412,000	412,000	69,000	537,000
Total retail	572,000	552,000	192,000	751,000
Total with an allowance recorded	\$ 3,671,000	\$ 3,651,000	\$ 546,000	\$ 3,440,000
Total impaired loans:				
Commercial	\$ 15,757,000	\$ 15,682,000	\$ 354,000	\$ 19,123,000
Retail	4,911,000	3,684,000	192,000	4,174,000
Total impaired loans	\$ 20,668,000	\$ 19,366,000	\$ 546,000	\$ 23,297,000

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

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

	<u>Unpaid Contractual Principal Balance</u>	<u>Recorded Principal Balance</u>	<u>Related Allowance</u>	<u>Year-To- Date Average Recorded Principal Balance</u>
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	<u>21,365,000</u>	<u>21,176,000</u>		<u>13,652,000</u>
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	<u>5,527,000</u>	<u>3,562,000</u>		<u>3,663,000</u>
 Total with no related allowance recorded	 <u>\$26,892,000</u>	 <u>\$24,738,000</u>		 <u>\$17,315,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

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 \$1.5 million in 2021, and \$1.3 million in 2020 and 2019. Interest income recognized on nonaccrual loans totaled less than \$0.1 million in 2021, 2020 and 2019, reflecting the collection of interest at the time of principal pay-off. Lost interest income on nonaccrual loans totaled \$0.1 million in 2021, \$0.2 million in 2020, and \$0.1 million in 2019.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021:

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)	\$ 729,224,000	\$ 28,390,000	\$ 346,082,000	\$ 503,482,000	\$ 119,473,000
Grades 5 – 7	398,378,000	14,730,000	208,060,000	511,280,000	56,968,000
Grades 8 – 9	<u>9,817,000</u>	<u>119,000</u>	<u>11,616,000</u>	<u>12,653,000</u>	<u>152,000</u>
Total commercial	<u>\$ 1,137,419,000</u>	<u>\$ 43,239,000</u>	<u>\$ 565,758,000</u>	<u>\$ 1,027,415,000</u>	<u>\$ 176,593,000</u>

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Performing	60,369,000	440,861,000
Nonperforming	119,000	1,686,000
Total retail	<u>\$ 60,488,000</u>	<u>\$ 442,547,000</u>

- (1) Included in Commercial and Industrial Loans Grades 1 – 4 are \$40.1 million of loans originated under the Paycheck Protection Program.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

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	<u>10,103,000</u>	<u>110,000</u>	<u>29,278,000</u>	<u>341,000</u>	<u>273,000</u>
Total commercial	<u>\$ 1,145,423,000</u>	<u>\$ 55,055,000</u>	<u>\$ 529,953,000</u>	<u>\$ 917,436,000</u>	<u>\$ 146,095,000</u>

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Performing	61,378,000	335,559,000
Nonperforming	242,000	2,329,000
Total retail	<u>\$ 61,620,000</u>	<u>\$ 337,888,000</u>

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021 are as follows (dollars in thousands):

	Commercial and industrial	Commercial vacant land, land development and residential construction	Commercial real estate – owner occupied	Commercial real estate – non-occupied owner occupied	Commercial real estate – multi-family and residential rental	Home equity and other	1 – 4 family mortgages	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 9,424	\$ 679	\$ 8,246	\$ 13,611	\$ 1,819	\$ 889	\$ 3,240	\$ 59	\$ 37,967
Provision for loan losses	2,030	(618)	(3,308)	(310)	(150)	(301)	(1,629)	(14)	(4,300)
Charge-offs	(882)	(15)	(12)	0	0	(43)	(92)	0	(1,044)
Recoveries	210	374	1,119	0	26	81	930	0	2,740
Ending balance	\$ 10,782	\$ 420	\$ 6,045	\$ 13,301	\$ 1,695	\$ 626	\$ 2,449	\$ 45	\$ 35,363
Ending balance: individually evaluated for impairment	\$ 266	\$ 0	\$ 84	\$ 0	\$ 4	\$ 123	\$ 69	\$ 0	\$ 546
Ending balance: collectively evaluated for impairment	\$ 10,516	\$ 420	\$ 5,961	\$ 13,301	\$ 1,691	\$ 503	\$ 2,380	\$ 45	\$ 34,817
Total loans (*):									
Ending balance	\$ 1,097,309	\$ 43,239	\$ 565,758	\$ 1,027,415	\$ 176,593	\$ 60,488	\$ 442,547		\$ 3,413,349
Ending balance: individually evaluated for impairment	\$ 5,010	\$ 0	\$ 10,435	\$ 146	\$ 91	\$ 1,247	\$ 2,437		\$ 19,366
Ending balance: collectively evaluated for impairment	\$ 1,092,299	\$ 43,239	\$ 555,323	\$ 1,027,269	\$ 176,502	\$ 59,241	\$ 440,110		\$ 3,393,983

(*) Excludes \$40.1 million in loans originated under the Paycheck Protection Program.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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 (dollars in thousands):

	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	Home equity and other	1 – 4 family mortgages	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 6,659	\$ 466	\$ 6,291	\$ 6,761	\$ 893	\$ 861	\$ 1,888	\$ 70	\$ 23,889
Provision for loan losses	2,921	289	1,881	6,837	907	58	1,168	(11)	14,050
Charge-offs	(247)	(113)	(235)	0	(18)	(96)	(129)	0	(838)
Recoveries	91	37	309	13	37	66	313	0	866
Ending balance	\$ 9,424	\$ 679	\$ 8,246	\$ 13,611	\$ 1,819	\$ 889	\$ 3,240	\$ 59	\$ 37,967
Ending balance: individually evaluated for impairment	\$ 53	\$ 0	\$ 77	\$ 8	\$ 0	\$ 241	\$ 172	\$ 0	\$ 551
Ending balance: collectively evaluated for impairment	\$ 9,371	\$ 679	\$ 8,169	\$ 13,603	\$ 1,819	\$ 648	\$ 3,068	\$ 59	\$ 37,416
Total loans (*):	\$ 780,164	\$ 55,055	\$ 529,953	\$ 917,436	\$ 146,095	\$ 61,620	\$ 337,888		\$ 2,828,211
Ending balance: individually evaluated for impairment	\$ 6,585	\$ 0	\$ 15,327	\$ 503	\$ 0	\$ 1,270	\$ 3,273		\$ 26,958
Ending balance: collectively evaluated for impairment	\$ 773,579	\$ 55,055	\$ 514,626	\$ 916,933	\$ 146,095	\$ 60,350	\$ 334,615		\$ 2,801,253

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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 (dollars in thousands):

	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	Home equity and other	1 – 4 family mortgages	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 6,168	\$ 337	\$ 5,866	\$ 6,408	\$ 840	\$ 883	1,834	\$ 44	\$ 22,380
Provision for loan losses	764	105	331	342	36	(19)	165	26	1,750
Charge-offs	(393)	(12)	(48)	(2)	0	(66)	(362)	0	(883)
Recoveries	120	36	142	13	17	63	251	0	642
Ending balance	\$ 6,659	\$ 466	\$ 6,291	\$ 6,761	\$ 893	\$ 861	1,888	\$ 70	\$ 23,889
Ending balance: individually evaluated for impairment	\$ 202	\$ 0	\$ 982	\$ 0	\$ 0	\$ 356	83	\$ 0	\$ 1,623
Ending balance: collectively evaluated for impairment	\$ 6,457	\$ 466	\$ 5,309	\$ 6,761	\$ 893	\$ 505	1,805	\$ 70	\$ 22,266
Total loans:									
Ending balance	\$ 846,551	\$ 56,119	\$ 579,003	\$ 835,346	\$ 124,525	\$ 75,374	339,749		\$ 2,856,667
Ending balance: individually evaluated for impairment	\$ 8,587	\$ 85	\$ 1,745	\$ 178	\$ 9	\$ 1,694	2,324		\$ 14,622
Ending balance: collectively evaluated for impairment	\$ 837,964	\$ 56,034	\$ 577,258	\$ 835,168	\$ 124,516	\$ 73,680	337,425		\$ 2,842,045

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

Loans modified as troubled debt restructurings during the year-ended December 31, 2021 were as follows:

	<u>Number of Contracts</u>	<u>Pre- Modification Recorded Principal Balance</u>	<u>Post- Modification Recorded Principal Balance</u>
Commercial:			
Commercial and industrial	10	\$ 3,017,000	\$ 3,016,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	1	692,000	692,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	1	93,000	93,000
Total commercial	<u>12</u>	<u>3,802,000</u>	<u>3,801,000</u>
Retail:			
Home equity and other	4	485,000	482,000
1-4 family mortgages	2	46,000	46,000
Total retail	<u>6</u>	<u>531,000</u>	<u>528,000</u>
Total	<u>18</u>	<u>\$ 4,333,000</u>	<u>\$ 4,329,000</u>

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

	<u>Number of Contracts</u>	<u>Pre- Modification Recorded Principal Balance</u>	<u>Post- Modification Recorded Principal Balance</u>
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	<u>23</u>	<u>21,896,000</u>	<u>22,698,000</u>
Retail:			
Home equity and other	16	451,000	452,000
1-4 family mortgages	6	151,000	148,000
Total retail	<u>22</u>	<u>602,000</u>	<u>600,000</u>
Total	<u>45</u>	<u>\$ 22,498,000</u>	<u>\$ 23,298,000</u>

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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, 2021 (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, 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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

Activity for loans categorized as troubled debt restructurings during the year-ended December 31, 2021 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	\$ 6,414,000	\$ 0	\$ 14,797,000	\$ 480,000	\$ 0
Charge-Offs	(17,000)	0	0	0	0
Payments	(4,278,000)	0	(5,048,000)	(334,000)	(1,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	<u>2,854,000</u>	<u>0</u>	<u>686,000</u>	<u>0</u>	<u>92,000</u>
Ending Balance	<u>\$ 4,973,000</u>	<u>\$ 0</u>	<u>\$ 10,435,000</u>	<u>\$ 146,000</u>	<u>\$ 91,000</u>
			Retail Home Equity and Other	Retail 1-4 Family Mortgages	
Retail Loan Portfolio:					
Beginning Balance			\$ 1,146,000	\$ 806,000	
Charge-Offs			0	0	
Payments			(426,000)	(224,000)	
Transfers to ORE			0	0	
Net Additions/Deletions			<u>482,000</u>	<u>45,000</u>	
Ending Balance			<u>\$ 1,202,000</u>	<u>\$ 627,000</u>	

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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	<u>9,087,000</u>	<u>0</u>	<u>17,417,000</u>	<u>887,000</u>	<u>0</u>
Ending Balance	<u>\$ 6,414,000</u>	<u>\$ 0</u>	<u>\$ 14,797,000</u>	<u>\$ 480,000</u>	<u>\$ 0</u>

	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	<u>612,000</u>	<u>150,000</u>
Ending Balance	<u>\$ 1,146,000</u>	<u>\$ 806,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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	<u>14,813,000</u>	<u>87,000</u>	<u>1,962,000</u>	<u>0</u>	<u>0</u>
Ending Balance	<u>\$ 8,587,000</u>	<u>\$ 85,000</u>	<u>\$ 1,145,000</u>	<u>\$ 178,000</u>	<u>\$ 7,000</u>
			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			<u>303,000</u>	<u>308,000</u>	
Ending Balance			<u>\$ 1,415,000</u>	<u>\$ 724,000</u>	

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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

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

	December 31, 2021	December 31, 2020
Commercial:		
Commercial and industrial	\$ 266,000	\$ 53,000
Vacant land, land development, and residential construction	0	0
Real estate – owner occupied	84,000	59,000
Real estate – non-owner occupied	5,000	8,000
Real estate – multi-family and residential rental	0	0
Total commercial	355,000	120,000
Retail:		
Home equity and other	95,000	202,000
1-4 family mortgages	69,000	145,000
Total retail	164,000	347,000
Total related allowance	\$ 519,000	\$ 467,000

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:

	2021	2020
Land and improvements	\$ 15,111,000	\$ 16,533,000
Buildings	56,168,000	56,114,000
Furniture and equipment	22,974,000	21,522,000
	94,253,000	94,169,000
Less: accumulated depreciation	36,955,000	35,210,000
Total premises and equipment	\$ 57,298,000	\$ 58,959,000

Depreciation expense totaled \$5.8 million in 2021, \$5.2 million in 2020, and \$3.9 million in 2019.

MERCANTILE BANK CORPORATION
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NOTE 4 – PREMISES AND EQUIPMENT, NET (Continued)

We enter into facility leases in the normal course of business. As of December 31, 2021, we were under lease contracts for ten of our branch facilities. The leases have maturity dates ranging from June, 2022 through December, 2026, with a weighted average life of the lease term of 2.8 years as of December 31, 2021. All of our leases have multiple three- to five-year extensions; however, these were not factored in the lease maturities and weighted average lease term as it is not reasonably certain we will exercise the options.

Leases are classified as either operating or finance leases at the lease commencement date, with all of our current leases determined to be operating leases. Lease expense for operating leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent our right to use an underlying asset for the lease term, while lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date at the estimated present value of lease payments over the lease term. We use our incremental borrowing rate, on a collateralized basis, at lease commencement to calculate the present value of lease payments. The weighted average discount rate for leases was 4.71% as of December 31, 2021.

The right-of-use assets, included in premises and equipment, net on our Consolidated Balance Sheets, and the lease liabilities, included in other liabilities on our Consolidated Balance Sheets, totaled \$2.9 million and \$2.8 million as of December 31, 2021, respectively, and totaled \$1.1 million and \$0.9 million as of December 31, 2020, respectively. As permitted by applicable accounting standards, we have elected not to recognize short-term leases with original terms of twelve months or less on our Consolidated Balance Sheet. Total operating lease expense associated with the leases aggregated \$0.6 million in each of 2021 and 2020, and \$0.5 million in 2019.

Future lease payments at December 31, 2021 totaled \$3.6 million, comprised of \$0.8 million in one year, \$1.4 million in one to three years, \$0.3 million in three to five years and \$1.1 million in over five years. 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.

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:

	2021	2020
Mortgage loan portfolios serviced for:		
Federal Home Loan Mortgage Corporation	\$ 1,320,550,000	\$ 1,030,211,000
Federal Home Loan Bank	23,505,000	8,717,000
Total mortgage loans serviced for others	\$ 1,344,055,000	\$ 1,038,928,000

Custodial escrow balances, which are reported as deposits on the Consolidated Balance Sheets, maintained in connection with serviced loans were \$12.1 million and \$11.8 million as of December 31, 2021 and December 31, 2020, respectively.

MERCANTILE BANK CORPORATION
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NOTE 5 – MORTGAGE LOAN SERVICING (Continued)

Activity for capitalized mortgage loan servicing rights during 2021 and 2020 was as follows:

	2021	2020
Balance at beginning of year	\$ 8,189,000	\$ 4,652,000
Additions	7,711,000	6,467,000
Amortized to expense	(3,652,000)	(2,930,000)
Balance at end of year	\$ 12,248,000	\$ 8,189,000

We determined that no valuation allowance was necessary as of December 31, 2021 or December 31, 2020. The estimated fair value of mortgage servicing rights was \$15.4 million and \$10.0 million as of December 31, 2021 and December 31, 2020, 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 2021, fair value was determined using a discount rate of 8.0%, a weighted average constant prepayment rate of 7.4%, depending on the stratification of the specific right, and a weighted average delinquency rate of 0.25%. 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%.

The weighted average amortization period was 8.5 years and 6.1 years as of December 31, 2021 and December 31, 2020, respectively. Forecasted amortization as of December 31, 2021 is as follows:

2022	\$ 1,186,000
2023	992,000
2024	814,000
2025	654,000
2026	516,000
Thereafter	8,086,000

NOTE 6 – CORE DEPOSIT INTANGIBLE ASSET, NET

The gross carrying amount of core deposit intangible assets, included in other assets on our Consolidated Balance Sheets, totaled \$17.5 million as of December 31, 2021 and December 31, 2020. As of December 31, 2021, the accumulated amortization on core deposit intangible assets was \$16.1 million, providing for a net carry balance of \$1.4 million. 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.

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

2022	\$ 768,000
2023	450,000
2024	133,000

(Continued)

MERCANTILE BANK CORPORATION
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NOTE 7 – DEPOSITS

Deposits at year-end are summarized as follows:

	December 31, 2021		December 31, 2020		Percent Increase (Decrease)
	Balance	%	Balance	%	
Noninterest-bearing checking	\$ 1,677,952,000	41.1%	\$ 1,433,403,000	42.0%	17.1%
Interest-bearing checking	538,838,000	13.2	473,053,000	13.9	13.9
Money market	1,040,176,000	25.5	611,912,000	17.9	70.0
Savings	394,330,000	9.7	338,070,000	9.9	16.6
Time, under \$100,000	132,776,000	3.2	165,548,000	4.9	(19.8)
Time, \$100,000 and over	<u>275,208,000</u>	<u>6.7</u>	<u>342,633,000</u>	<u>10.0</u>	<u>(19.7)</u>
Total local deposits	4,059,280,000	99.4	3,364,619,000	98.6	20.6
Out-of-area time, \$100,000 and over	<u>23,913,000</u>	<u>0.6</u>	<u>46,934,000</u>	<u>1.4</u>	<u>(49.0)</u>
Total deposits	<u>\$ 4,083,193,000</u>	<u>100.0%</u>	<u>\$ 3,411,553,000</u>	<u>100.0%</u>	<u>19.7%</u>

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:

	2021	2020
In one year or less	\$ 260,501,000	\$ 327,246,000
In one to two years	78,024,000	139,801,000
In two to three years	34,595,000	39,801,000
In three to four years	7,863,000	25,577,000
In four to five years	<u>50,914,000</u>	<u>22,690,000</u>
Total certificates of deposit	<u>\$ 431,897,000</u>	<u>\$ 555,115,000</u>

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

	2021	2020
Up to three months	\$ 68,887,000	\$ 79,500,000
Three months to six months	53,077,000	79,373,000
Six months to twelve months	56,612,000	77,363,000
Over twelve months	<u>120,545,000</u>	<u>153,331,000</u>
Total certificates of deposit	<u>\$ 299,121,000</u>	<u>\$ 389,567,000</u>

Total time deposits of more than \$250,000 totaled \$207 million and \$272 million at year-end 2021 and 2020, respectively.

MERCANTILE BANK CORPORATION
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NOTE 8 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

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

	2021	2020
Outstanding balance at year-end	\$ 197,463,000	\$ 118,365,000
Weighted average interest rate at year-end	0.11%	0.12%
Average daily balance during the year	\$ 158,855,000	\$ 132,880,000
Weighted average interest rate during the year	0.11%	0.12%
Maximum daily balance during the year	\$ 209,093,000	\$ 173,186,000

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 \$374 million at December 31, 2021, and were expected to mature at varying dates from January 2022 through June 2027, with fixed rates of interest from 0.55% to 3.18% and averaging 2.00%. 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%.

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, 2021 totaled \$889 million, with remaining availability based on collateral of \$509 million.

Scheduled maturities as of December 31, 2021:

2022		\$ 94,000,000
2023		80,000,000
2024		80,000,000
2025		50,000,000
2026		30,000,000
2027		40,000,000

MERCANTILE BANK CORPORATION
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NOTE 10 - FEDERAL INCOME TAXES

The consolidated income tax expense is as follows:

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Current expense	\$ 12,675,000	\$ 14,945,000	\$ 10,978,000
Deferred expense	2,020,000	(4,141,000)	26,000
Change in valuation allowance	0	(94,000)	0
Tax expense	<u>\$ 14,695,000</u>	<u>\$ 10,710,000</u>	<u>\$ 11,004,000</u>

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:

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Tax at statutory rate	\$ 15,481,000	\$ 11,518,000	\$ 12,697,000
Increase (decrease) from			
Tax-exempt interest	(658,000)	(681,000)	(644,000)
Bank owned life insurance	(233,000)	(238,000)	(804,000)
Change in valuation allowance	0	(94,000)	0
Other	105,000	205,000	(245,000)
Tax expense	<u>\$ 14,695,000</u>	<u>\$ 10,710,000</u>	<u>\$ 11,004,000</u>

The statutory tax rate was 21% for 2021, 2020 and 2019.

Significant components of deferred tax assets and liabilities as of December 31, 2021 and 2020 are as follows:

	<u>2021</u>	<u>2020</u>
Deferred income tax assets		
Allowance for loan losses	\$ 7,426,000	\$ 7,973,000
Deferred compensation	259,000	511,000
Stock compensation	941,000	541,000
Nonaccrual loan interest income	159,000	211,000
Deferred loan fees	520,000	924,000
Unrealized loss on securities	991,000	0
Fair value write-downs on foreclosed properties	0	537,000
Other	1,344,000	938,000
Deferred tax asset	<u>11,640,000</u>	<u>11,635,000</u>
Deferred income tax liabilities		
Depreciation	1,168,000	1,175,000
Prepaid expenses	416,000	297,000
Core deposit intangible	276,000	498,000
Mortgage loan servicing rights	2,572,000	1,720,000
Unrealized gain on securities	0	1,458,000
Business combination adjustments	2,013,000	2,142,000
Other	942,000	521,000
Deferred tax liability	<u>7,387,000</u>	<u>7,811,000</u>
Total net deferred tax asset	<u>\$ 4,253,000</u>	<u>\$ 3,824,000</u>

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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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. We determined that no valuation allowance was required at year-end 2020 or 2021.

We had no unrecognized tax benefits at any time during 2021 or 2020 and do not anticipate any significant increase in unrecognized tax benefits during 2022. 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 2021 or 2020. Our U.S. federal income tax returns are no longer subject to examination for all years before 2018.

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 and 2021, 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 and 2021 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 2021 fully vest after three years and, in the case of performance-based restricted stock issued to executive officers in 2018 through 2021, 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 2021, there were approximately 187,000 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.

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MERCANTILE BANK CORPORATION
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NOTE 11 – STOCK-BASED COMPENSATION (Continued)

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

	2021		2020		2019	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Nonvested at beginning of year	262,336	\$ 29.42	262,260	\$ 34.91	262,967	\$ 33.97
Granted	163,000	33.68	121,518	24.65	84,596	35.29
Vested	(59,772)	31.82	(85,445)	37.08	(81,772)	32.19
Forfeited	(11,873)	29.54	(35,997)	33.71	(3,531)	34.85
Nonvested at end of year	<u>353,691</u>	<u>\$ 30.71</u>	<u>262,336</u>	<u>\$ 29.42</u>	<u>262,260</u>	<u>\$ 34.91</u>

Of the restricted stock shares granted in 2021, 2020 and 2019, a total of 22,703 shares, 31,295 shares and 23,596 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 granted shares during 2021, a total of 11,454, 23,053 and 22,836 shares reflect increases in performance-based grants to our Named Executive Officers that were awarded in 2020, 2019 and 2018, respectively. 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 adjustments were based on an analysis of the pre-determined performance goals taking into account actual performance since the grant date and updated forecasts for the remainder of the three-year performance period.

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

	2021		2020		2019	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	9,700	\$ 32.83	10,700	\$ 30.25	18,900	\$ 23.92
Granted	0	NA	0	NA	0	NA
Exercised	(2,000)	24.91	(1,000)	5.19	(8,200)	15.69
Forfeited or expired	0	NA	0	NA	0	NA
Outstanding at end of year	<u>7,700</u>	<u>\$ 34.89</u>	<u>9,700</u>	<u>\$ 32.83</u>	<u>10,700</u>	<u>\$ 30.25</u>
Options exercisable at year-end	<u>7,700</u>	<u>\$ 34.89</u>	<u>9,700</u>	<u>\$ 32.83</u>	<u>10,700</u>	<u>\$ 30.25</u>

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.

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MERCANTILE BANK CORPORATION
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NOTE 11 – STOCK-BASED COMPENSATION (Continued)

Options at year-end 2021 were as follows:

Range of Exercise Prices	Outstanding			Exercisable	
	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$27.00 - \$28.00	1,200	0.9	\$ 27.66	1,200	27.66
\$36.00 - \$37.00	<u>6,500</u>	1.9	36.22	<u>6,500</u>	36.22
Outstanding at year end	<u><u>7,700</u></u>	1.7	\$ 34.89	<u><u>7,700</u></u>	34.89

Information related to options outstanding at year-end 2021, 2020 and 2019 is as follows:

	2021	2020	2019
Minimum exercise price	\$ 27.66	\$ 22.15	\$ 5.19
Maximum exercise price	36.22	36.22	36.22
Average remaining option term (years)	1.7	2.4	3.2

Information related to stock option grants and exercises during 2021, 2020 and 2019 is as follows:

	2021	2020	2019
Aggregate intrinsic value of stock options exercised	\$ 13,000	\$ 17,000	\$ 157,000
Cash received from stock option exercises	50,000	3,000	126,000
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, 2021 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.

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December 31, 2021

NOTE 11– STOCK-BASED COMPENSATION (Continued)

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 straight-line 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 straight-line 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 was expensed on a straight-line 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 was expensed over the respective nine-month period. On May 27, 2021, we granted about 10,000 shares of common stock to our Corporate and Bank Boards of Directors for retainer payments for the period of June 1, 2021 through May 31, 2022. The associated \$0.3 million cost is being expensed on a straight-line basis over the respective twelve 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 2021 and 2020, our bank had \$104 million and \$122 million in loan commitments to directors and executive officers, of which \$87.7 million and \$108 million were outstanding at year-end 2021 and 2020, respectively, as reflected in the following table.

	2021	2020
Beginning balance	\$ 108,042,000	\$ 104,043,000
New loans	2,542,000	13,823,000
Repayments	(22,912,000)	(9,824,000)
Ending balance	\$ 87,672,000	\$ 108,042,000

We had no PPP loans outstanding to related companies of our directors as of December 31, 2021. PPP loans to related companies of our directors totaled \$0.3 million as of December 31, 2020.

Related party deposits and repurchase agreements totaled \$18.4 million and \$19.4 million at year-end 2021 and 2020, respectively.

MERCANTILE BANK CORPORATION
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December 31, 2021

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, 2021 and 2020.

At year-end 2021 and 2020, 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:

	2021	2020
Commercial unused lines of credit	\$ 1,098,951,000	\$ 1,019,496,000
Unused lines of credit secured by 1 – 4 family residential properties	64,313,000	59,396,000
Credit card unused lines of credit	92,146,000	72,495,000
Other consumer unused lines of credit	64,876,000	30,707,000
Commitments to make loans	212,476,000	227,558,000
Standby letters of credit	33,109,000	20,543,000
Total commitments	\$ 1,565,871,000	\$ 1,430,195,000

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 have been 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 have been 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 have been 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. Effective January 1, 2022, we replaced the 30-Day Libor Rate with the CBM Term SOFR Rate for all new floating rate commercial loan commitments. It is expected that currently outstanding commercial loans tied to the 30-Day Libor Rate will convert to an equivalent fallback SOFR Rate on or about June 30, 2023.

MERCANTILE BANK CORPORATION
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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 as an other liability on our Consolidated Balance Sheets.

	2021		2020	
	Contract Amount	Carrying Value	Contract Amount	Carrying Value
Standby letters of credit	\$ 33,109,000	\$ 212,000	\$ 20,543,000	\$ 138,000

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 2021, 2020 and 2019 matching 401(k) contributions charged to expense were \$2.1 million, \$1.9 million and \$1.7 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 \$1.2 million and \$2.4 million as of December 31, 2021 and 2020, 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 less than \$0.1 million during 2021, and \$0.1 million during 2020 and 2019.

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 1,481 and 2,264 in 2021 and 2020, respectively. As of December 31, 2021, there were approximately 237,000 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.

MERCANTILE BANK CORPORATION
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NOTE 15 – DERIVATIVES AND HEDGING ACTIVITIES (Continued)

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 correspondent banks 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 banks are recognized directly to earnings.

The fair value of derivative instruments as of December 31, 2021, are reflected in the following table.

	<u>Notional Amount</u>	<u>Balance Sheet Location</u>	<u>Fair Value</u>
Derivative Assets			
Interest rate swaps	\$ 279,419,000	Other Assets	\$ 4,609,000
Derivative Liabilities			
Interest rate swaps	279,419,000	Other Liabilities	4,857,000

The effect of interest rate swaps that are not designated as hedging instruments resulted in noninterest expense of \$0.2 million during the year-ended December 31, 2021. 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 \$4.9 million as of December 31, 2021. Cash collateral totaling \$3.6 million was provided to the counterparty correspondent banks as of December 31, 2021.

Interest rate swaps entered into with commercial loan customers had notional amounts aggregating \$279 million as of December 31, 2021. Associated credit exposure is generally mitigated by securing the interest rates swaps with the underlying collateral of the loan instrument that has been hedged.

The fair value of derivative instruments as of December 31, 2020, are reflected in the following table.

	<u>Notional Amount</u>	<u>Balance Sheet Location</u>	<u>Fair Value</u>
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.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

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	2021		2020	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets					
Cash	Level 1	\$ 17,872	\$ 17,872	\$ 16,953	\$ 16,953
Cash equivalents	Level 1	957,288	957,288	609,053	609,053
Securities available for sale	(1)	592,743	592,743	387,347	387,347
Federal Home Loan Bank stock	(2)	18,002	18,002	18,002	18,002
Loans, net	Level 3	3,418,096	3,498,345	3,155,503	3,294,522
Loans held for sale	Level 2	16,117	16,707	22,888	24,029
Mortgage servicing rights receivable	Level 2	12,248	15,445	8,189	10,006
Interest rate swaps	Level 2	9,311	9,311	10,861	10,861
		4,609	4,609	1,003	1,003
Financial liabilities					
Deposits	Level 2	4,083,193	4,028,249	3,411,553	3,397,768
Securities sold under agreements to repurchase	Level 2	197,463	197,463	118,365	118,365
Federal Home Loan Bank advances	Level 2	374,000	384,927	394,000	410,881
Subordinated debentures	Level 2	48,244	48,284	47,563	47,574
Subordinated notes	Level 2	73,646	73,646	0	0
Accrued interest payable	Level 2	1,393	1,393	2,313	2,313
Interest rate swaps	Level 2	4,857	4,857	1,027	1,027

- (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.

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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, 2021 or 2020. We have no Level 1 securities available for sale.

MERCANTILE BANK CORPORATION
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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, 2021 and 2020, we determined the fair value of our mortgage loans held for sale to be \$16.7 million and \$24.0 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, 2021 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)
U.S. Government agency debt obligations	\$390,371,000	\$ 0	\$390,371,000	\$ 0
Mortgage-backed securities	41,803,000	0	41,803,000	0
Municipal general obligation bonds	137,594,000	0	136,917,000	677,000
Municipal revenue bonds	22,475,000	0	22,475,000	0
Other investments	500,000	0	500,000	0
Interest rate swaps	4,609,000	0	4,609,000	0
Total	<u>\$597,352,000</u>	<u>\$ 0</u>	<u>\$596,675,000</u>	<u>\$ 677,000</u>

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2021. The \$0.1 million reduction in Level 3 municipal general obligation bonds during 2021 reflects the scheduled maturities of such bonds.

MERCANTILE BANK CORPORATION
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NOTE 17 – FAIR VALUE MEASUREMENTS (Continued)

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)
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
Interest rate swaps	1,003,000	0	1,003,000	0
Total	<u>\$388,350,000</u>	<u>\$ 0</u>	<u>\$387,584,000</u>	<u>\$ 766,000</u>

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.

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, 2021 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	\$ 3,807,000	\$ 0	\$ 0	\$ 3,807,000
Foreclosed assets	0	0	0	0
Total	<u>\$ 3,807,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 3,087,000</u>

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 17 – FAIR VALUE MEASUREMENTS (Continued)

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

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

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:

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Basic			
Net income attributable to common shares	<u>\$ 59,021,000</u>	<u>\$ 44,138,000</u>	<u>\$ 49,456,000</u>
Weighted average common shares outstanding	<u>15,986,857</u>	<u>16,268,689</u>	<u>16,405,159</u>
Basic earnings per common share	<u>\$ 3.69</u>	<u>\$ 2.71</u>	<u>\$ 3.01</u>
Diluted			
Net income attributable to common shares	<u>\$ 59,021,000</u>	<u>\$ 44,138,000</u>	<u>\$ 49,456,000</u>
Weighted average common shares outstanding for basic earnings per common share	15,986,857	16,268,689	16,405,159
Add: Dilutive effects of share-based awards	<u>446</u>	<u>630</u>	<u>3,976</u>
Average shares and dilutive potential common shares	<u>15,987,303</u>	<u>16,269,319</u>	<u>16,409,135</u>
Diluted earnings per common share	<u>\$ 3.69</u>	<u>\$ 2.71</u>	<u>\$ 3.01</u>

Stock options for approximately 7,000, 9,000 and 7,000 shares of common stock were antidilutive and were not included in determining dilutive earnings per share in 2021, 2020 and 2019, respectively.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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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.

The following table depicts our five business trusts as of December 31, 2021:

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

MERCANTILE BANK CORPORATION
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NOTE 20 – SUBORDINATED NOTES

On December 15, 2021, we entered into Subordinated Note Purchase Agreements with certain institutional accredited investors pursuant to which we issued and sold \$75.0 million in aggregate principal amount of its 3.25% fixed-to-floating rate subordinated notes (“Notes”). The Notes have a stated maturity of January 30, 2032, are redeemable by us at our option, in whole or in part, on or after January 30, 2027 on any interest payment date at a redemption of price of 100% of the principal amount of the Notes being redeemed. The Notes are not subject to redemption at the option of the holder. The Notes will bear interest at a fixed rate of 3.25% per year until January 29, 2027. Commencing on January 30, 2027 and through the stated maturity date of January 30, 2032, the interest rate will reset quarterly at a variable rate equal to the then-current Three-Month Term SOFR plus 212 basis points. On December 15, 2021, we injected \$70.0 million of the issuance proceeds to our bank as an increase to equity capital.

On January 14, 2022, we issued an additional \$15.0 million of its Notes to certain institutional accredited investors, reflecting an expansion of the \$75.0 million issuance completed on December 15, 2021. The additional \$15.0 million issuance was completed on the same terms as the prior offering and under the existing indenture. On January 14, 2022, we injected \$15.0 million of the issuance proceeds to our bank as an increase to equity capital.

NOTE 21 - 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 2021 and 2020, 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, 2021 that we believe have changed our bank’s categorization.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 21 - 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
<u>2021</u>						
Total capital (to risk weighted assets)						
Consolidated	\$ 565,143	14.0%	\$ 324,101	8.0%	NA	NA
Bank	551,760	13.6	323,928	8.0	404,910	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	456,133	11.3	243,076	6.0	NA	NA
Bank	516,397	12.8	242,946	6.0	323,928	8.0
Common equity (to risk weighted assets)						
Consolidated	409,963	10.1	182,307	4.5	NA	NA
Bank	516,397	12.8	182,210	4.5	263,192	6.5
Tier 1 capital (to average assets)						
Consolidated	456,133	9.2	198,574	4.0	NA	NA
Bank	516,397	10.4	198,510	4.0	248,137	5.0
<u>2020</u>						
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

(Continued)

MERCANTILE BANK CORPORATION
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NOTE 21 - 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, 2021, 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 2021, under the most restrictive of these regulations, our bank could distribute \$108 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 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.29 per share that was paid on March 17, 2021 to shareholders of record as of March 5, 2021. On April 15, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.29 per share that was paid on June 16, 2021 to shareholders of record as of June 4, 2021. On July 15, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.30 per share that was paid on September 15, 2021 to shareholders of record as of September 3, 2021. On October 14, 2021, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.30 per share that was paid on December 15, 2021 to shareholders of record as of December 3, 2021. On January 13, 2022, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.31 per share that will be paid on March 16, 2022 to shareholders of record as of March 4, 2022.

As part of \$20.0 million common stock repurchase programs announced in May of 2019 and 2021, respectively, we repurchased approximately 683,000 shares for \$21.4 million, at a weighted average all-in cost per share of \$31.29, during 2021. The 2021 common stock repurchase program replaced the 2019 common stock repurchase program, which was nearing exhaustion. The actual timing, number and value of shares repurchased will be determined by us in our discretion and will depend on a number of factors, including the stock price, capital position, financial performance, general market and economic conditions, alternative uses of capital and applicable legal requirements. As of December 31, 2021, availability under the current common stock repurchase program, which may be discontinued at any time, equaled \$6.8 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, 2021 and 2020 include \$46.2 million and \$45.5 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, 2021 and 2020, all \$46.2 million and \$45.5 million, respectively, of the trust preferred securities were included as Tier 1 capital of Mercantile.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 22 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

At December 31, 2021, accumulated other comprehensive income (loss), net of tax effects (as applicable), consisted of a net unrealized loss on available for sale securities of \$3.7 million. At December 31, 2020, accumulated other comprehensive income (loss), net of tax effects (as applicable), consisted of a net unrealized gain on available for sale securities of \$5.5 million.

NOTE 23 - QUARTERLY FINANCIAL DATA (Unaudited)

	Interest Income	Net Interest Income	Net Income	Earnings per Share	
				Basic	Diluted
<u>2021</u>					
First quarter	\$34,786,000	\$29,533,000	\$14,240,000	\$ 0.87	\$ 0.87
Second quarter	35,774,000	30,871,000	18,091,000	1.12	1.12
Third quarter	35,888,000	31,124,000	15,051,000	0.95	0.95
Fourth quarter	37,046,000	32,534,000	11,639,000	0.74	0.74
<u>2020</u>					
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

**NOTE 24 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)
CONDENSED FINANCIAL STATEMENTS**

CONDENSED BALANCE SHEETS

	<u>2021</u>	<u>2020</u>
ASSETS		
Cash and cash equivalents	\$ 14,570,000	\$ 12,746,000
Investment in bank subsidiary	545,691,000	458,830,000
Other assets	<u>19,576,000</u>	<u>18,934,000</u>
Total assets	<u>\$ 579,837,000</u>	<u>\$ 490,510,000</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities	\$ 1,388,000	\$ 1,393,000
Subordinated debentures	48,244,000	47,563,000
Subordinated notes	73,646,000	0
Shareholders' equity	<u>456,559,000</u>	<u>441,554,000</u>
Total liabilities and shareholders' equity	<u>\$ 579,837,000</u>	<u>\$ 490,510,000</u>

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 24 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)
CONDENSED FINANCIAL STATEMENTS (Continued)

CONDENSED STATEMENTS OF INCOME

	2021	2020	2019
Income			
Interest and dividends from subsidiaries	\$ 39,058,000	\$ 32,588,000	\$ 22,246,000
Total income	39,058,000	32,588,000	22,246,000
Expenses			
Interest expense	1,934,000	2,268,000	3,153,000
Other operating expenses	5,831,000	4,441,000	4,804,000
Total expenses	7,765,000	6,709,000	7,957,000
Income before income tax benefit and equity in undistributed net income of subsidiary	31,293,000	25,879,000	14,289,000
Federal income tax benefit	(1,653,000)	(1,173,000)	(1,718,000)
Equity in undistributed net income of subsidiary	26,075,000	17,086,000	33,449,000
Net income	\$ 59,021,000	\$ 44,138,000	\$ 49,456,000
Comprehensive income	\$ 49,806,000	\$ 45,929,000	\$ 61,390,000

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021

NOTE 24 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)
CONDENSED FINANCIAL STATEMENTS (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

	2021	2020	2019
Cash flows from operating activities			
Net income	\$ 59,021,000	\$ 44,138,000	\$ 49,456,000
Adjustments to reconcile net income to net cash from operating activities:			
Equity in undistributed net income of subsidiary	(26,075,000)	(17,086,000)	(33,449,000)
Stock-based compensation expense	3,784,000	2,325,000	2,931,000
Stock grants to directors for retainer fees	344,000	394,000	375,000
Change in other assets	49,000	(227,000)	2,387,000
Change in other liabilities	(5,000)	812,000	(1,924,000)
Net cash from operating activities	37,118,000	30,356,000	19,776,000
Cash flows from investing activities			
Net capital investment into subsidiaries	(70,000,000)	0	0
Net cash for investing activities	(70,000,000)	0	0
Cash flows from financing activities			
Stock option exercises, net of cashless exercises	50,000	3,000	128,000
Employee stock purchase plan	48,000	49,000	50,000
Dividend reinvestment plan	877,000	814,000	729,000
Net proceeds from subordinated notes issuance	73,635,000	0	0
Repurchase of common shares	(21,380,000)	(6,591,000)	(7,183,000)
Cash dividends on common stock	(18,524,000)	(17,930,000)	(17,108,000)
Net cash for financing activities	34,706,000	(23,655,000)	(23,384,000)
Net change in cash and cash equivalents	1,824,000	6,701,000	(3,608,000)
Cash and cash equivalents at beginning of period	12,746,000	6,045,000	9,653,000
Cash and cash equivalents at end of period	\$ 14,570,000	\$ 12,746,000	\$ 6,045,000

EXHIBIT INDEX

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
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.
4.2	Subordinated indenture, dated December 15, 2021, by and between Mercantile Bank Corporation and Wilmington Trust, National Association, as trustee, incorporated by reference to our Current Report on Form 8-K filed December 17, 2021
4.3	First Supplemental Indenture to Subordinated indenture, dated December 15, 2021, by and between Mercantile Bank Corporation and Wilmington Trust, National Association, as trustee, incorporated by reference to our Current Report on Form 8-K filed December 17, 2021
4.4	Form of 3.25% Fixed-to-Floating Rate Subordinated Note due 2032, incorporated by reference to our Current Report on Form 8-K filed December 17, 2021
4.5	Form of Subordinated Note Purchase Agreement dated December 15, 2021, by and among Mercantile Bank Corporation and the Purchasers, incorporated by reference to our Current Report on Form 8-K filed December 17, 2021
4.6	Form of Registration Rights Agreement dated December 15, 2021, by and among Mercantile Bank Corporation and the Purchasers, incorporated by reference to our Current Report on Form 8-K filed December 17, 2021
10.1	Form of Mercantile Bank Split Dollar Agreement that has been entered into between our bank and each of 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	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*

EXHIBIT NO.EXHIBIT DESCRIPTION

- 10.7 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*
- 10.8 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*
- 10.9 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*
- 10.10 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*
- 10.11 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*
- 10.12 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*
- 10.13 Form of Performance Based Restricted Stock Award Agreement, incorporated by reference to exhibit 10.8 of our Form 8-K filed December 3, 2018*
- 10.14 2019 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 24, 2019*
- 10.15 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*
- 10.16 Form of Performance-Based Restricted Stock Award Agreement, in connection with the Mercantile Bank Corporation Stock Incentive Plan of 2020, incorporated by reference to exhibit 10.17 of our Form 10-K for the year ended December 31, 2020*
- 10.17 2020 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed November 19, 2020*
- 10.18 2021 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed July 15, 2021*
- 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

EXHIBIT NO.

EXHIBIT DESCRIPTION

- | | |
|-----|---|
| 101 | The following information from Mercantile's Annual Report on Form 10-K for the year ended December 31, 2021, 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 4, 2022.

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 4, 2022.

/s/ David M. Cassard

David M. Cassard, Director

/s/ Michael H. Price

Michael H. Price, Chairman of the Board

/s/ Michael S. Davenport

Michael S. Davenport, Director

/s/ David B. Ramaker

David B. Ramaker, Director

/s/ Michelle L. Eldridge

Michelle L. Eldridge, Director

/s/ Charles E. Christmas

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

/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)



MERCANTILE BANK OF MICHIGAN 2021 STRATEGIC PLANNING TEAM

Mark S. Augustyn

Executive Vice President
Chief Lending Officer

Charles E. Christmas

Executive Vice President
Chief Financial Officer

Douglas J. Holtrop

Executive Vice President
Senior Lending Officer

Brett E. Hoover▲

Senior Vice President
Associate Human Resource Director

Amy W.M. Kam

Vice President
Executive Administrator

Robert B. Kaminski, Jr.

Chief Executive Officer

Justin M. Karl

Executive Vice President
Senior Lending 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 Digital Banking Officer

Tara M. Randall

Senior Vice President
Chief Retail Banking Officer

Scott P. Setlock

Executive Vice President
Chief Operating Officer

Lonna L. Wiersma▲

Senior Vice President
Human Resource Director

Robert T. Worthington

Senior Vice President
Chief Risk Officer, General Counsel
and Secretary

MERCANTILE BANK CORPORATION SHAREHOLDER INFORMATION

Annual Meeting

The Corporation's Annual Meeting of Shareholders will be held virtually.

Thursday, May 26, 2022 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



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